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## Conference on Single Currency Speakers See Strong Prospects for Euro's Success, But Note Political, Economic Challenges Remain

In a little more than a month, the European Union's new single currency—the euro—will replace the national currencies of 11 countries, as the third and final phase of European economic and monetary union (EMU) is launched on January 1, 1999.

The potential impact of the euro on trade and industry and financial markets was the focus of the seventeenth

annual International Monetary and Trade Conference, "The Euro: Foreseen and Unforeseen Consequences," on November 16. Convened by the Global Interdependence Center, a Philadelphia-based organization, the conference featured participants from academia, government, and trade and industry. Speakers were Robert Solomon, Guest Scholar at the Brookings Institution; Paul Volcker, former Chairman of the Board of Governors of the U.S. Federal Reserve System and currently Henry Kaufman Visiting Professor at New York University's Stern School of

Business; Robert Hormats, Vice-Chair, Goldman Sachs (International); Craig Owens, Finance Director, Coca-Cola Beverages, plc (United Kingdom); Kurt Grotenhuis of SAP Strategic Initiatives; Eduard J. Van Wely, Senior Vice-President, DuPont Company; and John Richardson, Deputy Head of the European Commission Delegation to the United States.

### Evolution of the Euro

That EMU, the formerly "flightless fowl," will fly is now no longer in doubt, Robert Solomon said. But he warned that even its most enthusiastic supporters are aware of the risks and dangers that must be weighed and prepared for if EMU is to stay aloft. A chief concern voiced by several participants is the recent leftward shift in the political atmosphere in Europe—particularly in

Germany—and the reverberations from the Asian financial crisis, which, along with continuing high unemployment in many EMU countries, have had a dampening effect on their economies. These developments are likely to pose challenges to some of the fundamental principles of EMU—including the ability of the European Central Bank (ECB)—formally established in June 1998—to maintain its independence in pursuit of the objective of stability. Another concern is the possibility of instability between the euro and other currencies—in particular, the U.S. dollar and the (Continued on the following page)

### World Bank, IMF, and IDB to Assist Honduras and Nicaragua on External Debt

Following is the text of an IMF News Brief issued on November 16.

The World Bank, the IMF, and the Inter-American Development Bank (IDB) have agreed to undertake with the governments of Honduras and Nicaragua a comprehensive assessment of their external debt situation and related requirements for debt relief. This assessment would be undertaken as soon as conditions permit. A document summarizing the results of this assessment in the context of the debt initiative for Heavily Indebted Poor Countries (HIPC) would be presented for consideration by the Boards of the institutions as soon as possible.

In the meantime, the institutions are working to ensure that the external debt-service payments of Honduras and Nicaragua will not impede the reconstruction and recovery efforts from Hurricane Mitch. They welcomed the announcement by several countries to provide immediate debt relief to these countries.

The World Bank is also working with the IMF and the IDB to establish a trust fund that will channel donor resources to help these countries cover multilateral debt-service obligations. This fund will be operational in early December and has already received generous indications of support from bilateral donors, including Norway and the United Kingdom.

New Arrangements  
to Borrow become  
effective. See page 370.



The Federal Reserve Bank of Philadelphia was the site of the conference on the euro.

## Supplementary Resources for IMF New Arrangements to Borrow Enter into Force

With the adherence of the United States and Germany, the New Arrangements to Borrow (NAB), approved by the IMF Executive Board on January 27, 1997 (see Press Release No. 97/5, *IMF Survey*, February 10, 1997), became effective on November 17, 1998. The NAB are a set of credit arrangements between the IMF and 25 members and institutions to provide supplementary resources to the IMF to forestall or cope with an impairment of the international monetary system or to deal with an exceptional situation that poses a threat to the stability of that system.

The NAB do not replace the existing General Arrangements to Borrow (GAB), which remain in force. The total amount of resources available to the IMF under the NAB and GAB combined will be up to SDR 34 billion (about \$48 billion), double the amount available under the GAB alone. By strengthening the IMF's ability to support the adjustment efforts of its members and to address their balance of payments difficulties, the NAB are an important element of the IMF's capacity to respond to potential systemic problems.

The NAB decision will be in effect for five years from November 17, 1998, and may be renewed. The list of NAB participants and their credit arrangements follows.

### Participants and Amount of Credit Arrangements Under the NAB

Participant	Amount (million SDRs)
Australia	810
Austria	412
Belgium <sup>1</sup>	967
Canada <sup>1</sup>	1,396
Denmark	371
Deutsche Bundesbank <sup>1</sup>	3,557
Finland	340
France <sup>1</sup>	2,577
Hong Kong Monetary Authority	340
Italy <sup>1</sup>	1,772
Japan <sup>1</sup>	3,557
Korea	340
Kuwait	345
Luxembourg	340
Malaysia	340
Netherlands <sup>1</sup>	1,316
Norway	383
Saudi Arabia <sup>1</sup>	1,780
Singapore	340
Spain	672
Sveriges Riksbank <sup>1</sup>	859
Swiss National Bank <sup>1</sup>	1,557
Thailand	340
United Kingdom <sup>1</sup>	2,577
United States of America <sup>1</sup>	6,712
Total <sup>2</sup>	34,000

<sup>1</sup>Also a participant in, or associated with, the GAB.

<sup>2</sup>On November 17, 1998, SDR 1 equaled US\$1.39731.

## Speakers Note Strong Prospects for Euro

(Continued from front page) yen—in the first years of its existence. Other unanswered questions are the future of the euro as a major international currency and Euroland representation in world councils like the IMF and the Group of Seven.

Strong political incentives have gone hand in hand with the concern for economic stability that has led to a single European currency. The relationship between France and Germany, Solomon said, was at the heart of European unity, as French leaders since Jean Monnet have been anxious to steer Germany westward.

### Monetary Policy and an Independent Central Bank

A fundamental principle of the EMU is the independence of the central bank. The framers of the Maastricht treaty adopted the strongest possible statute to guarantee that independence. But, as Paul Volcker noted, relying upon the law alone is not sufficient. The ECB, he said, needs the deep-seated support of the public and the national governments—such as the Bundesbank, one of the most independent central banks in the world, had built up over the years. However, the ECB is in the unusual position of being an independent central bank without a government to be independent from.

The primary objective of the European System of Central Banks (ESCB), as defined by statute in the Maastricht treaty, is to maintain price stability. Among the tasks to be carried out by the ESCB is to “define and implement the monetary policy of the Community.” The Governing Council of the ESCB sets monetary policy, but ECB officials do not form a majority of the Governing Council, which comprises the six-member ECB Executive Board and the governors of the 11 national central banks. As Solomon noted, deteriorating economic conditions, structural problems, and changes in the political atmosphere—such as those in France, Germany, and Italy—could make it difficult for the ECB to withstand pressures for an easing of monetary policy. When the ECB was first designed, Robert Hormats added, the “Bundesbank orthodoxy” was firmly in place in most European countries. Now, he said, the ECB has “fewer friends” in national governments. How will the new generation of finance ministers deal with the ECB, particularly if growth deteriorates and unemployment remains high?

The ability of the ECB to remain independent and of the national central bank governors on the Governing Council to withstand pressure from their own finance ministers is clearly a major unknown, but most participants expressed cautious optimism. John Richardson likened the EMU to a supertanker, not easily blown off course by political storms and occasional squalls. Changing the objectives of the

ESCB or redelegating monetary policy would require an amendment of the Maastricht treaty. In addition, the ECB is required by law to explain its policy decisions to the European Parliament on a regular basis; the public and the markets will be watching, he said, which should act as a check on any reckless behavior.

