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Approval of Stand-By Arrangement

Indonesian Measures Welcomed as Important Step In Stabilizing Southeast Asian Financial Markets

A $10 billion three-year Stand-By Arrangement for Indonesia was approved by the IMF's Executive Board on November 5 [for complete text of Press Release, see pages 354–56]. The financing provided by the IMF will be supported by substantial funding from the World Bank and the Asian Development Bank and other lenders; the total amount of the first line of financial assistance to Indonesia, including the use of part of Indonesia's own external assets, will be on the order of $23 billion. In addition, a number of other economies—including Australia, China, Hong Kong Special Administrative Region, Japan, Malaysia, Singapore, and the United States—have indicated that, if necessary, they would consider making available supplemental financing to support Indonesia's program with the IMF.

"The bold policy actions being undertaken should help restore confidence in the Indonesian economy."

IMF Managing Director Michel Camdessus welcomed the Board's rapid approval of the arrangement, saying that it "marks an important step in stabilizing the financial markets in Southeast Asia." He added that "the bold policy actions now being undertaken by the Indonesian authorities should not only help restore confidence in the Indonesian economy but also do much to help calm the turmoil that has been sweeping the region since July.

"I would like to applaud the wide-ranging measures Indonesia has developed to address its economic difficulties," Camdessus continued. "These measures are consistent with the new strategy that was adopted by the IMF membership (Please turn to the following page)

Economic Forum

Recent Developments Highlight Exchange Rate Regime Issues in Developing Countries

Since the breakdown of the Bretton Woods par value system, the mix of officially reported exchange rate arrangements in developing countries has shifted markedly away from fixed rate systems to more flexible ones. Recent currency turmoil in Southeast Asia, swelling capital flows, and increasing globalization of financial markets have made the question of the optimal currency arrangement for developing countries a matter of concern for policymakers, especially in emerging market economies. To explore this issue, the IMF recently sponsored an Economic Forum. Moderated by Graham Hacche of the IMF's Research Department, participants included Susan Collins, Associate Professor of Economics at Georgetown University and Senior Fellow in Economic Studies at The Brookings Institution, and Francesco Caramazza and Jahangir Aziz of the IMF's Research Department. The discussion took place in the context of the IMF's October 1997 *World Economic Outlook,* which (Continued on page 356)

Susan Collins (left), Francesco Caramazza, Graham Hacche, and Jahangir Aziz at the Economic Forum on exchange rate regimes.

(Continued from front page) last year, *The Partnership for Sustained Growth* [see *IMF Survey,* October 14, 1996, page 327]. Under its program, Indonesia has committed itself not only to the continuation of appropriately tight financial policies and to a bold restructuring plan for the financial sector, but it is also attacking the obstacles that have accumulated over the years—such as the monopolies and the misallocation of resources that are serious impediments to economic progress.

"Indonesia's adoption of a program going considerably beyond the indispensable strengthening of the macroeconomic framework is anchored in many difficult decisions taken by the authorities. However, I believe that they were decisions necessary for Indonesia to return to the path of sustainable high-quality growth, to maintain its economic gains into the next millennium, and to play its key role in the region. They will greatly benefit the people of Indonesia, particularly the poorest."

IMF Approves Stand-By Credit for Indonesia

Following is the text of IMF Press Release No. 97/50, dated November 5, on the Board's approval of the Stand-By Arrangement for Indonesia:

The IMF approved a stand-by credit for Indonesia, authorizing drawings of up to SDR 7.3 billion (about $10.1 billion) over the next three years in support of Indonesia's macroeconomic stabilization and structural reform program. Of the total, SDR 2.2 billion (about $3.0 billion) is available immediately, and a further SDR 2.2 billion will be available after March 15, 1998, provided that end-December performance targets have been met and the first review of the program completed. Subsequent disbursements, on a quarterly basis, will be made available subject to the attainment of performance targets and program reviews. The stand-by credit is equivalent to 490 percent of Indonesia's quota of SDR 1.5 billion (about $2.1 billion) in the IMF.

In approving Indonesia's request for the stand-by credit, the IMF made use of the accelerated procedures established under the Emergency Financing Mechanism, which was adopted in September 1995. The Emergency Financing Mechanism strengthens the IMF's ability to respond swiftly in support of a member country facing an external financial crisis and seeking financial assistance from the IMF in support of a strong economic adjustment program.

Indonesia's economic performance over the past several decades has ranked among the best in the developing world, with real GDP growth averaging about 7 percent annually since 1970. This success has been based on a consistent adherence to prudent macroeconomic policies, high investment and savings rates, and market-oriented trade and exchange regimes. Broad-based labor-intensive growth, together with sustained improvements in basic education and health services, has dramatically reduced the incidence of poverty—from over 60 percent in the late 1960s to 11 percent by the mid-1990s.

The strong overall performance, however, masked the emergence of a number of underlying structural weaknesses that made Indonesia vulnerable to adverse external developments. Long-standing rigidities in the form of domestic trade regulations and some import monopolies impeded economic efficiency and competitiveness. At the same time, less transparency in decisions affecting the business environment and data deficiencies increased uncertainty and adversely affected investor confidence. In addition, large capital inflows intermediated through a weak banking system exposed Indonesia to a shift in financial market sentiment. Thus, Indonesia's banking sector was not prepared to withstand the financial turmoil that swept Southeast Asia starting in July. Similarly, the corporate sector was vulnerable to adverse external developments. Prompted by large interest rate differentials between domestic and foreign interest rates, private companies had increasingly borrowed abroad to finance domestic operations, which in the context of a relatively stable exchange rate were largely unhedged.

With the abrupt shift in market sentiment that has occurred since the middle of July, Indonesia has had to contend with a major crisis of confidence. The rupiah depreciation and the fall in equity prices have been among the largest in the area. The downward pressure on the rupiah persisted, despite policy measures that were timely and broadly appropriate, including the floating of the exchange rate, followed by increases in interest rates and fiscal retrenchment.

Medium-Term Policy Strategy

The government's three-year program that is supported by the Stand-By Arrangement has been set in the context of an unavoidable slowdown in economic growth and higher inflation over the next two years as a result of the current crisis. The policy package is designed to stabilize exchange market conditions, ensure an orderly adjustment of the external current account in response to lower capital inflows, and lay the groundwork for a resumption of sustained, rapid growth.

To achieve these objectives, the government has put in place a comprehensive package to restore confidence and stabilize the rupiah. First, the authorities will maintain tight fiscal and monetary policies, designed to stabilize financial conditions and narrow the current account deficit. Substantial fiscal measures have been put in place to keep the budget in surplus, despite the cyclical downturn, while monetary policy will be kept tight. Second, prompt and decisive action will be taken to restore the health of the financial sector, including

closing unviable banks. Third, a broad range of structural reforms will be implemented, including liberalization of foreign trade and investment, dismantling of domestic monopolies, allowing greater private sector participation in the provision of infrastructure, and expanding the privatization program.

Fiscal management will be improved by increasing the transparency of public sector activities, and this should enhance the quality of governance. The government's commitment to bring off-budget activities into the budget is also designed to permit a clearer assessment of the financial position of the wider public sector.

Program for 1997/98 and 1998/99

The main objectives of the program are to limit the downturn in growth; reduce the current account deficit to 2 percent of GDP; and maintain gross official reserves at about five months of imports.

To achieve these objectives, the program aims at a surplus equivalent to 1 percent of GDP in central government operations, or 0.5 percent of GDP including the carrying costs of the financial sector restructuring. This will require measures equivalent to 1 percent of GDP. On the expenditure side, the government recently formulated concrete plans to postpone or reschedule major state enterprise infrastructure projects. Revenues will be enhanced through an increase in the excise taxes, removal of some tax exemptions, and increases in nontax revenues. Fiscal policy will be supported by tight monetary conditions.

Financial Sector Restructuring

A comprehensive restructuring of troubled financial institutions will also be key to the success of the program. Decisive action has already been initiated to deal with the problem. Sixteen unviable banks have been closed, and weak but viable institutions have been required to quickly formulate and implement rehabilitation plans. At the same time, steps are being taken to strengthen the legal and regulatory environment and establish strong enforcement mechanisms and clear exit policy.

