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IMF Economic Forum

Exchange Regime Transitions, Boom-Bust Cycles Play Key Roles in Financial Market Turbulence

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Participants in the IMF Economic Forum, "Financial Markets: Coping with Turbulence," concluded that while turbulence is a feature of present-day markets, much could be done to make financial sectors more resilient.

The recent turbulence in financial markets has had an extraordinary global impact. The sweep and complexity of the crisis has prompted numerous diagnoses and proposed cures from a broad range of professions. On December 1, an IMF Economic Forum gathered a panel of practitioners from central and commercial banks, investment funds, and the IMF to examine key topics, notably how to diagnose the causes of turbulence more effectively; how to give more attention to critical, but perhaps underappreciated, elements in the crisis, namely, exchange regime transitions and boom-bust cycles; what might be a role

(Continued on the following page)

$18 Billion Package

IMF Approves Stand-By Credit for Brazil; Activates New Arrangements to Borrow

In a press release issued on December 2, the IMF announced approval of an $18 billion package in support of the Brazilian government's economic and financial program. The text of the press release follows.

The IMF approved Brazil's request for a three-year Stand-By credit equivalent to SDR 13.0 billion (about $18.1 billion) in support of the government's economic and financial program. The Stand-By credit is equivalent to 600 percent of Brazil's IMF quota of SDR 2.2 billion (about $3.0 billion). To help finance Brazil's drawings under the credit during the first year, the IMF also approved the first activation of the New Arrangements to Borrow (NAB).

Of the total credit, 70 percent—or SDR 9.1 billion (about $12.7 billion)—will be made available under the Supplemental Reserve Facility (SRF) (see Press Release No. 97/59, *IMF Survey,* January 12), and the remainder through the IMF's regular lending facilities. Through end-1999, the equivalent of SDR 11.3 billion (about $15.7 billion) will be made available, of which SDR 3.8 billion (about $5.3 billion) is available immediately.

Subject to implementation of the key fiscal measures and the completion of a review by the IMF Executive Board, a further SDR 3.3 billion (about $4.5 billion) would be available under the SRF by end-February 1999. However, this tranche could be brought forward at the request of the Brazilian authorities and subject to approval by the Executive Board. There are two further disbursements under the SRF, each in the amount of SDR 1.3 billion (about $1.8 billion), and each available subject to reviews currently scheduled to be completed by May 31, 1999, and August 31, 1999. Depending on circumstances and subject to the completion of these reviews, these two disbursements could also be brought forward to as early as March 1, 1999, and June 1, 1999, respectively, at the request of the

(Continued on page 389)

Financial Market Turbulence

(Continued from front page) for capital controls; and what lies ahead for emerging markets.

The discussion, moderated by Shakour Shaalan, an IMF Executive Director, featured the participation of Peter Fisher, Executive Vice President of the U.S. Federal Reserve Bank of New York; Desmond Lachman, Managing Director of Emerging Markets Economic Research for Salomon Smith Barney; Arminio Fraga, Managing Director of the Soros Fund Management LLC; and Charles Adams, Assistant Director of the IMF's Research Department.

The panel agreed that turbulence is, and will likely remain, a feature of financial markets. The wisest strategy, they said, is to develop policies and institutions that make financial sectors more resilient.

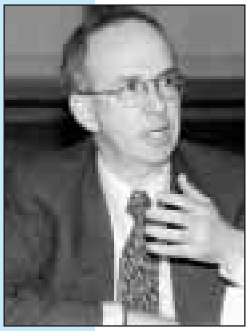
Peter Fisher: Exchange rate regime transitions are not as simple as excusing yourself from the dinner table.

Diagnosis

The handling of the financial crisis has suffered, Peter Fisher observed, from a premature formulation of conclusions before the root causes were fully understood. Analysis of the crisis has also labored under a decidedly unhappy mixed metaphor: contagion has been identified as the problem, and architecture has been prescribed as the remedy, but, as Fisher remarked, "buildings don't stop germs."

Fisher preferred to focus on the biological or medical metaphor. He viewed the markets as an interaction of independent organisms in a highly complex ecosystem, with the natural order producing a continuous adjustment process with a range of equilibriums.

Some of these equilibriums might be distinctly unpalatable—the biological equivalent of a disease—but nothing was gained, he said, by introducing moral judgments into the diagnosis. As economists, our duty, he suggested, should be similar to a doctor's—first, do no harm. This does not mean neglecting regulation or not pursuing changes in global capital flows, but economists should, he said, "understand acutely the incentive structures in this ecosystem" when they propose remedies.