### Domestic Policy

Fiscal policy will continue to be decentralized in Euroland, but control over even this single remaining macroeconomic policy tool is limited. The Stability and Growth Pact—agreed to by EU countries in June 1997—was instituted largely at the urging of the German authorities, who wanted to make sure that countries meeting the EMU entrance requirement of an annual fiscal deficit ceiling of 3 percent of GDP would continue to exercise fiscal restraint once they gained entry. Solomon said the pact allowed national authorities much-needed flexibility. Volcker said he found the budgetary restrictions somewhat rigid, however. Unlike the U.S. federal budget, the EU central budget is very small. In the case of asymmetric shock, Euroland finance ministers, acting as a body, would not be able to balance policy for one part of Europe in one phase of a business cycle against another part of Europe in another phase. However, he did not think the restraints imposed by the Stability and Growth Pact would be too onerous; individual national budgets in Europe were quite large, and automatic stabilizers could be counted on to kick in at the appropriate phase of a business cycle. Also, as Richardson pointed out, fiscal transfers to hard-hit member countries were available through regional stabilization flows from the EU central budget. Both Ireland and Portugal have benefited from such transfers.

Europe faces serious structural problems, as all speakers acknowledged. These include, according to Volcker and Hormats, tax systems that offer the wrong incentives, high unemployment, rigid labor markets, and vast unfunded pension liabilities, as well as an ingrained social welfare mentality that makes structural reform politically unpopular. Both Volcker and Hormats agreed, however, that the introduction of a common currency would help Euroland make the difficult structural changes that were more easily ignored when national authorities could use monetary and exchange rate policy to offset structural rigidities. Eduard Van Wely struck a cautious note, however: a deep recession in Europe and high unemployment in some countries could make these governments focus inward on their own national economies at the expense of the union.

### Impact on Financial Markets, Industry, and Trade

The single currency will be an essential building block for competition in Europe, according to Van Wely. High labor costs, inflexible labor markets, and higher taxes, prices, and materials costs have all combined to make

Europe less competitive than the United States. A single currency will reduce transaction costs and foreign exchange risks, he said, allow for price transparency, improve cross-border business, and simplify banking structures. The single currency is also an element in the battle to end market fragmentation in Europe, leading, eventually, to a single market, which would further sharpen Europe's competitive edge.

The introduction of the euro will also revolutionize the European securities industry, according to Robert Hormats. The euro will widen the choice for European consumers, investors, and users of capital by lowering currency risks, but it will also pose challenges for financial institutions. In particular, as in the United States, where regional banks have virtually disappeared and have been subsumed into national banks, Europe must unify its fragmented banking system.

Among the changes Hormats said the euro would engender is a move away from bond markets into equities. In Europe, a traditional resistance—especially in Germany and France—to the equity market, as well as the fragmentation of markets by currency risk, has kept the bulk of investment in bond markets. However, as firms are driven by the necessity to compete in a single market, mergers and acquisitions will increase, calling for the high-yield financing provided by equity issuance.

According to Kurt Grotenhuis, the coming of the euro is far more than an accounting issue affecting only corporations doing business in Europe; the European Union, including EMU, will have an economic capacity approaching that of the United States, and many corporations doing or contemplating doing business in Europe are gearing up for a major change in their relations with Euroland. Several, like SAP, DuPont, and Coca-Cola, have already invested considerable time and money transforming their accounting practices and adjusting product portfolios, price and organizational structures, and financing operations.

Speaking from the point of view of a company operating in Europe, Craig Owens said the single currency will



#### Selected IMF Rates

Week Beginning	SDR Interest Rate	Rate of Remuneration	Rate of Charge
November 16	3.81	3.81	4.08
November 23	3.80	3.80	4.07

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 107 percent) of the SDR interest rate, is the cost of using the IMF's financial resources. All three rates are computed each Friday for the following week. The basic rates of remuneration and charge are further adjusted to reflect burden-sharing arrangements. For the latest rates, call (202) 623-7171 or check the IMF website ([www.imf.org/external/np/tre/sdr/sdr.htm](http://www.imf.org/external/np/tre/sdr/sdr.htm)).

Data: IMF Treasurer's Department





lead to centralization, with European markets behaving more like U.S. markets. For companies like Coca-Cola, creating unified markets, such as “anchor bottling complexes,” and developing convergence systems, although costly in the short term, will have long-term benefits.

### New International Currency?

The combined GDP of Euroland could make it roughly analogous to the United States, according to Robert Solomon. As in the United States, foreign trade will be a smaller part of EMU's overall trading activity, as intra-Europe trade increases. Countries hoping to join the euro area will likely make payments in euros. But, Solomon said, it is unlikely that the rest of the world with large reserves in U.S. dollars or, as with Latin America, strong trading ties with the United States will dump dollars for euros or that the euro would pose serious competition to the dollar as a reserve asset. Richardson predicted, however, that the euro would grow in importance, eventually becoming a reserve currency, as Europe becomes a simpler place to do business, providing a stimulus to world growth and prompting market operators to want to hold euro balances. Van Wely, pointing to the likely expan-

sion of the EMU, also predicted that the euro would eventually become a second reserve currency.

Of more concern than the strength or weakness of the euro, which will be determined by the market's perceptions, Volcker said, was the risk of instability between the euro and the U.S. dollar. The extreme volatility observed between the U.S. dollar and the Japanese yen, for example, suggested an inefficient exchange mechanism, yet the United States has not been overly concerned because external trade is such a small part of its GDP. When Europe unifies, its external trade will also shrink relative to its combined GDP. But Volcker said there was a need to work toward designing a mechanism that would instill greater stability in the exchange system.

Despite several important issues that need to be resolved—including how Euroland will be represented in world councils like the IMF and the Group of Seven—and risks that cannot be completely hedged—including how impervious the ECB can be to political pressures and economic downshifts—prospects for a successful euro are definitely upbeat, in the view of conference participants. ■

Sara Kane  
Senior Editor, *IMF Survey*

### Press Conference

## Fischer Says Program Aims to Help Brazil to Strengthen Fiscal, Structural Reform Efforts

On November 13, the IMF briefed the press on the successfully concluded negotiations between Brazil and the IMF and what IMF Managing Director Michel Camdessus termed “a strong three-year program of economic and financial reform” (see *IMF Survey*, November 16, page 353, for the Managing Director's statement). IMF First Deputy Managing Director Stanley Fischer; Director of the Policy Development and Review Department Jack Boorman; and Deputy Director of the Western Hemisphere Department Teresa Ter-Minassian, who was the IMF's chief negotiator with the Brazilian authorities, responded to queries. Following are edited excerpts. The full text is available on the IMF's website ([www.imf.org](http://www.imf.org)).

**QUESTION:** *This program is going to live or die on its success in getting the private sector to keep its money in Brazil and grant it additional credits. What is the role of the private sector?*

**FISCHER:** You are absolutely right that the program's success will require the broad support of the financial community. Once the package is announced, the Brazilian authorities will approach foreign creditors—particularly foreign bank creditors—to explain the program

and the nature of the official support Brazil is receiving and to seek the support of the private sector.

We have been working over the past few weeks with the Brazilian authorities to put in place a system for monitoring private sector participation in support of Brazil. We expect, from the conversations taking place in a broad range of contexts between Brazil and the private sector participants and between official sectors in countries and private sector participants, that the private sector will be supportive of the program.

**QUESTION:** *Could you be more specific about the exchange rate regime and other assumptions?*

**FISCHER:** The Brazilians made clear during the Annual Meetings that the exchange rate regime will continue. It has a basic rate of crawl of about 7½ percent, with the Brazilian inflation rate expected to match that of industrial countries or the United States. That will mean a continuing rate of real devaluation of about 7½ percent a year. Also, the Brazilians have been gradually broadening the band around the central crawling rate, and that broadening of the band will also continue.

As for other targets in the program, the budget targets were announced by the Brazilians and incorporated in the program. We don't have targets on things like the inflation rate; we have assumptions as to how they are going to turn out. There are understandings

**We are working with the authorities on a system to monitor private sector participation.**

on monetary policy and, of course, on the reserves. But this program is designed to ensure that if Brazil is following its agreed-upon policies, there will be quite ample access to the reserves being provided under the facility.