These actions are part of the restructuring program that has been put together with technical assistance from the IMF, the World Bank, and the Asian Development Bank. The authorities are determined that only a small portion of the costs of the restructuring will be met from the public purse. The government will compensate small depositors only, and not private shareholders and creditors. The government will not guarantee any liabilities of private nonfinancial companies, domestic or foreign.

Structural Policies

Since 1995, Indonesia has been implementing a comprehensive tariff reform. A key element of the medium-term program is a further reduction of tariff barriers, including those on a number of items previously excluded from tariff reductions, such as chemicals, steel/metal products, and fishery products. Over the next three years, remaining nontariff barriers other than those warranted for health, safety, environmental, or security reasons will be phased out. The government has also indicated that it will implement ahead of schedule the World Trade Organization dispute panel ruling on the special tariff preferences given to the National Car, should the judgment on this case be decided against Indonesia. Export taxes will also be reduced and more sectors will be open to foreign investment.

Domestic competition will be further enhanced through deregulation and privatization. The government intends to phase out import and marketing monopolies and price restrictions (with the exception of rice and refined sugar) over the next three years, starting with the immediate elimination of import restrictions covering three key agricultural commodities.

Deregulation of domestic markets will be complemented by expanding the role of the private sector in providing infrastructure. The fundamental prerequisite for this strategy is the establishment of a clear framework to guide decision making to level the playing field for both domestic and foreign investors and thereby assure investor confidence. To these ends, the government has established regulations on government procurement and contracting for which the implementation guidelines will be issued by the end of 1997.

Privatization is another element of the structural reform effort. Responsibility for the management and

Indonesia: Selected Economic Indicators

	1994/95	1995/96	1996/97[1]	1997/98[2]	1998/99[2]
			(percent change)		
Real GDP growth	7.5	8.2	8.0	5.0	3.0
Consumer prices (end of period)	9.6	9.0	6.6	10.0	9.0
			(percent of GDP)		
Central government balance	0.2	0.9	1.2	0.8	1.0
External current account balance	–1.8	–3.3	–3.3	–2.7	–2.2
			(months of imports)		
Gross official reserves	4.9	5.0	5.9	5.9	5.2

[1] Projected.
[2] Program.

Data: Indonesian authorities and IMF staff estimates

restructuring of public enterprises has been shifted from line ministries to the Ministry of Finance, and a new Privatization Board has been established. A clear framework for the management and privatization of government assets is being developed, which will establish explicit criteria for determining whether an enterprise should be closed, restructured, or privatized. For enterprises remaining in the public sector, the framework will ensure that these operate efficiently, including through establishing profit and performance targets, which will be made public and reported annually.

Social Safety Net

Maintaining Indonesia's impressive record of poverty reduction over the past 30 years through the provision of basic education, health, and other social services is an integral part of the government's policy framework. Expenditures in these essential areas will be protected from budget cuts. Moreover, the special assistance programs for poor villages, which have provided a very cost-effective means to target social expenditures to those most in need, will be increased under the next five-year development plan, Repelita VII.

Financing Needs

In addition to the IMF funding of about $10 billion (SDR 7.3 billion), the reform program will be supported by substantial financing from the World Bank and the Asian Development Bank, which have made notable contributions to the design of the program, particularly in the field of financial sector rehabilitation and structural reform. These institutions intend to contribute to the program through technical assistance and loans, with financing amounting to $4½ billion and $3½ billion, respectively. In addition, taking account of other expected contributions to the financing package, including the use of part of Indonesia's own substantial external assets, there is a first line of financing on the order of $23 billion. At the same time, a number of important economies (including at this stage Australia, China, Hong Kong Special Administrative Region, Japan, Malaysia, Singapore, and the United States) have indicated that in the event that unanticipated adverse external circumstances create the need for additional resources to supplement Indonesia's reserves and the resources made available by the IMF, they would be prepared to consider making available supplemental financing in support of Indonesia's program with the IMF. ■

See *IMF Survey,* August 18, page 257, for an analysis of the social reform programs underlying Indonesia's recent economic growth.

Forum Explores Exchange Regime Issues

(Continued from front page) addressed such questions as: What influenced the shift in exchange rate arrangements over the past two decades? Is economic performance—notably, inflation and growth—affected by the choice of exchange rate regimes? Are there trade-offs between "flexibility" and "credibility"? Does exchange rate flexibility help manage the impact of volatile cross-border capital flows?

Evolution and Macroeconomic Impact

In analyzing changing patterns of exchange rate regimes, Jahangir Aziz noted that after the breakdown of the Bretton Woods par value system, most developing countries continued to peg their currencies either to a key currency—predominantly the U.S. dollar or the French franc—or to a basket of currencies. Starting in the late 1970s, however, a number of developing countries moved away from these arrangements. At first, the shift was mainly away from single-currency pegs to pegs defined in terms of baskets of currencies—for example, the SDR—or to limited flexibility with respect to a single currency. But since the early 1980s, there has been a marked shift toward more flexible exchange rate arrangements: in 1975, 87 percent of developing countries had some type of pegged exchange rate; by the mid-1990s, most countries had reportedly adopted a flexible exchange rate regime.

Accounting for the relative economic size of countries, the shift in exchange rate regimes is more pronounced. In 1975, developing countries with pegged exchange rates accounted for 70 percent of developing countries' total trade, while countries with flexible exchange rates accounted for only 8 percent. By 1996, this pattern had virtually reversed. Aziz cautioned, however, that these figures are based on officially declared exchange rate arrangements. In some countries, an arrangement may be officially classified as "managed floating" or even "independently floating," even though the authorities continue to effectively set the exchange rate and use it as a policy instrument. The shift toward more flexible exchange rate regimes since the 1970s may therefore be less pronounced than official classifications indicate, but it is still significant.

Offering an explanation for this shift, Susan Collins observed that the perceived costliness of managing a

Photo Credits: Padraic Hughes for the IMF, pages 353, 357, and 358; Michele Iannacci for the World Bank, page 359; Frank Fournier for PNI, page 360.

flexible exchange rate regime had fallen over time. From the perspective of policymakers, she added, the difference between adopting a fixed or a flexible exchange rate regime depended on whether exchange rate adjustments were to come about through explicit policy decisions or through market forces. Large swings in the values of the major industrial country currencies since the early 1980s and a series of external shocks affecting developing market economies are responsible for the increase in the political costliness of maintaining a fixed exchange rate. In today's environment, where massive amounts of capital can move in a relatively short time, the potential for shocks is even greater, and countries under fixed exchange rate regimes have much less time to engineer exchange rate changes. In response, policymakers are likely to move toward more flexible regimes that make it easier to accommodate the exchange rate changes.

Neither of the two main exchange rate regimes ranks above the other in terms of macroeconomic performance, Aziz noted, although—at least until recently—countries with pegged rates have experienced relatively lower and more stable rates of inflation and relatively less volatile real exchange rates. Output growth does not differ across exchange rate regimes but is often more variable under less flexible arrangements. These findings do not, however, imply that flexible exchange rates need necessarily be associated with high or more variable inflation in the future. Indeed, over the past several years, inflation in the developing world has come down sharply, even as the number of countries adopting more flexible exchange rate arrangements has steadily increased. While inflation in countries with pegged exchange rates has typically been lower than in countries with flexible exchange rates, there is no clear relationship between the exchange rate regime and output growth.

Challenges of Rapid Growth and Capital Inflows

Francesco Caramazza pointed out that it is often assumed that rapid economic growth in emerging market economies will—over the long run—result in an appreciation of their real effective exchange rates. This association, it is believed, stems from a tendency for productivity growth in the tradable goods sector to outpace that in the nontradable goods sector. Furthermore, the higher a country's total productivity growth rate, the more prices of nontraded goods will rise relative to the prices of traded goods, and the more the domestic currency will appreciate in real terms. Under these circumstances, the choice between the two regimes largely reflects policymakers' preferences either for nominal exchange rate appreciation or greater inflation, Caramazza explained. For example, between 1980 and 1996, while Hong Kong, China, which had a currency-board arrangement, experienced higher inflation than Singapore, which had a managed floating regime, their real effective exchange rates appreciated at roughly similar rates.