Desmond Lachman: Post-crisis reforms should include much closer IMF surveillance.

Desmond Lachman, agreeing that a correct diagnosis was a crucial step in prescribing the proper remedy, nonetheless stressed that the dimensions of the crisis had not afforded the luxury of a careful, considered diagnosis. The massive capital movements, extraordinary drying up of liquidity, and sharp rise in spreads on emerging market assets all signaled a major and fast-moving crisis.

He had other concerns about the architecture solution. While it was hard to disagree with the staple ingredients of the new architecture proposals (greater transparency, better bank supervision, and more—and more timely—statistics), they had, he said, the ring of a Group of Seven statement after the Mexico crisis to them. He preferred to see much closer IMF surveillance that provided judgments to the market in a more timely fashion.

Charles Adams also argued that the dimensions of the Asian crisis and the rapidity with which it developed made dealing with it and coming up with solutions the first order of business. With time, he said, we should be able to rethink the approaches used and address some of the fundamental questions about the nature of the problems and possible cures. He was convinced that the global nature of the crisis was likely to induce an effort to identify systemic problems and prescriptions and to move beyond problems in individual countries.

Exchange Regime Transitions

A key area for rethinking, according to Fisher, is the role of exchange regime transitions. The customary focus on optimal regimes may have led everyone to underestimate the complexities and profound implications of the transitions between regimes. In a banded exchange rate regime, central banks provide constant liquidity and comfort; in a floating regime, their role is almost exactly the opposite, with interventions meant to inflict pain and to shock market participants into behaving differently. The transition between these two regimes requires a complete change in modus operandi. It is not, he wryly pointed out, "a problem of excusing yourself politely and getting up from the table to leave a dinner party."

The extensive discussion over whether fixed or floating rates are preferable struck Fisher as a "hollow debate." Using an insurance metaphor, he examined how the cost of exchange rate volatility is borne in both regimes. In a completely open float, such as New Zealand's, the private sector insures itself; in a system such as Hong Kong SAR's, the public sector assumes the risk and collects insurance premiums through a currency board with high interest rates and the opportunity costs associated with holding large resources.

Both systems can work well. It is the "in-between variants," Fisher observed, that have proved difficult. The banded regime in which the government provides an implicit insurance guarantee and an insurance policy, but does not collect sufficient premiums, is an insurance company setting itself up for a fall.

Adams concurred that it is the transition stage that is most fraught with peril. In Asia, countries with relatively stable dollar exchange rates moved, at the time of crisis, to freely floating rates and experienced enormous difficulties with unhedged foreign exchange exposures. Many of us, he said, would like to have seen discrete, orderly adjustments, but in several cases these did not occur early, and international reserves dipped to dangerously low levels. And with confidence having dropped already, adjustment, when it did take place, occurred "in anything but the most desirable circumstances." Transitions must be done in a timely manner, but the complex issue is how these transitions are brought about and how systems can be prepared to deal with exposures and foreign exchange risk, he added.

Lachman observed that one lesson he expected to emerge from the Asian crisis is that there is a steep price for holding on to an exchange rate peg too long. He was convinced that there were only two logical alternatives—a currency board or a flexible system with a free flow of capital.

Arminio Fraga, sidestepping the transition question, raised the intriguing possibility that one aspect of the exchange rate problem might be "too many currencies." He suggested there were benefits to moving to fewer currencies and relying more heavily on common currencies. Among the possible rewards, he said, are greater discipline and credibility.

Fisher expressed some skepticism about the solution of fewer currencies. He preferred to examine instead the enormous rise in the standard of living (the cost of inflation notwithstanding) that had accompanied the rise of fiat (government-controlled) money. But Adams was at least partially in accord with Fraga, citing his own rising concern over the ability of smaller countries to "manage some of this noise in the system." There might be some value, he thought, in weighing the merits of a reduced number of currencies or a more formal rigid peg within regional exchange rate zones.

Can Boom-Bust Cycles Be Avoided?

Boom-bust cycles have characterized this century, according to Fraga, and it seems reasonable to assume they will not be completely eliminated any time soon. But if they cannot be avoided, the lessons of experience also suggest their amplitude can be lessened through sound policies and prompt and appropriate responses to their warning signs.

Boom-busts typically begin with abundant liquidity, although the specific roots of the trouble often differ from country to country and are difficult to pinpoint. In the past decade or two, they have had their origins in consumption booms (Mexico), investment booms (Asia), and budget deficits (Latin America in the 1980s).