**QUESTION:** *Is any money being disbursed up front after approval by the IMF Board? And how would you compare this program with those negotiated with the Asian countries and Russia?*

**FISCHER:** At least part of the first tranche is likely to be drawn. The Brazilians haven't yet decided whether they want to draw the whole tranche. They have indicated they want to treat this program as precautionary in several respects. We are not quite clear yet, nor possibly have they decided, whether they want to treat subsequent tranches as precautionary.

As to the relationship between this and other programs, it is different in several respects. First, the very large first tranche with parallel available financing from the bilateral lenders is different from the Asian programs. In the Asian programs, there was a very large first tranche in the Korean case, but the bilateral financing was in the second line of defense and came only much later and if needed.

Equally important, there is a floating tranche. The second tranche, which is as large as the first, would under a normal arrangement be available only after a certain date—typically, three months or possibly even six months after the first tranche. But in this case, provided Brazil is on track with the program and there is a need, that tranche could be advanced so that, possibly within a few months, Brazil could have access to two very large tranches that would quite possibly be a feature of the contingent reserve facility the IMF is now working on. So there are contingency and precautionary elements in both the design of the program and in Brazil's decision as to how it wants to treat this money.

**QUESTION:** *Is Brazil offering any kind of collateral?*

**BOORMAN:** The collateral a member offers is the program, which it agrees with the IMF, and the economic policies to which it commits itself. The IMF takes its security in the performance of the country.

**QUESTION:** *You said that the total package is significantly larger than you had thought was needed. Why?*

**FISCHER:** Because you want to reassure the markets that you're not slicing it very thin. You want the markets to

know there is a sufficient amount available comfortably.

**QUESTION:** *Could you touch on the tax policy reforms?*

**TER-MINASSIAN:** The details of the proposed tax reform have not yet been released by the authorities. We understand that the idea is to have a nationwide VAT [value-added tax] with a common base and common rate, the revenue of which will be shared among the different levels of government.

**QUESTION:** *Why did the negotiations take so long?*

**FISCHER:** We've gotten used to programs being negoti-



**Teresa Ter-Minassian (left), Stanley Fischer, and Jack Boorman respond to questions on the Brazilian program.**

ated in heroic circumstances with nobody sleeping for a week. Going through the process very carefully, having the Brazilians developing their program, working out what they want to do, discussing it with their congress, and presenting it domestically is far preferable. Of course, the Brazilians' decision to come to the IMF when their reserves were still very comfortable and when the situation was entirely manageable made this possible. That gave us the time to work things out carefully, check and recheck the calculations, and go through all the difficult points.

**QUESTION:** *Do you think a renegotiation or restructuring of the debt is needed to make this program work?*

**FISCHER:** The Brazilian authorities believe—and we agree with them—that in light of current market conditions a formal rollover isn't needed. They will speak to their creditors, explaining the program and asking their continuing support. It's a reasonable request and probably a profitable request to agree to under these circumstances.

And as to a formal restructuring of Brazil's debt, this is an issue where the Brazilians insist that the analogies with other countries are just wrong, and again we think they are right. Brazil has not, even during the 1980s, had trouble rolling over its domestic debt, and it hasn't in this crisis, either. It is gradually moving to lengthen its debt, but as in everything Brazil does, it tends to move incre-

**Photo Credits:** Federal Reserve Bank of Philadelphia, page 369; Andrew Wong for REUTERS, page 376; Shamil Zhumatov for REUTERS, page 384; Denio Zara and Padraic Hughes for the IMF, pages 373, 375, and 377.

mentally. They believe very firmly in the importance of maintaining the underlying stability of the economy. They have been moving to gradually lengthen the maturities of their domestic debts and very gradually moving to put more of it onto a fixed interest rates basis.

**QUESTION:** *As my colleagues read this Letter of Intent, we're all looking for the catch. Also, how will Brazil emerge from all of this?*

**FISCHER:** There is no catch. The Brazilians have said what they intend to do. They have been very, very careful to explain domestically what they are doing, and this is also laid out in the Letter of Intent.

As to how the country will emerge, Brazil has made remarkable progress in this decade, and the structural reforms began before the *Plan Real*. The cleaning up of federal/state fiscal relations and the banking system has been under way for some time. *Plan Real* is one of the most successful and technically most interesting and accomplished inflation stabilization plans ever undertaken. In the last couple of years, partly because the fiscal sector was not under sufficient control, the external deficit became large, and Brazil found itself, when the contagion from Russia developed, with a currency and reserves under attack.

I don't think we'll see a fundamentally different Brazil after this program, because we are already seeing a fundamentally different Brazil emerging—a Brazil

with what its minister of finance likes to call a "culture of stability." That concept—that the country is stable, doesn't go through drastic changes of policy every few years, and maintains low inflation, with no big shocks—is becoming ingrained. This loan is part of an attempt to ensure that that culture remains in place.

I think during this period Brazil will make further progress in a variety of different areas, including tax and fiscal sector reform. And it will take this opportunity to ensure that the balance of payments situation becomes sustainable. That's what this is basically about—the continuation and perhaps intensification of structural reforms and the fixing of the interlinked elements that are posing difficulty in the macro situation: the budget and the balance of payments. What is very significant is that Brazil has committed itself to a three-year program with the IME, so that the commitment to fix the budget—inevitably a longer-term commitment—is embodied in an international agreement that has the support of the international community.

We have a realistic program that will fix the main current problem in Brazil, a problem that has been affected to an important extent by contagion from elsewhere. ■

The text of the press conference on Brazil, as well as Brazil's letter of intent, which sets out the country's economic reform program, is available on the IMF's website ([www.imf.org](http://www.imf.org)).

## Composition of the Brazilian Support Package

The IMF and other official creditors, multilateral and bilateral, will provide support for Brazil totaling more than \$41 billion over the next three years.

### IMF Support

At a meeting to be held in early December, the IMF Executive Board will consider for approval Brazil's request for a three-year Stand-By Arrangement, under which the IMF would make available \$15.9 billion by end-1999, and \$18.1 billion during the full three years of the program to the end of 2001 (all amounts valued at today's SDR/US\$ exchange rate).

**First Tranche.** Of this, \$5.3 billion would be available upon Board approval, of which \$4.5 billion would be under the Supplemental Reserve Facility (SRF).

**"Floating" Tranches.** Subject to enactment of the key fiscal measures and the completion of a review by the Board, a further \$4.5 billion would be available under the SRF by end-February, 1999. However, depending on circumstances and subject to Board review, this tranche of the SRF could be brought forward to as early as December 15, 1998, at the request of the Brazilian authorities. There are two further purchases under the SRF, each of \$1.8 billion, the availability

of which is subject to Board reviews currently scheduled for completion by May 31, 1999, and August 31, 1999, respectively. Likewise, depending on circumstances and subject to Board reviews, these two purchases could be brought forward to as early as March 1, 1999, and June 1, 1999, respectively, at the request of the Brazilian authorities.

**Quarterly Tranches.** The remaining \$4.7 billion of IMF support would be available under the Stand-By Arrangement on a quarterly basis, starting with \$0.8 billion after February 28, 1999, and the rest through the remainder of the program.

### Other Official Support

**Bilateral Support.** The bilateral support stands at about \$14.5 billion and would be available over the next 12 months. The first disbursement of the bilateral support would be available alongside the first purchase under the SRF and would be proportional to SRF resources under the arrangement.

**World Bank and Inter-American Development Bank (IDB).** The World Bank intends to commit \$4.5 billion for the next three years and so does the IDB. A large share of these amounts is expected to be made available before the end of 1999. The World Bank loans are expected to support social security, public administration and financial sector reforms, and improvements in social protection. The IDB support is expected to focus especially on social protection, priority public investments, and credits to small enterprises.



# Camdessus Stresses Sound Banking System Requires Strong and Transparent Framework

In an address to the Federation of Latin American Banks in Panama on November 18, IMF Managing Director Michel Camdessus said the essential elements of a reformed international financial system would be sound, resilient national systems, supported by transparency in policymaking, and the likely need to extend aspects of regulation and supervision to institutions engaged in international capital flows.