Turning to the role of capital flows, Caramazza noted that between 1986 and 1990, net private capital flows to developing countries roughly doubled. This vastly expanded volume of capital flows and their volatility have made the maintenance of exchange rate pegs more difficult, especially when doing so is seen as being at odds with other economic policies and objectives. If, in response to such inflows, authorities do not allow the nominal exchange rate to appreciate—through official intervention to maintain a formal or informal peg—inflationary pressures will build up and the real exchange rate will appreciate through higher domestic inflation. To avoid such consequences, monetary authorities have frequently attempted to sterilize the inflows—often, however, with inadequate results:

> *Large, volatile capital flows make maintenance of pegs more difficult.*
> –Caramazza

- By preventing domestic interest rates from falling in response to capital inflows, sterilization tends to maintain the yield deferential that gave rise to the capital inflows in the first place. Sterilization thus serves to perpetuate these inflows.
- Quasi-fiscal losses of intervention, which arise from the differential between the interest earned on foreign reserves and that paid on debt denominated in domestic currency, may become large in the face of large capital inflows. So sterilization carries a cost.
- Given the relatively small size of the domestic financial market, compared with the size of international capital flows, sterilization tends to become less effective over time.

In addition to the traditional open market operations to sterilize inflows, some countries have used supplementary measures—such as increases in reserve requirements and measures to reduce banks' reserves. While these instruments can, for a time, relieve some of the pressure on the currency and ease inflationary pressures, they are unlikely to prevent completely an appreciation of the real exchange rate. Furthermore, as signs of overheating and tension between the authorities' desire and the need to maintain a stable nominal exchange rate become increasingly apparent, investors may begin to doubt whether

Aziz. There is no clear relationship between exchange rate regime and output growth.

the situation is sustainable. A turnaround in market sentiment can then bring about a sudden reversal in capital flows. Thus, in an evaluation of the advantages and disadvantages of alternative exchange rate regimes, an important consideration is that the short-term costs of preventing normal exchange rate appreciation do not outweigh the benefits—that is, if such preventative action jeopardizes long-run growth by causing macroeconomic disruptions, Caramazza said. If monetary policy is locked in by exchange rate policy, the burden of adjustment will fall largely on fiscal policy. This suggests that countries in which fiscal policy cannot be adjusted effectively in the short run should not adopt a rigidly pegged exchange rate system.

Caramazza. The success of a flexibly managed exchange system depends on the proper management of economic policies.

Choosing Between Fixed and Flexible Regimes

Caramazza concluded that the optimal exchange rate regime varies from country to country, depending on the nature of the shocks affecting the country and on the country's structural characteristics. Nonetheless, for many emerging market economies, more flexible exchange rate arrangements seem desirable in the face of greater capital mobility. Greater exchange rate flexibility need not imply freely floating rates, however. Freely floating exchange rates may not be realistic or desirable for many developing countries—exchange rates may be too volatile in the absence of well-developed financial markets.

Caramazza and Collins stressed that the success of a flexibly managed exchange rate system depends on the proper management of economic policies—consistent with the exchange rate regime—including strong supervision and regulation of the financial sector. Indeed, appropriate economic and financial policies are necessary to avoid exchange rate misalignments and safeguard macroeconomic stability under any exchange rate regime. ■

Mundell "Festschrift"

Conference Focuses on Currency Crises, Prospects for EMU

The financial turmoil and currency crises in Southeast Asian capital markets and the rapidly approaching deadline for the start-up of European economic and monetary union (EMU) provided an appropriate backdrop for a "Festschrift in Honor of Robert A. Mundell," held on October 23–24. The conference was hosted by the Economic Development Institute of the World Bank, in conjunction with the IMF, the University of Maryland, the University of California-Berkeley, and the Massachusetts Institute of Technology. Much of the discussion focused on the future of the international monetary system in a world in which the center (or centers) of gravity has yet to be determined and where the warning signs of impending crisis remain elusive. Other topics covered included the role of gold in the international monetary system, the role of economists in formulating government policy, and recent developments in China.

Currency Crises: What Do We Know?

In the 1990s, according to Robert Flood of the IMF and Nancy Marion of Dartmouth College, currency crises in Europe, Mexico, and Southeast Asia have drawn considerable attention to speculative attacks on government-controlled exchange rates. These currency crises have raised questions about whether such episodes can be predicted through systematic early warning signals or whether they are essentially unpredictable. Before 1990, Marion said, currency crises were thought to have a significant predictable component that was captured in a series of "first-generation" models. Fiscal expansion, credit creation, monetization of the budget deficit, and a decline in international reserves set the stage for a speculative attack on the fixed exchange rate by forward-looking agents who were able to sense and exploit bad policies. The empirical evidence of the 1970s and 1980s, Marion said, appeared to validate the predictions of these first-generation models.

The speculative attacks of the 1990s, however—particularly in Europe—challenged the view that currency crises were due largely to the government's inability to achieve fiscal and monetary discipline. For many countries, these crises were not preceded by overly expansionary policies. Although some governments make policy mistakes and are disciplined eventually, others face hard policy choices, including resolving the tension between commitment to a fixed exchange rate and the desire to pursue other policy goals. When speculators sense that a fixed parity is tightly constrained by other policy goals, that parity may be prone to attack.

Recent theoretical work, Flood said, has focused on a broader set of indicators, including unemployment and the state of the banking system. This has improved the ability to predict some crises, but it is hard to generalize these results across a range of countries and time periods. The most recent evidence, Flood and Marion concluded, reinforces the view that currency crises are not all alike and, therefore, extremely difficult to predict.

In a panel discussion, Paul Krugman of the Massachusetts Institute of Technology, Carmen Reinhart of the University of Maryland, and John Williamson of the World Bank offered varied responses to the question: "Currency Crises: What Have We Learned?"

Paul Krugman said crises would continue to happen. Real variables—like domestic credit—that the first-generation models had used as predictors were still relevant. Currency crises do not, he said, "come out of thin air." The first-generation models, however, were historical in nature. The new crises, he said, provide some idea of what is relevant now. In particular "second-generation" models focus less on the objective position of the central bank and more on the intentions of the government, with respect to wages, prices, and the desirability of an exchange rate adjustment that would give the authorities more room for monetary policy.

Some of the recent crises, Krugman said, did not appear to be based on the market's perception of the soundness of fundamentals. In fact, he was struck by the "astonishing complacency of the market," which had reacted very late to the Thai currency crisis. He said currency crises should be subject to the same rigorous analysis that is applied to corporate takeovers.

In Carmen Reinhart's opinion, early warning signals of an impending crisis can be identified, but observers need to look at more than one variable. Argentina and Brazil, which were hardest hit by the fallout of the Mexican crisis, had fixed exchange rates; but so did Thailand, which proved impervious. The Tequila effect was supposedly most virulent in countries with poor track records and spotty policy credibility; but in its Asian guise a year later, it did not spare Malaysia and Indonesia, both of which had credibility and a good track record.

Reinhart suggested that in focusing on contagion effects, analysts may be overlooking deteriorating fundamentals, particularly in financial sectors. For example, how much of the turmoil in Southeast Asian markets could be pinned on contagion effects? These economies were already beginning to slow down in 1996 and some, like Thailand, were experiencing banking sector problems.

Current analyses of currency crises, according to John Williamson, focus on whether an exchange regime will collapse, not on the long-term effect the collapse may have. Many recent breakdowns of exchange rate regimes have had no impact on the real economy, he said. It was therefore important to find ways of determining whether a breakdown in the exchange rate regime will turn into a long-run crisis. In Williamson's view, however, analysts were still far from identifying either the warning signs of a crisis or the appropriate policy response needed to head off or limit the effect of a speculative attack.

Currency crises have grown more frequent and deeper in recent years, Robert Mundell summed up, mainly because of the breakdown in an international system of fixed exchange rates. Individual countries that attempt to fix their rates do so without the support of an international system. In his view, currency crises will continue to occur until the international monetary system can find a way to support all countries' exchange rate regimes.

Honoree Robert Mundell (left), Jacob Frenkel, and Patrick Minford during a panel discussion on EMU's prospects.