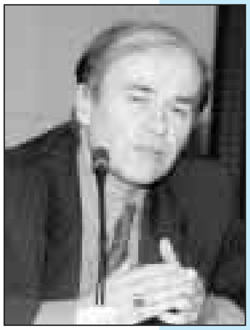
If the long-term roots are frequently country- or region-specific, signs of imminent danger tend to be universal. When maturities start to shorten, trouble is around the corner. The actual crisis may be triggered by a reversal of monetary policy or a major default—it hardly matters, Fraga said, because the vulnerability is there and has set the stage for the crisis. As an investor, he explained, he looks for certain warning signals—among them, explicit and implicit budget deficits, weak financial intermediation practices, bad perverse incentives, and politics (it is common, he noted, for governments, operating on short time horizons, to do "some silly things").

If boom-bust cycles are unavoidable, does contagion matter? Probably not, Fraga argued. In his experience, sound economies weather the contagion. Contagion is, in any case, positive as well as negative. Investor sentiment can spill over for good and ill. It is the boom-bust cycle that must be managed, he concluded, and the IMF is right to place its emphasis on the financial sector.

Arminio Fraga: It is the boom-bust cycle that must be managed, not the contagion.

Adams concurred that boom-bust cycles seem to be a feature of market economies and noted that the boom part of the cycle may have garnered too little attention. Asia's boom was characterized by a compression of spreads across a wide range of debt instruments. The pricing structure of risk changed, and significant types of capital inflows went to particular countries. If the goal is to moderate the amplitude of boom-bust cycles, then identifying the elements of, and dealing with, the buildup becomes a crucial task. Adams noted several elements—the very large highly leveraged positions and the various plays of yield spreads that created vulnerability and fragility this year. Russia, by prompting a reevaluation of default risk, and Malaysia's imposition of capital controls, by affecting transfer risk, appeared to trigger the most recent period of unprecedented turbulence.

For the emerging markets, Adams said, the message should be to make their financial markets as resilient as possible and perhaps examine the scope for various forms of prefunding and contingent conditions (looking at the Argentine experience).



Charles Adams: Any capital controls should be used as part of a broader effort to strengthen prudential regulation.

Case for Capital Controls?

The extreme volatility of capital movements throughout various phases of this crisis has made some converts to the cause of Chilean-style controls (taxes) on short-term flows. Lachman, citing his experience on Wall Street, questioned the economic purpose of the large volume of short-term flows across borders and favored looking for some price-based means of regulating them. Fraga, too, agreed that the crisis has spurred interest in learning how to deal with short-term capital flows as a policy matter, but he cautioned about the dangers of taking Chile's experience out of context. Chile was doing a lot of things right, he said, so identifying exactly what role the controls played could be problematic.

Indeed, Adams said, he preferred to see Chilean-style controls, if used, coming as a part of a much more comprehensive effort to strengthen prudential regulation as well as liquidity and risk management. The incentives to avoid these taxes are high, he warned, and controls on short-term flows will never obviate the need to pursue necessary underlying improvements. Also, any controls on short-term flows need to be implemented carefully to avoid stunting the growth of the financial sector.

Markets are still concerned about whether Asia is addressing its structural problems.

– Lachman

It is important, too, Fisher observed, to not misrepresent Asia's "experiment" with the free flow of capital. Short-term capital flowed freely, he noted, but there was no free flow of capital in the ownership of the financial sector. "You're importing the risk pool of capital globally for some purposes and not for others. And then you get caught in a mismatch." A true experiment in capital flows would need to encompass the different layers of capital.

Prognosis for Emerging Markets

What's ahead for the emerging markets? Adams noted that, after Russia, the markets saw a very sharp and fairly indiscriminate blowout of spreads across a whole range of countries, and new external financing for many emerging markets "effectively ground to a halt" for a couple of months following this phase of the crisis. After interest rate actions by several major central banks and an IMF financial package for Brazil, the situation seemed to stabilize, he said. Spreads are starting to come down, capital markets are beginning to reopen for some emerging markets, and new financing is coming back, albeit on a "subdued scale," but the situation remains fragile.

What is of particular concern to the marketplace, Lachman said, "is whether or not the structural problems in Asia are being addressed with the forthrightness that they demand if we are to avoid a Japanese-type of situation where countries are stuck at a very low level of growth."