## Financial Sector Soundness

Camdessus said that the IMF's 1998 study, *Toward a Framework for Financial Stability*, together with the Basle Core Principles, provides "a kind of road map" for disseminating standards and good practices through the IMF's regular policy discussions with its members. Four key principles, he said, emerged from the IMF study:

- *Foster intrinsically sound banks.* Seek to build high-quality assets by establishing clear criteria for entry and exit through competent, professional management with a high degree of integrity. Conflicts of interest between banks and their owners should be avoided.

- *Increase banking transparency.* Bank assets should be valued realistically. Report bad loans accurately and avoid the temptation to overvalue assets. Also, expect high standards of public disclosure and prudential reporting from banks. Underpin this with internationally consistent accounting and auditing systems.

- *Limit the distortions imposed by public sector policies.* Even when banks fail because of public policies, market-based solutions should be sought before using public resources. Any guarantees that are provided to address systemic concerns should be limited and transparent, with full awareness of their budgetary cost and within the framework of current monetary policy. These operations must not generate losses for central banks, and shareholders must bear full responsibility for their own losses.

- *Control risk through prudential regulation and supervision.* Authorities should focus on the soundness of the system through effective regulation and supervisory agencies with adequate autonomy, authority, and capacity. Prudential regulations should define clearly the scope of financial activities, strengthen internal governance, and reinforce market discipline.

Sound banking also requires a strong legal and judicial framework and sound financial market infrastructure (including an efficient payments system and robust money, foreign exchange, and capital markets). Beyond the rules and regulations, Camdessus noted, it is also critical that a "credit culture" develop—an environment in which credit contracts are routinely hon-

ored and enforced, and weak corporations are subject to market discipline and, if need be, bankruptcy. Sound banking must, he said, be undergirded by strong governance in the public and corporate sectors.

## Transparency in Policymaking

The IMF is working on a code of good practices for monetary and financial policies, and Camdessus noted the particular importance of transparency in policymaking, since it fosters accountability and imposes discipline on policymakers. Transparency is also an essential precondition for good governance, particularly if, as is desirable, autonomous central banks and regulatory bodies are to be developed. In addition, transparency enhances policymakers' credibility and effectiveness by making the private sector better able to anticipate policymakers' intentions and likely responses to developments.

While this code, Camdessus said, will not take a stance on specific monetary and financial policies, it will assume that promoting and deepening money and capital markets are overriding goals and that market-based instruments should be developed to implement monetary policy. Policy transparency will rest on four main steps:

- Clearly define the roles, responsibilities, and objectives of the key official institutions in the financial sector, giving them as much autonomy as possible;
- Hold these institutions to high standards of accountability and integrity;
- Have policymaking take place in an open and predictable fashion; and
- Have official agencies make available monetary and financial statistics and information for policy decisions routinely, regularly, and promptly. Information is the lubricant of the market economy.

## Regulating International Capital Flows

At present, Camdessus observed, the onus of supervising offshore or highly leveraged operations falls to national authorities. Several areas need to be addressed, each raising difficult questions of its own:

- Regulatory and supervisory functions for banking institutions may have to be extended, specifically to cover cross-border activities more thoroughly



**Camdessus: Sound banking must be undergirded by strong governance in the public and corporate sectors.**

and to recognize the goal of preserving international stability.

- Standards for regulating and supervising need to be coordinated and harmonized more extensively.
- The philosophy of the Basle Core Principles will have to be extended to a wider range of markets, institutions, and transactions.

Camdessus stressed that there are clear benefits for the global economy from an international system that begins to operate more efficiently within a more complete legal and regulatory framework. However, this will entail added responsibilities and an enhanced awareness of the global implications of their work. ■

### APEC Summit

## Members Resolve to Work Toward Early and Sustained Recovery from Crisis

*Following are edited excerpts of the declaration made by the 21 members of the Asia-Pacific Economic Cooperation (APEC) forum at the end of their two-day summit in Kuala Lumpur on November 18.*

Our meeting takes place at a critical time. We need to deal urgently with the financial crisis that has spread beyond the APEC region. It has resulted in far-reaching social costs, with the affected economies experiencing rising unemployment and falling real incomes, setting back decades of progress achieved in eliminating poverty and increasing education opportunities, as well as access to basic health and infrastructure facilities. We are resolved to work together to support an early and sustained recovery in the region, contain the risks of contagion, and prevent the possibility of a global recession.

APEC's emphasis on human resource development, including skills development, technological upgrading, and infrastructure improvements, will strengthen our resilience and capability in overcoming the challenges confronting the region during this time and in restoring stability and confidence.

There have been several encouraging developments in our economies and in the international financial system in recent months. In recent weeks, these developments have been reinforced by:

- the reduction of short-term interest rates in a number of industrial economies;
- Japan's commitment of substantial public resources to strengthen its financial system;
- progress toward providing additional resources to the IMF; and
- the Group of Seven's agreement to support the establishment of a new IMF facility to deal with contagion by providing a precautionary line of credit for economies with sound policies supported by the IMF.

We endorse the greater flexibility of the IMF program and welcome efforts by the World Bank to triple and the Asian Development Bank to double their social sector lending.

Revitalizing the private sector by helping to recapitalize financial institutions, addressing companies' heavy

debt burdens, and restoring their access to trade and working capital financing are critical to achieving renewed economic growth in the economies most severely affected by the crisis.

In this regard, we will encourage financial and corporate sector restructuring through mechanisms to:

- mobilize additional assistance to support implementation of accelerated financial and corporate sector restructuring, including through the use of multilateral development bank guarantees and other innovative mechanisms;
- mobilize significant private sector equity capital and investment to help distressed companies and financial institutions in the APEC region successfully restructure both their finances and their operations; and
- review and remove regulatory and legal impediments to the ability of private financial institutions to participate constructively in the restructuring of the debt of private sector borrowers, while encouraging export credit and insurance agencies to play a more catalytic role in encouraging such restructuring.

In order for the region to fully recover from the crisis, we must be able to attract growth-enhancing, stable capital flows into the region.

While our immediate priority must be to mitigate the adverse social impact of the crisis and to restore financial stability and economic growth, we must strengthen the international financial architecture so as to better prevent future financial instability and to resolve crises more effectively when they occur.

The expansion of trade and investment remains an essential element of our economic recovery, and we reiterate the need for liberal and open markets and an enabling environment for investment.

We reaffirm our commitment to uphold and strengthen the multilateral trading terms to ensure fair rules and benefits for all.

We urge the prompt accession to the WTO [World Trade Organization] of applicants in accordance with WTO rules, with a view toward achieving the universality of WTO membership. ■



## Temporary Fiscal Expansion Could Lessen Chance Of Prolonged Recession in Asian Crisis Countries

On November 8, W. Max Corden, Professor of International Economics, gave the annual Ernest Sturc Memorial Lecture at the Paul H. Nitze School of Advanced International Studies (SAIS) in Washington, D.C. His talk, "Sense and Nonsense on the Asian Crisis," is summarized here. The full text of the address is available on the SAIS website ([www.sais-jhu.edu](http://www.sais-jhu.edu)).

The investment boom—private sector lending and borrowing—began in the late 1980s in most of the affected countries and, fueled by mounting euphoria and herd behavior, got out of hand from about 1994, Corden said. Like all booms, this one had to come to an end. The problem was, the end came "very suddenly," with an abrupt change in sentiment, a loss of confidence, and financial panic.

Moral hazard, capital market liberalization, inadequate information, and short-term borrowing all played roles of varying intensity in causing the crisis, but, in Corden's view, massive short-term borrowing was the worst culprit.

### Is Recession Inevitable?

Financial and currency crises led to massive recessions in all the affected countries, but, Corden asked, were these severe recessions—in his view, the most unfortunate legacy of the crisis—inevitable? Could they have been avoided?

One cause of the recessions, he said, was simply a decline in demand. A "Keynesian remedy"—a temporary fiscal expansion of no more than two or three years—was needed to stimulate demand. But this, he noted, was the opposite of the policies the affected countries pursued initially. The limit to temporary fiscal expansion in a severe crisis is set by the amount of temporary financing available—that is, the funds available through the IMF and other bilateral and multilateral sources.