EMU and International Monetary System

EMU, its implications for Europe and for the global economy, was the topic of a panel discussion chaired by Manuel Guitián, Director of the IMF's Monetary and Exchange Affairs Department. Panel members generally agreed that EMU would begin on schedule (January 1, 1999) but were less sanguine about its prospects. A recurring theme, as Jacob Frenkel, Governor of the Bank of Israel, noted, was that the trigger for monetary union has come from political—not economic—debate. EMU has emerged only after a long preparatory stage, used by its advocates to generate public support and set up legal and institutional frameworks. The hard-won political commitment to EMU, Frenkel said, would make retreat difficult and costly. How successful EMU would be as a monetary union would depend, however, upon policy coordination. Governments need to be regulated nationally, Frenkel said, but market policy needs to be global. The Maastricht Treaty convergence criteria had been instrumental in making the economies of prospective EMU members more similar, but policy coordination was still crucial.

Patrick Minford of the University of Liverpool agreed that EMU will happen, but he remained uncertain about its future. The economic endowments of potential members, including high unemployment, continuing budget deficits, and the persistence of high and increasing unfunded pension liabilities, could pose serious problems—both economic and political. The European central bank could easily get caught in the middle of political crossfire. Minford envisaged a nightmarish scenario of politicians descending on Frankfurt protesting an overvalued euro just when the central bank was trying to establish its credibility. He concluded pessimistically that the probability of bad outcomes—the EMU breaks up, protectionism increases, and "fortress Europe" emerges—was 40 percent. Good outcomes—a united, outward-looking Europe with stable money and free markets—had only a 20 percent probability.

Hong Kong Stock Exchange. Recent evidence reinforces the view that currency crises are not all alike and, therefore, extremely difficult to predict, according to Flood and Marion.

Eligibility requirements for EMU are laid down in the Maastricht Treaty's convergence criteria, covering exchange rates, inflation rates, budget deficits, and debt-to-GDP ratios, said Michael Mussa, Economic Counsellor and Director of the IMF's Research Department. Certainly, the Maastricht criteria are important and sensible, he said, but are they both necessary and sufficient to ensure a successful EMU? According to Robert Mundell's 1961 article on optimal currency areas, the essential ingredient that enables a currency union to work without affecting the exchange rate is the degree of labor market flexibility. Yet, Mussa observed, despite the very real need for enhanced flexibility in labor markets, European policy has not moved far in that direction. Worse, Maastricht is silent on this "critical area of economic reform"; and that, Mussa said, is a "fundamental failure" that will need to be corrected if EMU is to deliver its full potential.

Echoing observations of his fellow panel members, Alexander Swoboda of the Graduate Institute of International Study said that EMU is moving forward for political reasons. For EMU to be successful, the European central bank's success in stabilizing prices in Europe must be matched by national efforts to consolidate fiscal deficits and deal with the problem of unfunded pension liabilities. Labor market reform is also an issue for each country, and EMU should not be blamed for a failure of national policy.

In his response to the panel, Mundell was decidedly more upbeat about EMU's chances. Long an adherent of fixed exchange rates, Mundell said that if an international monetary system based on a regime of fixed exchange rates was no longer possible, at least Europe could derive all the benefits of a fixed system under EMU.

A continuing source of tension in the planning stages leading up to EMU has been how (or if) a single monetary policy can be credibly and independently maintained in the context of a dozen or so national fiscal policies representing conflicting national interests, economic size, and power. According to Ronald McKinnon of Stanford University, for monetary union in Europe to succeed, the necessary fiscal conditions must be set right at the outset. Therefore, the Maastricht convergence criteria, which are intended to harmonize the economies as closely as possible without requiring that national authorities cede the ability to formulate policy to a central authority, are crucial.

Europe-wide political pressure to satisfy Maastricht's "draconian" constraints on current fiscal deficits has been unexpectedly successful in halting—or at least sharply slowing—the unsustainable buildup of government debt and unfunded social security obligations, McKinnon said. He had concluded in the early 1990s that European governments would not be able to achieve the fiscal retrenchment sufficient to sustain a common currency, because of the political hailstorms that major cutbacks in spending would provoke. But he had not reckoned, he said, with the determination of European governments for fiscal retrenchment in 1996/97 nor with the political economy of the situation. Politicians, he suggested, have seized on EMU to reduce the welfare state.

The Stability and Growth Pact—which commits EMU members to keep overall deficits under 1 percent of GNP in "normal" times and imposes a penalty for breaches of the 3 percent limit on current fiscal deficits—is of critical importance to secure the further fiscal retrenchment needed to reduce fiscal burdens on future generations, McKinnon said. However, the question remains whether the new European System of Central Banks will be capable of effectively disciplining the fiscal behavior of member governments on an ongoing basis. ■

Sara Kane
Senior Editor, *IMF Survey*

The proceedings of the conference are to be published by the MIT Press and should be available in 1998.

Incremental and Radical Pension Reforms Have Potential to Boost Saving Rate

Pension reform is on everyone's agenda these days. In industrial countries, aging populations and financial constraints have made the long-term health of their "mature" plans a present concern. The thorniness of the fiscal—and ultimately political—dilemmas facing the industrial countries has not been lost on developing countries. Those seeking to expand current programs or create new systems are taking a closer look at some basic issues in pension plan design and funding.

The principal purpose of public pension programs is to provide a reasonable degree of income security for the elderly. But pension regimes inevitably have important macroeconomic ramifications as well. The structure and soundness of public pension programs can affect saving, and thus investment, capital accumulation, and growth.

In IMF Occasional Paper 153, *Pension Regimes and Saving,* G. A. Mackenzie, Philip Gerson, and Alfredo Cuevas examine the impact of pension regimes on saving and focus on the circumstances under which pension reform could boost national saving rates. Much has been made in recent years about the boost in saving that could be derived from substituting private plans for public pensions. But the authors conclude that privatizing pensions will not in and of itself raise the saving rate. Achieving this goal will depend upon the same steps—notably government belt tightening and/or higher contribution rates—that would be needed to make existing systems more effective.

Reforms: Incremental and Radical

Public pension plans are typically one of three types: unfunded pay-as-you-go schemes, partially funded plans, or fully funded regimes. Most advanced economies operate either pay-as-you-go or partially funded programs. Commonly, both unfunded and partially funded schemes provide benefits that are determined by the participant's work and salary history—hence, a defined benefits plan.

Defined contribution plans are mandatory contribution plans whose participants normally receive as benefits no more than they have contributed and earned on their contributions. Chile's new privately managed, publicly regulated pension system—which covers all workers who have entered the work force since 1981 (save the self-employed, whose participation is voluntary)—and Singapore's Central Provident Fund—a mandatory savings plan—are the best-known examples of this alternative.

In their survey of pension reform options and the impact of pension regimes on saving, the authors highlight three scenarios—the introduction of a pay-as-you-go program; the incremental reform of an existing pay-as-you-go scheme with universal coverage; and the introduction of a defined contributions plan to replace an existing pay-as-you-go scheme—and weigh the possible implications for the saving rate of each option.

Introduction of a Pay-As-You-Go Scheme. Pay-as-you-go schemes characteristically redistribute wealth from generations with a high propensity to save (the young) to those with a low propensity to save (the elderly). The first retirees in such a scheme tend to enjoy a windfall benefit, receiving greater returns than their contributions would warrant. A theory of "social security wealth" argues that to the extent this wealth is consumed (spent), it will depress saving. The theory likewise argues that the first generation of workers will likely view their own contribution not as a tax (and thus a transfer to another generation) but as a form of involuntary saving. As a consequence, this first generation of workers is likely not to change its spending behavior and will either reduce saving or borrow to sustain its lifestyle. The cumulative effect is thus to increase spending and decrease saving. This theory, in its simplest form, may exaggerate the impact of social security wealth on saving, however. The authors note that although empirical evidence from the United States provides moderately strong support for it, elsewhere the evidence is considerably weaker.

Incremental Reform. Gradual reform of an existing pay-as-you-go scheme seeks to rebalance the program's costs and benefits without extensively revising its structure. In terms of boosting the saving rate, the quickest results would be gained by reducing the benefits of current retirees. But this, the authors warn, would also be the harshest means of reform and would constitute the most explicit break with the social contract that had been made with those workers. Gradual reform targeting younger workers produces comparable effects over time and can provide young workers with time to adapt their behavior to the modified pension regime.

Public pension plan expenditures can be reduced by raising the retirement age or by decreasing the ratio of pension benefits to pensionable income by slowing the rate at which benefits accrue, raising the minimum contribution period, or reducing maximum pensions. A substantial reform of a pay-as-you-go plan may transform it into a partially funded plan, which accumulates surpluses for a period of time. Admittedly, this moves the program away from a strictly pay-as-you-go system, but it remains a defined benefit scheme managed and administered by the government.