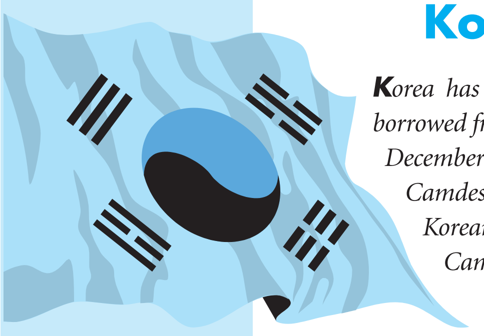
Fraga, commenting on the recent actions of the U.S. Federal Reserve and Japan, said that the tide may have turned, but standard banking procedures are still likely to be at work. Capital flows are likely to resume "when they are no longer necessary," he quipped. Ultimately, he believed, there may be a need for the IMF and the World Bank to lend in countercyclical fashion, and there may indeed be, as has been much discussed of late, a role for a true international lender of last resort.

What may also give policymakers and would-be architects food for thought is whether, as Fisher noted, the nature and dimensions of this global financial crisis have not pointed to critical disparities between the sophisticated and emerging markets within the global environment. Over the past 15–20 years, Fisher said, the industrial country financial firms have worked very hard to improve their risk management. These firms do occasionally get into trouble, but more typically they have demonstrated an aptitude for using their rapid, accurate, efficient risk management systems to adapt quickly and remain robust. But this agility in managing risk may have made the world in which emerging market banks operate more challenging. ■

Sheila Meehan
Senior Editor, *IMF Survey*

$2.8 Billion Repayment

Korea to Make Repurchases Under SRF



Korea has decided to begin repaying resources borrowed from the IMF. In a news brief issued on December 9, IMF Managing Director Michel Camdessus welcomed this decision by the Korean government. Following is the text of Camdessus's comments.

Since entering into a Stand-By Arrangement with the IMF on December 4, 1997, Korea has significantly strengthened its external position and has built up usable reserves to about $47 billion. Korea has also successfully lengthened the maturity structure of its external debt, while the record current account surplus has allowed the won to strengthen considerably during 1998. In light of Korea's reduced vulnerability at this time, it is entirely appropriate that the country begin to repay resources borrowed from the IMF. I am therefore pleased that the Korean government is in a position to make Supplemental Reserve Facility (SRF) repurchases as expected of $2.8 billion in December 1998. I believe that the international financial community will judge this repayment favorably and that it marks an important watershed in the process of Korea's emergence from last year's foreign exchange crisis. The IMF, of course, stands ready to assist all its members, including Korea, should there be a need for new borrowings in the future. ■

IMF Approves Stand-By Credit for Brazil

(Continued from front page) Brazilian authorities. The remaining IMF financial support would be available on a quarterly basis, starting with SDR 543 million (about $755 million) after February 28, 1999, and the rest through the remainder of the program.

The IMF is financing SDR 9.1 billion of the total of SDR 13.0 billion by borrowing the equivalent amount under the NAB, which became effective on November 17, 1998 (see Press Release No. 98/57, *IMF Survey,* November 30). Calls on the lending participants will be made in proportion to the amounts in the table (see page 390) and in line with drawings by Brazil under the SRF.

Since its inception in July 1994, Brazil's *Real Plan* has been instrumental in promoting a remarkable and sustained reduction of inflation, in combination with significant growth of real GDP per capita—a performance that contrasts sharply with the stagnation of real incomes and high inflation of the 1980s and early 1990s. Progress in achieving macroeconomic and financial stability was accompanied by substantial structural reforms. These reforms contributed to a recovery of domestic investment, a surge of foreign direct investment, and significant productivity growth.

The public finances, however, continued to be beset by fundamental weaknesses, made more evident by the progressive disappearance of the inflation tax. As a result, the primary balance of the consolidated public sector—including all levels of government, the central bank, and public enterprises—shifted from a surplus equivalent to 5.3 percent of GDP in 1994 to a deficit of about 1 percent of GDP by 1997. The sharp decline in public sector savings—only partly redressed by a recovery of private savings—was reflected in a deterioration of the external current account balance—from near equilibrium in 1994 to a deficit equivalent to 4.1 percent of GDP by 1997. This, in turn, heightened Brazil's vulnerability to external shocks and to sudden changes in market sentiment.