In Corden's view, to avoid the sudden increases in poverty and unemployment in the Asian crisis countries, what was needed were substantial foreign loans to cover current account deficits caused by the temporary fiscal expansions. The loans would cover deficits for only a few years, but the repayment should be stretched out over many years. Corden emphasized that, in the case of the Asian crisis countries, such loans—not grants—would have gone to illiquid, but not insolvent, countries with excellent macroeconomic track records and a history of honoring debt obligations—especially Korea and Thailand. That such loans were not forthcoming from the private markets was, in Corden's view, a market failure. Short-term debts, he said, should have been readily and quickly rolled over or replaced by long-term loans.

### Two Dilemmas

Corden closed by posing two, as-yet unrec- onciled, dilemmas. *Should markets get what they want, even if what they want is not reasonable?* In the case of the east Asian countries, why should the markets demand fiscal discipline as a condition for credibility and confidence when fiscal discipline has never been an issue for these countries—as it is, for example, with Russia? And, by extension, why should the IMF give primacy to market demands? Restoring confidence takes a long time; should these countries be expected to endure a drawn-out recession to restore market confidence when what their economies need is a temporary expansionary boost to restart their engines? Corden emphasized he was not recommending reckless expansion for every country in trouble; he was using the east Asian experience as an example of unreasonable market expectations.

*To what extent should a country's economic (and political) imperfections be removed before it is given financial support?* Corden illustrated this dilemma with the case of Indonesia. One of the great postwar success stories, Indonesia followed good macroeconomic policy and prospered despite well-known imperfections, such as corruption, trade restrictions, and "family values." Although much started going wrong about three years ago—excessive, uncontrolled borrowing, along with the persistence of corruption, cronyism, and nepotism—this did not explain the severity of the recession Indonesia is now experiencing. The cause, Corden said, was a loss of confidence in the ability of then-President Suharto to manage the crisis, coupled with political uncertainty about who would succeed Suharto.

When the IMF stepped in, it recommended several micro reforms, including the closing of unprofitable concerns, many of which were "family-owned." The markets noted the government's reluctance to close these enterprises, and confidence plummeted, worsening the already adverse effects of the crisis. But if the IMF had not insisted on reforms, in the interest of maintaining confidence, then it would have been accused of funding a corrupt and inefficient regime.

Thus, Corden asked, if governments and institutions are not perfect, to what extent should the IMF support a country with serious imperfections and how many of these imperfections should be removed before the IMF (or other multilateral lenders or donors) should provide financing?



W. Max Corden

## Discussions Center on Progress in Building Sound Banking Systems

Since the mid-1980s, many African countries have made progress in liberalizing domestic prices and marketing; restructuring and privatizing state enterprises; reducing labor market rigidities; opening up foreign trade and exchange systems; adopting realistic exchange rates; and reforming the structures of taxation and public expenditures. Participating in a workshop entitled “Building Banking Systems in Sub-Saharan Africa: Current Issues and Policy Agenda,” many speakers highlighted the complementarity between banking system reforms and these structural and macroeconomic reforms implemented in the context of comprehensive adjustment programs.

The workshop, held in Geneva on October 26–28, was organized by the Geneva-based Graduate Institute of International Studies, the Economic Development Institute of the World Bank, and the Swiss Federal Office for Foreign Economic Affairs. Anupam Basu of the IMF’s African Department and Piero Ugolini of the IMF’s Monetary and Exchange Affairs Department took part in the workshop.

Over the past four years, these structural reforms have helped African countries reduce public sector deficits, progress toward macroeconomic stability, expand exports, and raise economic growth rates. More important, they have given rise to a market-oriented framework that is facilitating private sector development, economic growth and diversification, and Africa’s integration into the global economy. The new economic environment has enabled banks to progres-

sively shift from financing public sector deficits and losses to lending to the private sector.

### Causes of Banking Sector Problems

In the 1970s and 1980s, banking sectors in many sub-Saharan African countries were seriously weakened, primarily because bank lending—through state-owned and other banks—was used to finance fiscal deficits, the losses of enterprises in which the state held a majority share, and unproductive public sector projects. As a result, banks were saddled with large nonperforming loans and loan losses, often causing their insolvency. These problems were compounded by structural weaknesses in both the banking sector and the general economic environment, as well as by deteriorating macroeconomic conditions (see box, this page).

### Financial and Operational Restructuring

In response to the new environment in many countries, governments have tried to help financially distressed banks through programs of financial and operational restructuring. Vilévo Biova Devo, Director of Credit of the Central Bank of West African States (BCEAO), discussed the important efforts to restructure the banking sector in the countries of the West African Monetary Union. These included:

- reducing banks’ operating losses;
- closing unprofitable or insolvent banks;
- recovering nonperforming loans;
- recapitalizing banks; and
- phasing out state ownership and government involvement in the management of banks.

Similar reforms have been or are being implemented in other African countries—for example, Mozambique, Tanzania, and Uganda. Workshop participants cautioned that delays in dealing with financially distressed banks carry the risk of heavy fiscal costs and loss of monetary control and stressed the importance of taking timely actions to liquidate insolvent banks. It was recognized that central bank lender-of-last-resort facilities, which are designed to provide short-term, temporary accommodation of banks’ liquidity needs, should not be used to prop up insolvent banks.

### Improving Information and Operations

The demand for bank credit by the private sector will continue to grow. Moreover, banks will face the challenge of lending to a growing number of clients, comprising recently privatized enterprises and industries benefiting from lower levels of protection and government transfers than in the past. Banks must adapt by improving their

### Structural Weaknesses

In the banking sector, structural problems include:

- dominance of inefficient state-owned banks;
- administered interest rate structures with preferential rates and negative real interest rates;
- insider lending activities;
- a paucity of financial data on both banks and nonfinancial enterprises;
- inadequate regulatory frameworks, supervisory practices, and legal systems; and
- political interference in banking activities.

In the general economic environment, banks in many countries had to lend under particularly difficult circumstances because of:

- virtual absence of real economic growth;
- undiversified structure of the economies; and
- risks stemming from exposure to large terms of trade shocks, recurrent droughts, and policy uncertainty.

ability to analyze credit and market risks. Patrick Honohan, lead economist for the World Bank, noted that comprehensive and reliable company information helps banks process information and that good financial performance requires coherent laws and fair and efficient legal procedures for resolving contractual disputes. To this end, many countries have sought to improve the availability and quality of financial information that banks and nonfinancial enterprises are required to disclose, as well as the legal and judicial framework governing banking and commercial activities.

Their efforts have entailed modernizing accounting standards and banking and commercial laws. (The CFA franc countries, for example, are harmonizing their business laws.) Countries are introducing legal reforms to support efficient bankruptcy procedures, contract enforcement, the establishment of property rights, the operation of foreclosure laws, and the marketability of land or land lease titles. Participants stressed the need to enforce compliance with these laws and to ensure that financial contractual cases are settled expeditiously, including by setting up specialized courts.

### Strengthening Supervision

In his presentation on the Basle Core Principles for Effective Banking Supervision, Philip Turner of the Bank for International Settlements stressed that adequate supervision of credit risk involves oversight of, and standards for, banks' policies for making credit assessments a basis for lending; evaluating the quality of assets, including provisioning against impaired assets; managing concentrations of risk in lending to a single borrower, a group of related borrowers, or a particular industry (including supervisory limits on them); guarding against connected lending abuses (such as loans to owners or managers or related businesses); and banks' management of country risks. Discussing capital adequacy, he recalled that "the Basle risk-weighted standard was always intended as a minimum which national regulations could supplement as circumstances warranted." He then suggested that capital ratios should be higher in countries where economic activity is highly volatile and where accounting weaknesses and legal obstacles impede banks' recovery of delinquent loans.