Would effective incremental reforms, the authors ask, raise the saving rate as well as improve the health of

the pension plan? An increase in public sector saving is widely thought to be partially offset by a decline in private sector saving, as workers and pensioners adapt their spending and saving behavior. The overall effect, however, is expected to be an increase in total saving.

Defined Contribution Plans. Defined contribution schemes offer a more radical alternative, essentially functioning as compulsory savings plans. Chile's defined contribution system is privately administered but subject to fairly extensive government regulation. The scheme ensures a minimum pension, but for the most part directly links benefits to contributions, plus returns on contributions.

Does radical reform—that is, the *introduction* of a fully funded defined contribution scheme—produce higher rates of saving than could be achieved through incremental reform to pay-as-you go schemes? Clearly the introduction of a pay-as-you-go scheme does create "social security wealth," and this can, in possibly varying degrees, depress the national saving rate. The same effect can also result if developing countries replace pay-as-you-go schemes with limited coverage with schemes with broader, and expanding, coverage.

What is less clear is whether *replacing* a pay-as-you-go by a defined contribution plan will increase saving. If mandatory contribution rates are set at current combined payroll tax rates, and benefits are not reduced, it may be said that to a first approximation the reform should have no impact on those who move to the new system or on current pensioners. The government's increased deficit will be offset by a private sector surplus, but there will be no net increase in the saving rate.

Two factors play a critical role in determining the impact of such a switch on the saving rate: the contribution rate under a new scheme and the extent of an accompanying fiscal consolidation. The authors argue that the saving rate could rise if the contribution rate is set higher than the combined employer-employee payroll tax rate (and if participants do not compensate for this by reducing voluntary saving). Reduced benefits might also serve to reduce the public sector deficit or encourage workers to save more for their retirement—in either case boosting overall saving. To the extent that the introduction of a defined benefit scheme provides the impetus for a broader cut in government expenditures, it could also result in an increased saving rate. The impact of increased saving on economic growth is greater the higher the productivity of additional investment. But there is no direct link per se between pension reform and fiscal consolidation, and thus no assurance that one invariably leads to the other. In terms of its impact on the saving rate, there need be no substantive differences between radical reform and the incremental reform of pay-as-you-go pension schemes.

Pros and Cons of Radical Reform

Even without fiscal consolidation or a high contribution rate, there may be benefits from a switch to a defined contribution scheme, however. In an article in the December 1997 issue of *Finance & Development*, the authors note two potential gains:

• *Reduced labor market distortions.* In the absence of payroll taxes, labor markets may be subject to fewer distortions and therefore function more efficiently. Increased labor participation may raise output and employment, and ultimately boost saving and capital accumulation.

• *Improved capital markets.* The surplus created by private pension plans is likely to spur the development of capital markets—notably where these are underdeveloped—with a positive impact on growth and saving.

But radical reform is not without its drawbacks:

• *Shift in the risks.* In the shift from a defined benefit plan to a defined contribution plan, there is a fundamental shift in risk from the public sector to individual participants. The progressive or redistributive element of most intergenerational plans is also eliminated. Defined contribution plans may—as Chile's does—stipulate a minimum benefit, but barring other forms of transfers, benefits in defined contribution plans are strictly determined by the level of contributions and the rate of return they earn.

• *High administrative costs.* In some countries, administrative costs absorb nearly one-third of the contributions. Costs are lower in the United States—particularly for stock market index funds—but they are unlikely to drop to the low public plan levels given the continuing need for regulation to avoid fraud or abuse.

• *Inefficient annuity markets.* Typically, defined contribution plans provide lump sum benefits to their participants upon retirement. Participants will then want to convert into annuities, but even in countries with highly developed capital markets, this conversion is costly and can substantially reduce the expected value of the plan for participants.

In the end, fiscal and economic realities may well convince countries of the need to reform, but countries will likely choose the type of reform on the basis of other criteria. There are fundamental decisions to be made about preferences for consumption versus investment and about the relative interests of retirees and workers. These are issues about which politicians will have as much, if not more, to say than economists. ■

Copies of IMF Occasional Paper No. 153, *Pension Regimes and Saving,* by G.A. Mackenzie, Philip Gerson, and Alfredo Cuevas, are available for $15.00 (academic rate: $12.00) from Publication Services, Box XS700, IMF, Washington, DC 20431 U.S.A. Telephone: (202) 623-7430; fax: (202) 623-7201; e-mail: publications@imf.org; Internet: http://www.imf.org.

From the Executive Board

Following are excerpts of recent IMF press releases. Full texts are available on the IMF's web site (http://www.imf.org/external/news.htm) or on request from the IMF's Public Affairs Division (fax: (202) 623-6278).

Yemen: ESAF/EFF

The IMF has approved a loan and credit package for the Republic of Yemen over the next three years totaling the equivalent of SDR 370.6 million (about $512 million) to support the government's economic program for 1997–2000. Of this amount, SDR 264.8 million (about $366 million) is available in loans under the Enhanced Structural Adjustment Facility (ESAF), and an SDR 105.9 million credit (about $146 million) is available under the Extended Fund Facility (EFF).

Medium-Term Strategy and 1997/98 Program

Yemen's medium-term strategy for 1997–2000 aims to achieve real non-oil GDP growth of 6 percent a year on average, a core inflation rate of at most 5 percent a year on average, a reduction in the external current account deficit to an average 2 percent of GDP, and the maintenance of sufficient foreign exchange reserves to cover 4.5 months of imports. To these ends, the government will further strengthen its demand management stance as well as its structural reform efforts. The overall cash budget deficit will be limited to about 2 percent of GDP on average.

Within this medium-term framework, the program for calendar year 1997 aims at achieving non-oil GDP growth of 5.5 percent and core inflation of at most 5 percent; limiting the overall cash budget deficit to 2.5 percent of GDP; containing the external current account deficit to less than 2 percent of GDP; and maintaining sufficient foreign exchange reserves to cover 4.5 months of imports. The 1998 program

Republic of Yemen: Selected Economic Indicators

	1996[1]	1997[2]	1998[2]	1999[2]	2000[2]
			(percent change)		
Real GDP	3.0	5.4	5.2	5.5	6.0
Real non-oil GDP	3.2	5.5	6.0	6.5	7.0
Core inflation	12.3	5.0	5.0	5.0	5.0
			(percent of GDP)		
Overall fiscal balance (cash basis)	–2.3	–2.5	–2.2	–2.1	–2.0
External current account balance	0.8	–1.7	–2.3	–2.0	–2.0
Overall balance of payments	–7.0	–10.9	–11.2	–9.8	–5.4
			(months of imports)		
Central bank gross foreign assets	4.6	4.5	4.5	4.5	4.5

[1]Provisional.
[2]Program.

Data: Yemen authorities and IMF staff estimates and projections

Recent IMF Publications

Working Papers ($7.00)

97/141: *Reform of the Canada Pension Plan: Analytical Considerations*, Charles Kramer and Yutong Li. Illustrates some of the economic effects of a pay-as-you-go public pension system on economic behavior, in the context of a stylized model of the Canadian economy.

97/142: *Stylized Facts of Government Finance in the G-7*, Riccardo Fiorito. An evaluation of the cyclical features of the Group of Seven industrial countries.

97/143: *Aging in the Asian "Tigers": Challenges for Fiscal Policy,* Peter S. Heller. An assessment of the government expenditure effects from changing demographics in the Asian "Tiger" economies through 2050.

97/144: *Liquid Asset Ratios and Financial Sector Reform,* Anne-Marie Gulde and others. Examines the role and effectiveness of liquid asset requirements as a monetary, selective credit, debt-management, and prudential instrument.

97/145: *Determinants of Inflation in Mozambique*, Angel Ubide. Suggests that Mozambique's inflation pattern is a combination of a "fundamental" trend set by economic policies, seasonal behavior, and irregular events that correspond mainly to agroclimatic conditions.

97/146: *Sources of Debt Accumulation in a Small Open Economy*, Abdelhak Senhadji. An analysis of the borrowing behavior of a small open economy in a developing country that relies heavily on imports for its capital formation and faces an upward-sloping supply function of foreign loans.

97/147: *Nominal Income and the Inflation-Growth Divide*, Sheetal K. Chand. Deals with aggregate demand fluctuations and their price and output effects.