Strong external pressures developed after the Russian devaluation in mid-August 1998. The government responded swiftly by sharply raising interest rates, taking emergency measures to reduce the 1998 federal budget expenditures and the federal enterprises investment program, and creating a high-level interministerial commission to closely monitor the public finances and propose corrective measures as needed. The authorities also announced in September, ahead of the presidential elections, the intention to put in place a front-loaded three-year fiscal adjustment program with growing primary surpluses sufficient to stabilize the ratio of the public debt to GDP by the year 2000. They also intensified the dialogue with the international financial institutions and other members of the international financial community to gain support for their adjustment program.

Program Objectives

The authorities' medium-term economic program is centered on fiscal adjustment and structural reform and is expected to allow the resumption of sustained growth in real per capita income beginning in the year 2000, following a likely decline in 1999; the continuation of low inflation; and a gradual improvement of the current account deficit to a level fully sustainable over the medium term. The main elements of the program are:

Brazil: Selected Economic Indicators

	1995	1996	1997	1998[1]	1999[1]
			(percent)		
Change in real GDP	4.2	2.8	3.2	0.5	–1.0
Change in consumer prices (12 months)	17.8	9.3	7.5	1.5	2.0
			(percent of GDP)		
Public sector borrowing requirement	7.2	5.9	6.1	8.1	4.7
Primary balance of the federal government	0.6	0.4	–0.3	0.5	1.8
Net public debt	30.5	33.3	34.5	43.3	46.7

[1] Estimates.

Data: Brazilian authorities and IMF staff estimates

- a strong and front-loaded fiscal adjustment effort—with most of the fiscal adjustment expected to occur in the first half of 1999—aimed at arresting quickly the rapid growth of the public sector debt;
- maintenance of the current exchange rate regime;
- a firm monetary policy stance, aimed at supporting the exchange rate regime, while safeguarding net international reserves; and
- wide-ranging structural reforms.

The macroeconomic scenario underlying the fiscal program assumes that confidence will be rebuilt gradually, as the announced measures are implemented and begin to improve the fiscal accounts and as access to foreign financing improves for Brazil, as well as other emerging market borrowers. Under this scenario, interest rates are assumed to remain relatively high, albeit declining, through the first half of 1999 and to further decline beyond this period. Real GDP growth is expected to recover to 3 percent and 4 percent in 2000 and 2001, respectively.

Fiscal Adjustment

The government's fiscal adjustment program aims at broadly stabilizing the ratio of the net public debt to GDP by the year 2000 and reducing it gradually thereafter in accordance with the achievement of primary surpluses of the consolidated public sector equivalent to 2.6 percent of GDP in 1999, 2.8 percent in 2000, and 3 percent in 2001. Under these assumptions, the public sector borrowing requirements (PSBR) would decline to about 4.7 percent of GDP in 1999, and further to about 3 percent in 2000, and to 2 percent in 2001. All levels of government are expected to contribute to the fiscal adjustment effort.

To achieve the targeted improvement at the federal level, the government has announced a comprehensive set of revenue-raising and expenditure-reducing measures designed to yield overall savings to the budget on the order of 3.4 percent of GDP in 1999. On the revenue side, measures include increases in the financial transactions tax and in social security contributions by public employees. On the expenditure side, the measures include substantial cuts in discretionary current and capital spending, as well as savings expected from the implementation of the recently approved constitutional reforms of the civil service and of social security. In the allocation of the expenditure cuts, the government has endeavored to safeguard social programs as much as possible.

Brazil: Stand-By Arrangement
Proposed Calls Under the NAB
(million SDRs)

Participating Member or Institution[1]	Credit Arrangements	Total Proposed Calls
Australia	810	237
Austria	412	120
Belgium	967	283
Canada	1,396	408
Denmark	371	108
Deutsche Bundesbank	3,557	1,039
Finland	340	99
France	2,577	753
Hong Kong Monetary Authority	340	99
Italy	1,772	518
Japan	3,557	1,039
Kuwait	345	101
Luxembourg	340	99
Netherlands	1,316	385
Norway	383	112
Singapore	340	99
Spain	672	196
Sveriges Riksbank	859	251
Swiss National Bank	1,557	455
United Kingdom	2,577	753
United States	6,712	1,961
Total[2]	**31,200**	**9,117**

[1] Excludes participants that have opted out under Paragraph 7A (c) of the NAB decision.
[2] Totals may not add because of rounding.

Structural Reforms

The Brazilian authorities fully recognize that a sustainable improvement in public sector finances requires fundamental structural reforms to address long-standing weaknesses in the budget process, the tax system and the tax administration, public administration, social security, and the efficiency of public expenditure, especially in the social area.