Other speakers noted several African countries' efforts to ensure that banks adhere to prudential guidelines on sound lending practices. Given the undiversified structure of most sub-Saharan African economies, it was also recognized that banks in the region needed to adhere to higher prudential standards than the minimum indicated by the Basle Core Principles. Moreover, the authorities needed to be vigilant in supervising the banking system through off-site and on-site bank examinations and audits. Some participants also saw merit in establishing mechanisms for sharing information on the creditworthiness of borrowers, including through the development of credit rating agencies.

### Developing Regulatory Institutions

In most African countries, the central bank has been entrusted with bank supervision responsibilities, largely because central banks tend to have staff with relevant experience. In the BCEAO countries and those of the Bank of Central African States (BEAC), two regional banking commissions (separate from the central banks) supervise the banks. Representatives of the BCEAO and the BEAC explained that the two commissions had promoted the regional coordination of banking regulations and supervisory practices.

Gérard Caprio of the Development Research Group of the World Bank underscored the role of incentives in building a motivated body of supervisory staff. Participants recognized that it was also important to provide appropriate salary scales, establish a proper code of ethics, and ensure that governments support supervisors' work. The central bank or the supervisory body needed to have the necessary independence from political interference to enforce the legal standards of bank supervision, prudential regulation, and licensing.

### Promoting Competition

Several participants welcomed the efforts of some African countries to make the banking sector more competitive by phasing out the monopoly of state-owned banks and allowing the entry of new, private banks. Some speakers argued that permitting the entry of foreign banks or joint ventures would provide access to technological and managerial know-how and lead to efficiency gains. They cautioned, however, that new banks should meet appropriate licensing requirements; for example, they should have an adequate capital base.

### Indirect Instruments

With the ongoing liberalization of financial and exchange systems, a number of sub-Saharan African countries have tried to build the institutional and technical capacities they need to conduct monetary policy with indirect instruments. Many of them have begun dismantling preferential and directed credit allocations. Other countries—such as Angola, Ethiopia, Mozambique, and Rwanda—are at an early stage of developing short-term bill markets; typically, they are still phasing out the remaining controls on banks' deposit and lending rates and are establishing auctions of treasury bills and central bank bills to enable short-term interest rates to be market determined. The countries that have moved the furthest in this direction are Kenya and South Africa.

Against this background, central banks have been developing their capabilities for reserve money programming and open market operations. Countries in the early stage of the transition to indirect instruments will have to reduce their reliance on reserve requirements and develop bill markets and interbank markets for money and foreign exchange. Most other countries need to



establish secondary bill markets, create primary dealer systems, shift from a paper-based to an electronic book-entry system to speed up trading in securities, and develop repurchase agreement facilities.

### Central Bank Accountability

Several speakers noted that, during the 1990s, several African countries have modernized their central banking laws, thereby clarifying the primary objective of monetary policy—typically, price stability: how to achieve it, the autonomy available to the central bank, and the accountability and reporting standards that it would have to observe. Currently, the autonomy and accountability of central banks in the region vary substantially. Most other countries confer only limited autonomy on their central banks and need to make further progress in this area.

Throughout the discussions, most participants agreed that the economic recovery, the opening up and growth of

foreign trade, and the privatization programs being implemented in sub-Saharan Africa today offer opportunities for the banking and the private sectors to grow. In this context, some speakers noted that, despite recent reforms, the region's financial markets have remained fragmented because of the lack of progress toward linking the formal and informal sectors; small borrowers, especially in the rural sector, continue to be disadvantaged relative to large firms; and long-term finance remains scarcer than short-term loans. They hoped that in the future, more attention would be given to addressing these issues. At the same time, everyone recognized that it was important for Africa's banks to participate in the growth process in a way that safeguards the soundness of the banking system and complements the efforts of African governments to ensure stable macroeconomic conditions. ■

Anupam Basu  
IMF African Department

## From the Executive Board

*Following is an excerpt of a recent IMF press release. The full text is available on the IMF's website ([www.imf.org](http://www.imf.org)) under "news" or on request from the IMF's Public Affairs Division (fax: (202) 623-6278).*

### Uganda: ESAF

The IMF approved the second annual loan for Uganda under the Enhanced Structural Adjustment Facility (ESAF), equivalent to SDR 33.5 million (about \$46 million), to support the government's economic program for 1998/99 (July–June). The loan is available in two semiannual installments, the first of which, equivalent to SDR 16.7 million (about \$23 million), will be disbursed on November 25.

#### Medium-Term Strategy

The government's medium-term economic strategy is aimed at realizing average real growth of 7 percent a year, containing inflation at 5 percent, and maintaining gross international reserves at a level equivalent to about five months of imports of goods and nonfactor services. The overall fiscal deficit (excluding grants) would increase moderately to 6.7 percent of GDP during 1998/99, and decline gradually to 6.0 percent by 2000/01.

#### Structural Reforms

The authorities' program envisages a deepening and strengthening of structural reforms in the financial sector, with emphasis on bank supervision and enforcement of prudential regulations. Public enterprise reform and reforms within the civil service and pension system are among additional measures seen.

Uganda joined the IMF on September 27, 1963. Its quota is SDR 133.9 million (about \$186 million). As of September 30, 1998, Uganda's outstanding use of IMF resources totaled SDR 272 million (about \$377 million).

### Uganda: Selected Economic and Financial Indicators

	1994/95	1995/96	1996/97	1997/98		1998/99	1999/00	2000/01
				Program	Projected			
	(annual percent change)							
GDP at constant prices	10.5	8.1	5.2	5.0	5.5	7.0	7.0	7.0
Consumer prices	6.1	7.5	7.8	8.8	5.8	5.0	5.0	5.0
	(percent of GDP at factor cost)							
Government balance (excluding grants)	-7.6	-6.5	-6.6	-5.8	-6.4	-6.7	-6.4	-6.0
	(percent of exports of goods and nonfactor services)							
Debt-service ratio <sup>1</sup>								
Including Fund obligations	23.5	21.8	17.9	26.9	26.7	15.6	16.2	12.7
Excluding Fund obligations	18.8	15.6	10.6	17.7	16.9	7.4	10.2	7.9
	(months of imports of goods and nonfactor services)							
Gross foreign exchange reserves	3.4	3.6	4.5	4.7	4.9	5.0	5.0	5.0

Note: Fiscal year begins in July.

<sup>1</sup>The debt-service ratio incorporates estimates of the effects of the April 1998 Paris Club stock-of-debt operation and assumes rescheduling with non-Paris Club bilateral and commercial creditors on comparable terms.

Data: Ugandan authorities and IMF staff estimates and projections

### Public Information Notices

Public 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:

**Australia, No. 85, November 17**

Full texts are available on the IMF's worldwide website ([www.imf.org/pins](http://www.imf.org/pins)).

November 30, 1998

**World Economic and Financial Surveys**

*World Economic Outlook, October 1998* (\$36.00; academic rate: \$25.00)