Papers on Policy Analysis and Assessment ($7.00)

97/8: *Legal and Institutional Obstacles to Growth and Business in Russia,* Elaine Buckberg. Examines the most critical reforms for promoting private sector development in Russia.

Publications are available from Publication Services, Box XS700, IMF, Washington, DC 20431 U.S.A. Telephone: (202) 623-7430; fax: (202) 623-7201; Internet: publications@imf.org

For information on the IMF on the Internet—including the full text of the English edition of the *IMF Survey*, the *IMF Survey's* annual *Supplement on the IMF*, an updated *IMF Publications Catalog*, and daily SDR exchange rates of 45 currencies—please visit the IMF's web site (http://www.imf.org).

targets growth of 6 percent, a budget deficit of 2.2 percent, and inflation and external sector outcomes similar to those envisaged for 1997.

Structural reforms will focus on expenditure reorientation toward the social sectors and public investment in infrastructure; direct and indirect tax reforms; the elimination of subsidies; civil service, pension fund, customs administration, and budget management reforms; financial sector reforms focused on indirect monetary control, the quality of the banking system, and prudential supervision; and a rapidly moving and broad privatization program.

The government intends to accelerate its efforts to broaden the social safety net and expand health and education services.

Yemen's membership in the IMF dates from May 22, 1990; its quota is SDR 176.5 million (about $244 million), and its outstanding use of IMF credit currently totals SDR 132 million (about $182 million).

Press Release No. 97/49, October 31

The IMF uses its financial resources to help members address their balance of payments problems and cushion the impact of adjustment policies.

Stand-By, EFF, and ESAF Arrangements as of October 31

Member	Date of Arrangement	Expiration Date	Amount Approved	Undrawn Balance
			(million SDRs)	
Stand-By Arrangements			**5,501.66**	**3,307.08**
Argentina	April 12, 1996	January 11, 1998	720.00	107.00
Bulgaria	April 11, 1997	June 10, 1998	371.90	186.50
Djibouti	April 15, 1996	March 31, 1998	6.60	2.63
Egypt	October 11, 1996	September 30, 1998	271.40	271.40
El Salvador	February 28, 1997	April 27, 1998	37.68	37.68
Hungary	March 15, 1996	February 14, 1998	264.18	264.18
Latvia	October 10, 1996	April 9, 1999	33.00	33.00
Papua New Guinea	July 14, 1995	December 15, 1997	71.48	36.14
Romania	April 22, 1997	May 21, 1998	301.50	180.90
Thailand	August 20, 1997	June 19, 2000	2,900.00	1,700.00
Ukraine	August 25, 1997	August 24, 1998	398.92	362.65
Uruguay	June 20, 1997	March 19, 1999	125.00	125.00
EFF Arrangements			**10,926.90**	**5,618.84**
Algeria	May 22, 1995	May 21, 1998	1,169.28	253.28
Azerbaijan	December 20, 1996	December 19, 1999	58.50	44.46
Croatia	March 12, 1997	March 11, 2000	353.16	324.38
Gabon	November 8, 1995	November 7, 1998	110.30	49.63
Jordan	February 9, 1996	February 8, 1999	238.04	76.25
Kazakhstan	July 17, 1996	July 16, 1999	309.40	309.40
Moldova	May 20, 1996	May 19, 1999	135.00	97.50
Pakistan	October 20, 1997	October 19, 2000	454.92	417.01
Peru	July 1, 1996	March 31, 1999	300.20	139.70
Philippines	June 24, 1994	December 31, 1997	791.20	245.95
Russia	March 26, 1996	March 25, 1999	6,901.00	3,564.74
Yemen	October 29, 1997	October 28, 2000	105.90	105.90
ESAF Arrangements			**4,571.71**	**2,371.89**
Armenia	February 14, 1996	February 13, 1999	101.25	50.63
Azerbaijan	December 20, 1996	December 19, 1999	93.60	52.64
Benin	August 28, 1996	August 27, 1999	27.18	18.12
Bolivia	December 19, 1994	September 9, 1998	100.96	16.82
Burkina Faso	June 14, 1996	June 13, 1999	39.78	19.89
Cameroon	August 20, 1997	August 19, 2000	162.12	135.10
Chad	September 1, 1995	August 31, 1998	49.56	16.52
Congo, Republic of	June 28, 1996	June 27, 1999	69.48	55.58
Ethiopia	October 11, 1996	October 10, 1999	88.47	73.72
Georgia	February 28, 1996	February 27, 1999	166.50	58.50
Ghana	June 30, 1995	June 29, 1998	164.40	109.60
Guinea	January 13, 1997	January 12, 2000	70.80	47.20
Guinea-Bissau	January 18, 1995	July 24, 1998	10.50	2.36
Guyana	July 20, 1994	April 17, 1998	53.76	8.96
Haiti	October 18, 1996	October 17, 1999	91.05	75.88
Kenya	April 26, 1996	April 25, 1999	149.55	124.63
Kyrgyz Republic	July 20, 1994	March 31, 1998	88.15	16.13
Macedonia, FYR	April 11, 1997	April 10, 2000	54.56	45.47
Madagascar	November 27, 1996	November 26, 1999	81.36	54.24
Malawi	October 18, 1995	October 17, 1998	45.81	15.27
Mali	April 10, 1996	April 9, 1999	62.01	31.01
Mauritania	January 25, 1995	July 13, 1998	42.75	7.13
Mongolia	July 30, 1997	July 29, 2000	33.39	27.83
Mozambique	June 21, 1996	June 20, 1999	75.60	37.80
Niger	June 12, 1996	June 11, 1999	57.96	28.98
Pakistan	October 20, 1997	October 19, 2000	682.38	682.38
Senegal	August 29, 1994	January 12, 1998	130.79	—
Sierra Leone	March 28, 1994	May 4, 1998	101.90	5.06
Tanzania	November 8, 1996	November 7, 1999	161.59	110.18
Togo	September 16, 1994	June 29, 1998	65.16	21.72
Uganda	September 6, 1994	November 17, 1997	120.51	—
Vietnam	November 11, 1994	November 10, 1997	362.40	120.80
Yemen	October 29, 1997	October 28, 2000	264.75	264.75
Zambia	December 6, 1995	December 5, 1998	701.68	40.00
Total			**21,000.27**	**11,297.83**

EFF = Extended Fund Facility
ESAF = Enhanced Structural Adjustment Facility
Figures may not add to totals owing to rounding.

Data: IMF Treasurer's Department

Albania: Post-Conflict Assistance

The IMF approved a credit for Albania equivalent to SDR 8.8 million (about $12 million), under the IMF's emergency post conflict assistance, to support the government's economic program for 1997–98.

1997–98 Program

The government's primary macroeconomic goals for 1997–98 are rapid disinflation and resumption of growth. The key macroeconomic objectives of the program are to limit the decline of real GDP to 8 percent in 1997 and achieve real growth of about 12 percent in 1998; contain the annual inflation rate to the range of 51–54 percent in 1997 and bring it down to 15–20 percent in 1998; and keep gross international reserves above the equivalent of 3.5 months of imports through 1998. To achieve these objectives, fiscal policy will aim at limiting the domestically financed budget deficit to about 13 percent of GDP in 1997 and to below 10 percent of GDP in 1998.

Under the program the authorities are planning a broad range of structural reforms, including progress toward privatization or liquidation of two of the three state-owned commercial banks; winding up the companies that operated pyramid schemes; civil service reform; a resumption of enterprise privatization; and creation of a functioning agricultural land market.

Addressing Social Needs

The crisis has resulted in an impoverishment of the Albanian population. In the medium term, the alleviation of poverty will be based on achieving high sustainable growth driven by private sector development. However, in the short term, temporary support targeted toward the poorest families will also be required. The government will therefore accelerate disbursements of social assistance, and will also introduce public works/community service schemes for social assistance beneficiaries who can work.

Albania joined the IMF on October 15, 1991, and its quota is SDR 35.3 million (about $49 million). Its outstanding use of IMF financing currently totals SDR 32 million (about $45 million).

Press Release No. 97/51, November 7

Albania: Selected Economic Indicators

	1994	1995	1996	1997[1]	1998[1]
			(percent change)		
Real GDP	9.4	8.9	9.1	–8.0	12.0
Retail prices (end of period)	15.8	6.0	17.4	51–54.0	15–20.0
			(percent of GDP)		
Domestically financed fiscal deficit	–7.0	–6.3	–10.5	–13.2	–9.7
External current account balance (excluding official transfers)	–14.3	–7.5	–9.2	–8.9	–14.0
			(months of imports)		
Gross official reserves	3.2	3.5	3.1	5.0	3.5

[1]Projections.

Data: Albanian authorities and IMF staff estimates and projections

Uganda: ESAF

The IMF approved a three-year loan for Uganda under the Enhanced Structural Adjustment Facility (ESAF), in an amount equivalent to SDR 100.4 million (about $138 million) in support of the government's economic program for 1997/98–1999/2000. The first annual loan, in an amount equivalent to SDR 40.2 million (about $55 million), is available in two equal semiannual installments, the first of which is available immediately.

Medium-Term Strategy and Program for 1997/98

The principal objectives of the government's program for 1997/98 and 1999/2000, supported by the ESAF loans, are to sustain high and broad-based economic growth and ensure that the poor are able to participate in, and benefit from, increased economic activity. The overall strategy will focus on maintaining macroeconomic stability; liberalizing further the economy to promote private sector, export-oriented growth; and undertaking structural and institutional reforms that will further reduce impediments to growth and job creation. The program aims at achieving a real GDP growth rate of at least 7 percent a year on average, reducing annual inflation to about 5 percent and increasing gross international reserves to the equivalent of 4.9 months of imports of goods and nonfactor services.

At the core of the government's medium-term program is an increase in the gross investment-to-GDP ratio to about 23 percent in 1999/2000 and a reduction in the overall fiscal deficit by about 1.7 percent of GDP over the program period. In the framework of this medium-term strategy, the macroeconomic targets for 1997/98 are to achieve a real GDP growth of 7.5 percent; to hold inflation to 5 percent on an end-year basis; and to contain the external current account deficit to 7.0 percent of GDP while maintaining gross reserves at 4.6 months

Uganda: Selected Economic Indicators

	1993/94	1994/95	1995/96	1996/97[1]	1997/98[2]	1998/99[2]	1999/2000[2]
				(percent change)			
Real GDP	5.3	10.5	8.1	5.0	7.5	7.0	7.0
Consumer prices (end of period)	16.1	3.4	5.4	10.4	5.0	5.0	5.0
				(percent of GDP)			
Overall fiscal balance (excluding grants)	–11.1	–8.5	–6.7	–6.5	–5.8	–5.3	–4.8
External current account balance (excluding official grants)	–6.9	–8.4	–6.9	–6.1	–7.0	–6.3	–5.8
				(months of imports of goods and nonfactor services)			
Gross foreign exchange reserves	3.1	3.4	3.6	4.6	4.6	4.8	4.9

[1]Provisional.
[2]Program.

Data: Ugandan authorities and IMF staff estimates and projections

of imports. Uganda has made significant progress in reducing its debt burden in recent years and with the full application of the HIPC Initiative, its indebtedness will decline further.

Uganda joined the IMF on September 27, 1963. Its quota is SDR 133.9 million (about $185 million). Uganda's outstanding use of IMF financing currently totals SDR 276 million (about $380 million).

Press Release No. 97/52, November 10

Press Information Notices

Press Information Notices (PINs) are IMF Executive Board assessments of members' economic prospects and policies issued—with the consent of the member—following Article IV consultations, with background on the members' economies. Recently issued PINs include:

Pakistan, No. 97/32, November 4
France, No. 97/33, November 4
United Kingdom, No. 97/34, November 6
Portugal, No. 97/35, November 7

Full texts of PINs are available on the IMF's web site (http://www.imf.org/pins).

Members' Use of IMF Credit
(million SDRs)

	October 1997	Jan.–Oct. 1997	Jan.–Oct. 1996
General Resources Account	47.27	4,898.31	4,583.30
Stand-By Arrangements	0.00	2,078.66	2,122.19
EFF Arrangements	47.27	2,712.05	2,286.49
CCFF	0.00	107.60	174.62
SAF and ESAF Arrangements	27.75	450.80	480.80
Total	**75.02**	**5,349.11**	**5,064.10**

Note: EFF = Extended Fund Facility
CCFF = Compensatory and Contingency Financing Facility
SAF = Structural Adjustment Facility
ESAF = Enhanced Structural Adjustment Facility
Figures may not add to totals shown owing to rounding.

Data: IMF Treasurer's Department

Selected IMF Rates

Week Beginning	SDR Interest Rate	Rate of Remuneration	Rate of Charge
November 3	4.21	4.21	4.61
November 10	4.32	4.32	4.73

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 U.S. dollar, weighted 39 percent; deutsche mark, 21 percent; Japanese yen, 18 percent; French franc, 11 percent; and U.K. pound, 11 percent). The rate of remuneration is the rate of return on members' remunerated reserve tranche positions. The rate of charge, a proportion (currently 109.6 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.
Data: IMF Treasurer's Department

Latin American Banking Crises Offer Lessons

In the 1990s, several Latin American economies experienced banking crises. These were characterized by varying degrees of deposit withdrawals, capital flight, and bank failures. In a recent IMF Working Paper entitled *Banking Crises in Latin America in the 1990s: Lessons from Argentina, Paraguay, and Venezuela*, Alicia García-Herrero analyzes several elements that determine the macroeconomic consequences of a banking crisis. These elements include the causes of a crisis—whether related to specific bank problems or macroeconomic imbalances, or both; the economic and structural characteristics of a country—the exchange rate regime, the degree of dollarization, and the structure of the banking system; and the authorities' responses to the crisis. García-Herrero finds that crises stemming from both macroeconomic and bank-specific causes had the largest macroeconomic impact. Countries with high levels of dollarization and a large share of foreign and government-owned banks were able to maintain a more stable deposit base, at least temporarily, through the shift to dollar-denominated deposits and to foreign and government-owned banks. A rapid, consistent, and comprehensive policy response was essential for reducing the crises' negative macroeconomic consequences.

Causes of Crises

Banking crises resulting from both macroeconomic and bank-specific causes tend to worsen negative macroeconomic consequences. Among the banking crises examined by García-Herrero, the Venezuelan crisis had the largest negative impact on inflation and growth. This resulted from a combination of macroeconomic imbalances, incomplete financial liberalization, and a lack of adequate banking supervision that allowed banks to hide high levels of insider lending and fraud. An unstable political environment and high real interest rates preceded the crisis, which was triggered by the collapse of Venezuela's second largest bank in January 1994.

In Venezuela, inflation surged during the crisis because of lax monetary and fiscal policies (see chart, page 368). Despite negative real interest rates, credit to the private sector fell, which had a negative impact on the already distressed real sector. In 1994, the economy entered a sharp recession. The banking crisis affected the real economy not only through the reduction of credit but also through the authorities' decision to intervene in nonfinancial enterprises related to failed banks. This move also led to a wave of bankruptcies in the real sector. At the same time, the imposition of exchange rate controls on the current account reduced imports substantially, negatively affecting economic growth.

Argentina's banking crisis, which began in early 1995, was coupled with massive capital outflows. Both originated from an external shock—the December 1994 Mexican devaluation—and such macroeconomic imbalances as persistent current account deficits, a low level of domestic savings, and a deteriorating fiscal position. Shortly after the Mexican devaluation, the closure of an Argentine bond trader—heavily exposed in Mexican bond and securities—created financial panic. Most banks cut their credit lines to other bond traders, further damaging the bond market. This, in turn, eroded the financial position of several banks with large inventories of bonds. Large-scale withdrawals forced several banks into liquidation and produced a major banking crisis.

The Argentine banking crisis had a relatively large negative impact on growth and no impact on inflation (see chart, page 368). While inflation decreased even further in the aftermath of the crisis, the real economy recovered less rapidly than financial markets. The sluggishness of the real sector was probably related to the persistent fall in private credit. In 1995, real GDP declined by 4.5 percent, and began to recover only in early 1996. Unemployment jumped from 12.5 percent in October 1994 to an all-time high of 18.6 percent in May 1995.