**Working Papers (\$7.00)**

- 98/130: *Perspectives on the Recent Currency Crisis Literature*, Robert P. Flood and Nancy P. Marion. Provides some perspective on recent analyses of currency crises in the 1990s and relates it to earlier research.
- 98/131: *Can Short-Term Capital Controls Promote Capital Inflows?* Tito Cordella. Finds that short-term capital controls can be effective in reducing the vulnerability of emerging markets to financial crises.
- 98/132: *Output Decline and Recovery in Uzbekistan: Past Performance and Future Prospects*, Günther Taube and Jeromin Zettelmeyer. Analyzes Uzbekistan's mild "transformational recession" and moderate recovery during 1996–97.
- 98/133: *The Uzbek Growth Puzzle*, Jeromin Zettelmeyer. Explores reasons for Uzbekistan's favorable output performance following the breakup of the Soviet Union.
- 98/134: *The Role of Allocation in a Globalized Corporate Income Tax*, Jack M. Mintz. Considers the development of national corporate tax policies in the context of the internationalization of business activity.
- 98/135: *Tax Revenue in Sub-Saharan Africa: Effects of Economic Policies and Corruption*, Dhaneshwar Ghura. Analyzes variations in tax revenue-GDP data ratios using data for 39 sub-Saharan African countries during 1985–96.
- 98/136: *Is the United States CPI Biased Across Income and Age Groups?* S. Nuri Erbaş and Chera L. Sayers. Suggests that overall CPI may be biased against lower-income elderly households.
- 98/137: *East Asian Growth Before and After the Crisis*, Nicholas Crafts. Surveys literature on growth performance in east Asian economies in recent decades.
- 98/138: *Managing Corporate Distress in the Philippines: Some Policy Recommendations*, Cheng Hoon Lim and Charles Woodruff. Reviews the Philippine corporate sector and recommends measures to improve transparency and oversight.
- 98/139: *Can the Neoclassical Model Explain the Distribution of Foreign Direct Investment Across Developing Countries?* Harm Zebregs. Investigates whether foreign direct investment flows can be explained by the standard neoclassical model or by modified versions.
- 98/140: *From Autarky to Integration: Imitation, Foreign Borrowing, and Growth*, Rachel van Elkan. Analyzes the effects on growth of the integration of an autarkic country into the world economy.
- 98/141: *Recovery and Growth in Transition Economies 1990–98: A Stylized Regression Analysis*, Oleh Havrylyshyn. Analyzes the determinants of growth in 25 transition economies during 1990–97.
- 98/142: *Contagion: Monsoonal Effects, Spillovers, and Jumps Between Multiple Equilibria*, Paul Masson. Argues that only models that allow for multiple criteria are capable of producing true contagion.
- 98/143: *Crises, Contagion, and the Closed-End Country Fund Puzzle*, Eduardo Levy-Yeyati and Angel Ubide. Analyzes the behavior of closed-end country fund discounts, including evidence from the Mexican and east Asian crises.
- 98/144: *Monetary Operations and Government Debt Management Under Islamic Banking*, V. Sundararajan and others. Outlines recent progress in developing Islamic financial instruments for the management of monetary policy.
- 98/145: *Explaining the Recent Behavior of Inflation and Unemployment in the United States*, Vincent Hogan. Examines reasons for the low rates of inflation in the United States in recent years despite a decline in the unemployment rate.
- 98/146: *Optimal Fiscal Policy and the Environment*, Jenny E. Ligthart. Studies the setting of optimal fiscal policy in a second-best world with environmental externalities.
- 98/147: *Real Exchange Rate Volatility: Does the Nominal Exchange Rate Regime Matter?* Hong Liang. Examines the behavior of the real exchange rate using alternative data sets over the period 1880–1997.
- 98/148: *Purchasing Power Parities in Five East African Countries: Burundi, Kenya, Rwanda, Tanzania, and Uganda*, Noureddine Krichene. Finds in five case studies that bilateral real exchange rates revert to a long-term equilibrium.
- 98/149: *Time-Series Analysis of Export Demand Equations: A Cross-Country Analysis*, Abdelhak Senhadji and Claudio Montenegro. Estimates export demand elasticities for developing and developed countries.
- 98/150: *European Trade and Foreign Direct Investment U-Shaping Industrial Output in Central and Eastern Europe: Theory and Practice*, Alexander Repkine and Patrick P. Walsh. Examines industrial output in four countries during 1989–95.
- 98/151: *Pension Developments and Reforms in Transition Economies*, Marco Cangiano and others. Reviews pension systems in 11 transition economies during the 1990s.

**Other Publications**

*Research Activities of the International Monetary Fund, January 1991–December 1997* (free). Comprehensive reference list categorized by major economic areas of research.

Publications are available from IMF Publication Services, Box XS800, IMF, Washington, DC 20431 U.S.A. Telephone: (202) 623-7430; fax: (202) 623-7201; e-mail: [publications@imf.org](mailto:publications@imf.org).

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



## Kazakhstan Follows Pragmatic Path in Restructuring Its Banking System

In pursuit of a stable, independent, and more market-oriented banking sector, Kazakhstan undertook a major restructuring of its banking system in 1992. Its first priorities were to reorganize the large state banks and tighten entry requirements for new banks. Having achieved a measure of stability by 1995, Kazakhstan turned its attention to broad regulatory and accounting changes and steps to enhance prudential and supervisory capabilities.

How was this wide-ranging reform structured and what lessons does it yield? David S. Hoelscher, the IMF's Resident Representative in Kazakhstan between 1996 and 1998, reviews the authorities' efforts in IMF

Efforts to rehabilitate the mining and metal industries proved most effective, with comprehensive downsizing and restructuring plans developed for all of the affected industries.

In the immediate aftermath of the Soviet era, banks had no limits on aggregate exposure to an individual or group of individuals, no required provisioning for nonperforming loans, inadequate accounting and reporting standards, and weak enforcement of existing prudential regulations. In 1994, the NBK took the first steps to bring its standards more in line with international ones. It instituted a minimum capital requirement of \$500,000 for banks taking household deposits, established a risk-weighted capital asset ratio of 8 percent, and lowered the limits on loans to individual shareholders to 20 percent of the bank's assets and to 40 percent for a single borrower.

But even these intermediary steps could not be met by a large portion of the banking system. Recapitalization resources could not be raised in local capital markets, and few international investors sought bank shares. If the NBK were to close and liquidate all noncompliant banks, the system would have collapsed. The NBK opted instead to give banks added time to develop rehabilitation programs that would permit them to conform with prudential requirements, complementing this forbearance with enhanced surveillance.

During 1993–95, the financial position of the large banks improved somewhat, largely reflecting the removal of nonperforming loans. Notwithstanding these improvements, however, nonperforming loans accounted for an estimated 55 percent of all commercial loans at the end of 1995.

### Operational Restructuring, 1995–97

With an immediate crisis averted and the rapid expansion of the banking system checked, the NBK focused on creating an appropriate regulatory and institutional framework, supported by technical assistance from the World Bank and the IMF. These reforms included:

**Legal Reform.** Although some reforms in central bank, foreign exchange, and commercial bank operations had taken place in 1993, important limitations remained. In 1995, the authorities began to address these limitations through a series of presidential decrees that clarified property rights and established norms for enterprise reorganization, out-of-court settlement procedures, and creditor rights. In early 1997, a new bankruptcy law defined the reorganization and liquidation process and allowed for a court-appointed liquidator with wide powers.

### Commercial Banks and Branches

	State	Joint-Venture <sup>1</sup>	Other	Total	Branches <sup>2</sup>
1991	...	...	...	72	...
1992	...	...	...	158	890
1993	...	...	...	184	952
1994	3	10	178	191	1,022
1995	3	7	120	130	1,036
1996	4	8	89	101	949
1997	4	8	71	83	...

<sup>1</sup>Foreign participation greater than 50 percent.

<sup>2</sup>Excluding the 4,480 offices of People's Bank.

Data: National Bank of Kazakhstan

Working Paper No. 96, *Banking System Restructuring in Kazakhstan*, and concludes that the restructuring helped stave off a generalized banking system failure and has led to a banking regulatory and supervisory framework that increasingly reflects international standards. Full recovery of the banking sector, however, depends on continued macroeconomic stability and the recovery of the corporate sector.

### Early Steps

In its first steps to restructure the banking system, the National Bank of Kazakhstan (NBK) sharply increased the minimum capital required to establish a new bank and significantly slowed the authorization of new banks. A systematic evaluation of the banking system eventually resulted in the liquidation of 60 banks—most of them small with negative reported capital.

To deal with the significant portion of nonperforming loans in the portfolios of state banks, the authorities created several asset management companies (AMCs). In 1994, loans totaling the equivalent of 11 percent of GDP were shifted from the originating banks to newly created debt resolution agencies that specialized in rehabilitating large mining and metallurgical enterprises and agricultural and foreign export credit loans.



**Accounting Reform.** To address the poor quality of accounting and financial disclosure, a new chart of accounts for commercial banks was introduced and an intensive training program begun in 1995. By late 1997, all banks had shifted to the new chart.