Paraguay's banking crisis started in May 1995, largely because of bank-specific problems stemming from financial liberalization without adequate bank regulation or supervision, which resulted in an undercapitalized financial system. Reserve requirements were maintained at high levels, encouraging the expansion of the informal sector. The banking system also suffered from poor credit risk and risk assessment, high levels of insider lending and loan concentration, and fraud. A highly publicized accounting discrepancy of about $4 million in local currency held by the central bank triggered the crisis. At the same time, the third and fourth largest commercial banks were unable to meet their clearing obligations, adding to the turmoil. The Paraguayan banking crisis had a relatively small impact on inflation as restrictive monetary policy, coupled with a cautious fiscal policy, dampened price pressures. At the same time, the restrictive monetary policy, coupled with a shortage of private credit, led to a slowdown in economic activity that continued into 1996 (see chart, page 368).

Economic and Structural Characteristics

While previous government bailouts and deposit guarantees lead to excessive risk taking by banks, they also tend to build public confidence during an ongoing crisis, reducing the extent of bank runs and the cost of the crisis. In Argentina, severe previous crises had forced the government to take such drastic measures as the freezing of deposits. In 1995, depositors, recalling these costly measures, made extremely rapid and substantial deposit withdrawals. In Paraguay, the general perception prior to the crisis was that an implicit government guarantee existed for all banks and for all kinds of deposits. Indeed, very few banks in Paraguay had ever experienced an official intervention, and those that had received sufficient resources from the central bank to protect all creditors. In Venezuela, the history of government bailouts of distressed banks limited deposit runs somewhat. However, because neither shareholders nor depositors had borne the costs of previous bank failures, the banking sector engaged in excessive risk taking, which increased the costs of the crisis.

Exchange rate controls may be counterproductive. For countries committed to a fixed exchange rate, using inflation—through a devaluation—to shrink banks' balance sheets in real terms may be too costly. The case of Argentina shows that authorities did not consider the option of shrinking banks' balance sheets through an exchange rate devaluation, given the loss of credibility it would have brought and the large amounts of dollar-denominated debt. When the 1994 Venezuelan banking crisis reached its peak, the authorities fixed the exchange rate and introduced exchange controls. These actions did not stop capital outflows, and only temporarily limited a surge in inflation. The deposit base continued to fall and inflation accelerated to even higher levels when the government lifted the controls. Exchange rate controls, in turn, introduced serious allocative distortions and weakened external financing prospects.

Bailouts can lead to excessive risk taking, but can also instill public confidence.

Domestic dollarization can help stabilize the deposit base. During the first stage of Argentina's crisis, depositors shifted their holdings from peso to dollar deposits, but still retained their deposits in the domestic banking system. Later, when confidence in the country's economic situation waned, dollar deposits fell sharply, resulting in substantial capital flight. In Paraguay, dollar-denominated deposits also helped stabilize the deposit base, although to a lesser extent than in Argentina. This may be related to the existence of an offshore market, closely linked to the domestic system, to which depositors could easily shift their savings. In Venezuela, dollar deposits were practically nonexistent within the domestic banking system, but a large offshore market had developed where Venezuelans kept their savings and obtained credit in dollars. This "external" dollarization destabilized the country's deposit base.

Foreign and government-owned banks can help stabilize the deposit base—at least temporarily—by promoting "flight to quality" rather than capital flight. In Argentina and Paraguay, the large share of foreign and government-owned banks—perceived to have guarantees

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from their overseas headquarters or the government—fostered flight to quality rather than capital flight, and thus helped to stabilize the deposit base. In Venezuela, foreign and government-owned banks nearly tripled their deposits during the crisis. Nevertheless, since these banks represented only a small market share, Venezuela suffered from relatively large capital flight.

A high concentration and a large share of assets in foreign banks tend to accelerate the reduction in credit. The experiences of Argentina and Paraguay show that high bank concentration and a large participation of foreign-owned banks may delay the recovery in private credit. If the crisis is accompanied by flight to quality to foreign-owned banks, information on borrowers is not easily transmitted from banks facing deposit withdrawals to banks receiving deposits.

Authorities' Response

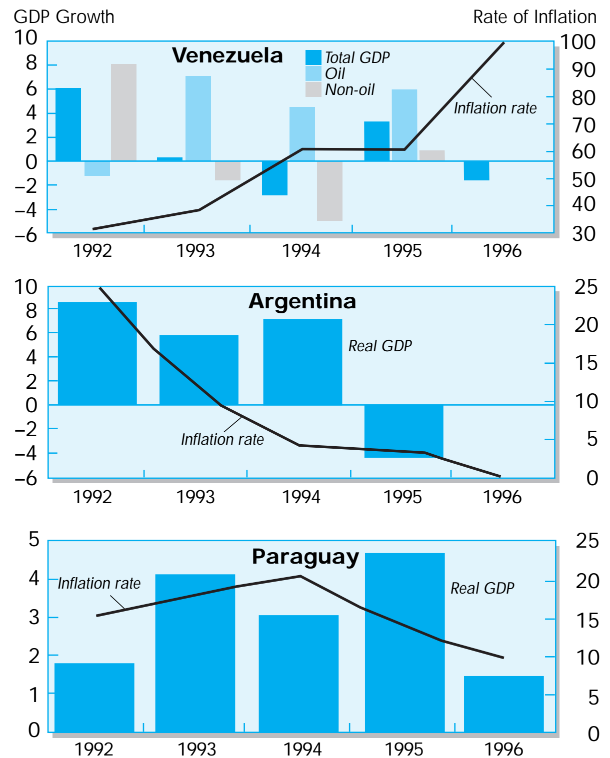
Delays in authorities' responses can create breakdowns in the payments system and reduce public confidence. The relatively small negative impact of Argentina's crisis on the economy attests to the benefits of a timely, consistent, and comprehensive response to banking sector weaknesses. The authorities responded to deposit withdrawals by enlarging the central bank's limited lender-of-last-resort role and establishing trust funds to restructure the banking system. The Venezuelan authorities, on the other hand, did not respond rapidly enough. The bank that had triggered the crisis remained closed for over two months, with no notification to depositors' of any intended solution to the problem. In Paraguay, delays in providing liquidity to distressed banks so they could honor their deposits disrupted the payments system and affected economic growth.

Lender-of-last-resort facilities must be limited, but well functioning. As noted above, in Argentina, the government rapidly extended and increased the flexibility of the central bank's lender-of-last-resort facilities. This provided the banking system with necessary liquidity and enhanced public confidence. In Paraguay, the central bank gave massive financial assistance to distressed banks to enable them to honor their deposits, without, however, attaching sufficient conditionality or valuable collateral. As a result, the fiscal cost of the bailout or failure of institutions was much larger than would have been the case had the banks been closed when the problems first emerged. The subsequent establishment of a new lender-of-last-resort facility, although costly, helped foster confidence in the banking system.

Sound Policies

Sound macroeconomic policies can help alleviate negative macroeconomic impacts of a banking crisis. Argentina's deteriorating fiscal position at the outbreak of the crisis worsened the country's economic problems. At the beginning of the crisis, the public's fears stemmed primarily

Growth in Real GDP and Inflation
(percent change)



Data: IMF staff estimates

from the possibility of a devaluation, and not from the country's overall macroeconomic situation. Once fears about the country's macroeconomic situation spread, however, capital flight increased as deposits dropped abruptly. Notwithstanding measures taken by the authorities to avoid such massive withdrawals, only the announcement of a new economic program slowed the fall in the deposit base.

In Paraguay, favorable macroeconomic conditions and cautious fiscal policy offset the impact of the expansion of central bank credit to distressed banks. The restrictive fiscal policy stance also helped avert pressures on the foreign exchange market and on interest rates.

In Venezuela, inadequate macroeconomic policies before the crisis contributed to an unsustainable price boom and to a general climate of macroeconomic instability, with periodic episodes of capital flight and an erosion of real money demand. During the crisis, lax monetary policy resulted in negative real interest rates, contributing to the fall in the demand for money and pressures on the domestic currency. ■

Copies of IMF Working Paper 97/140, *Banking Crises in Latin America in the 1990s: Lessons from Argentina, Paraguay, and Venezuela*, by Alicia García-Herrero, are available for $7.00 from Publication Services, Box XS700, IMF, Washington, DC 20431 U.S.A. Telephone: (202) 623-7430; fax: (202) 623-7201; Internet: publications@imf.org. The full text is also available on the IMF's web site (http://www.imf.org).