**Prudential Standards.** In 1995, new regulations on liquidity, lending limits, insider transactions, reserve requirements, loan classification, and loan loss reserve requirements were introduced that brought Kazakhstan more in line with international practice. As before, the financial condition of the banks made it all but impossible for most of them to meet the new requirements immediately. The NBK acknowledged the need for a lengthy period of supervisory forbearance but insisted on a full and accurate classification of loans and required banks to draw up a business plan, with monitorable benchmarks, to meet the remaining requirements within five years. Failure to meet any benchmark would result in intensified supervision, intervention by the NBK, and, possibly, bank closure.

**Bank Supervision.** To address supervisory deficiencies, the NBK dramatically expanded the number and training of its supervisory staff, centralized much of the supervisory work, created an off-site analytical unit, and established a separate unit to handle the liquidation of commercial banks. The NBK also intensified on-site inspections and developed a full range of enforcement measures.

**Banks “Too Big to Fail.”** Kazakhstan’s banking system remains, highly concentrated. The NBK was concerned that the failure of any one of the five largest banks could endanger the banking system. Four of the five did experience serious financial difficulties during 1993–97, necessitating the extension of emergency credit. To qualify for the support, the banks had to adopt a comprehensive restructuring plan that entailed provisioning for nonperforming loans and development of a recapitalization plan. During restructuring, most activities of these banks were curtailed. Operating costs were reduced through downsizing, and internal credit and risk analysis procedures were improved.

### Impact of Restructuring

Kazakhstan did not experience a systemwide collapse despite growth in nonperforming loans, large-scale liquidation of small banks, and failure of several large banks in 1996. This resilience, suggests Hoelscher, may be attributable to the fact that household deposits were concentrated in People’s Bank (widely perceived to have an implicit government guarantee) and enterprise deposits were concentrated in banks with close ties to those enterprises. Furthermore, Kazakh banks did not have large exposures in the interbank market. As a result, there was limited contagion from bank failures.

## Banking Sector Restructuring: Lessons from Experience

The complex process of restructuring a banking system entails identifying and liquidating nonviable banks, reversing insolvency and poor profitability in insolvent but viable banks, modernizing the regulatory environment, and restructuring supervisory institutions. Successful restructuring should leave the remaining banks strong and the banking system better able to weather individual bank failures.

The increased frequency of banking sector crises throughout the world and the efforts of both industrial and developing countries to redress or prevent these crises have yielded important lessons. Among these lessons are:

**Program Design and Implementation.** Successful restructuring efforts typically rely on a detailed diagnosis of the causes of the crisis and employ a comprehensive restructuring strategy to address individual bank and systemic weaknesses. Removal of obstacles to banking sector efficiency, such as interest rate controls, high reserve requirements, and tax system distortions, is an important part of effective restructuring efforts. This broad approach to restructuring necessitates coordination among a variety of government agencies and sometimes leads to the creation of a temporary specialized institution.

**Individual Bank Restructuring.** Bank insolvency—a stock problem—requires financial restructuring of the bank, while poor profitability—a flow problem—requires operational restructuring.

**Financial Restructuring.** Financial restructuring, which is intended to improve a bank’s balance sheet and increase its net worth, can be achieved by working with debtors to develop a loan repayment schedule for nonperforming loans (a task that sometimes entails the creation of a specialized workout unit); transferring nonperforming loans to an asset management company; injecting new capital; or writing down liabilities or converting debt to equity.

**Operational Restructuring.** If a bank is to remain solvent and restore its profitability, the environment in which it operates must be improved. A strengthened operational framework may require changes in bank management, improved internal evaluation procedures, strengthened loan recovery procedures, and new measures to reduce costs. Operational restructuring is difficult to design and time-consuming to implement, but it is an essential element in successful bank restructuring.

**Banking System Restructuring.** The climate in which banks operate must be sound and macroeconomic conditions must be stable. Among the systemic reforms that should accompany improved performance at the individual bank level are the creation of rules to govern the exit and entry of banks; enhanced competition and market discipline; clear and enforceable bankruptcy procedures; adequate and enforceable corporate, contract, and accounting laws; modern and enforceable bank regulation and supervision; and prudential rules that reflect the realities of capital markets and modern banking services. Crisis- and restructuring-related costs should be allocated in a transparent and equitable manner.



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Despite progress in stabilizing macroeconomic conditions and in bank restructuring, the banking system's role in financial intermediation remains limited. Financial intermediation—as evidenced by deposits and commercial bank credit as a percentage of GDP—dropped drastically between 1992 and 1994 and has yet to recover to anything approaching levels now evident in Eastern Europe or the Baltics. The low levels in Kazakhstan reflect, in part, the lack of private sector confidence in the banking system. “The continued existence of nonviable banks together with the lack of transparency in financial statements made households reluctant,” Hoelscher notes, “to hold resources in the banking system.”

Conditions in the real sector also contributed to the low levels of financial intermediation. Commercial banks had little incentive to mobilize deposits to lend to private ventures because of difficulties identifying clients, poor accounting practices, and inadequate information about the enterprises.

### Lessons Learned

Kazakhstan largely succeeded in restructuring its banking system, and several lessons can be gleaned from its experience:

**Sequencing.** The restructuring process did not begin with a comprehensive plan to deal with the financial problems of individual banks and the country's weak legal and regulatory environment. For a variety of reasons—many of them pragmatic—priority was given to financial restructuring. But the continued operation of a large number of undercapitalized and nonviable banks posed a threat to the system's overall stability and colored private sector perceptions of the system's viability. An earlier commitment to operational restructuring and enforcement of prudential norms could have produced a more streamlined banking sector and improved private sector confidence in financial entities.

**Banking and Enterprise Reform.** In Kazakhstan, banking sector reform outpaced enterprise reform; ideally, they should be coordinated. Given the uneven pace of reform in the two sectors, the banking sector tended to concentrate its activities on short-term, low-risk operations to avoid the relatively high-risk enterprise sector. As a result, banks developed a weak client base and enterprises were unable to raise needed resources. Closer coordination between banking and enterprise reform could have strengthened both sectors.

**NBK as Lead Agency.** The lead role taken by the NBK resulted in an emphasis on supervision and prudential regulation. Given scarce qualified personnel and other constraints, the government had little choice in a lead agency, but linkages with complementary areas, such as enterprise reform, suffered as a consequence.

**Prudential Norms.** The NBK recognized the importance of modernizing prudential norms but was equally cognizant of the need for considerable supervisory forbear-



An oil and gas refinery in Kazakhstan. Much of the corporate lending in Kazakhstan goes to natural resource-based industries.

ance. The practical course it followed placed a premium on transparency. Nonperforming loans were required to be adequately provisioned, but banks were allowed time to meet other prudential requirements. The NBK effectively combined forbearance with clear expectations, enhanced monitoring, and adequate enforcement.

**Operation of AMCs.** Kazakhstan's AMCs gave priority to restructuring existing enterprises rather than rapidly closing and liquidating nonviable enterprises. Delays in identifying nonviable enterprises absorbed scarce government resources and slowed the emergence of a vibrant private enterprise sector. The AMCs would have been more effective had insolvent firms been closed quickly, their assets sold off, and nonperforming loans liquidated.

**Preventing a Banking Collapse.** Kazakhstan's avoidance of a generalized bank system failure had its roots in two key factors: an extremely limited interbank market and the NBK's explicit policy of providing only emergency liquidity and refusing to bail out insolvent banks. For “banks too big to fail,” the NBK typically insisted on a change of bank management or conservatorship, implementation of wide-ranging restructuring policies, and a ban on participation in a broad range of banking activities. Ultimately, Kazakhstan's experience suggests that generalized banking failure can be prevented through a “combination of avoidance of moral hazard, appropriate restructuring policies, and limits on risk-taking by existing banks in the system,” Hoelscher finds.

Copies of IMF Working Paper 98/96, *Banking System Restructuring in Kazakhstan*, by David S. Hoelscher, are available for \$7.00 from IMF Publication Services. See page 381 for ordering information.