To these ends, the government intends to introduce a number of reforms in the budget process aimed at strengthening budget discipline at all levels of government and making the budget a more effective instrument for allocating public resources. A centerpiece of this effort will be the Fiscal Responsibility Act, which will be submitted to congress shortly.

To complete the recently approved administrative reform, the government has already submitted to congress various enabling laws and regulations that should ensure that reforms begin to produce effects during 1999. The government has also just announced a comprehensive reform of the system of indirect taxation.

Following the recent approval by congress of a constitutional amendment on social security reform, the authorities intend to introduce early next year complementary legislation to deepen the reform, with a view to putting social security finances on a sound footing and increasing the fairness of the system, while broadening the scope for individual choice.

In the past few years, the Brazilian government has undertaken one of the most ambitious privatization programs in the world. In 1999, the program will include companies in the electrical sector; power generation and distribution; some of the remaining state banks; and some water, gas, and sewage public utilities.

The authorities recognize that well-targeted and efficient social expenditure programs play a vital role in the alleviation of poverty and in the development of human capital. The government intends to give priority to primary education and basic health care in the allocation of social expenditures, to promote more efficient use and financing of health and education—particularly at the higher levels—and to better target social expenditures to the poor.

Additional Financing

In addition to the IMF funding in support of the Brazilian program, the President of the World Bank has indicated his readiness to recommend for the Bank Board's approval the provision of up to $4.5 billion in support of Brazil's program. Similarly, the President of the Inter-American Development Bank (IADB) has also recommended to his Board an IADB support package of $4.5 billion.

Brazil's program will also receive bilateral support from a number of industrial countries in North America, Europe, and Asia, whose governments or central banks will provide through, or in coordination with, the Bank for International Settlements (BIS) additional financing totaling approximately $14.5 billion. This additional amount will be available over the next 12 months. The first disbursement will be proportional to Brazil's first drawing from the SRF resources under the credit.

Brazil is an original member of the IMF. Its outstanding use of IMF credit currently totals SDR 7.8 million (about $11 million). ■

Sharp Fall in Import Prices Helps Shape U.S. Inflation Performance

The long expansion that has characterized the U.S. economy since 1991 has been exceptional in that unemployment has fallen to relatively low levels without exerting the kind of upward pressure on prices that would be expected based on historical relationships. For policymakers charting the future course of the U.S. economy, it is particularly crucial to understand why this phenomenon has occurred.

The debate on the subject has been centered on the question of whether there have been changes in the structure of the U.S. economy that might suggest a permanent lowering in the country's natural rate of unemployment (which is the rate of unemployment consistent with a relatively stable inflation rate) or whether the current favorable price environment is simply the product of a series of fortuitous, but transient, factors that could be reversed.

In the IMF Working Paper, *Explaining the Recent Behavior of Inflation and Unemployment in the United States*, Vincent Hogan, formerly of the IMF's Western Hemisphere Department, examines why the historic relationship between unemployment and inflation failed to accurately predict inflation performance in the past few years. He finds that a decline in the natural rate of unemployment might explain some of the error in predicting inflation, but that a more convincing hypothesis is that the United States has benefited from favorable supply shocks, reflecting a combination of the dollar's appreciation, commodity price declines, and, more recently, the effects of the Asian crisis on U.S. import prices.

Historically, U.S. inflation has followed a fairly predictable course in relation to U.S. economic upswings: rising during expansions, peaking slightly after the end of booms, and declining during recessions, before picking up again as the economy reached capacity during the ensuing expansions. A traditional Phillips curve suggests that there is a negative relationship between inflation and the unemployment gap (measured as unemployment in excess of the natural rate, which provides an indicator of how close an economy may be to its full capacity). Since the 1990s, however, both inflation and

Recent IMF Publications

Books

Australia: Benefiting from Economic Reform, Anoop Singh and others ($25.00). Surveys Australia's long-term economic performance and the results of successive reform agendas.

Trade Reform and Regional Integration in Africa, edited by Zubair Iqbal and Mohsin S. Khan ($22.00). Papers presented at the IMF African Consortium Seminar, December 1997.

Occasional Papers ($18.00; academic rate: $15.00)

No. 173: *The Baltic Countries: From Economic Stabilization to EU Accession*, Julian Berengaut and others. Surveys economic developments and policy challenges in the Baltic countries since 1994–95.

Working Papers ($7.00)

98/152: *The Effects of Tax Wedges on Hours Worked and Unemployment in Sweden,* Alun Thomas. Investigates the relationship between labor taxation and unemployment in Sweden.

98/153: *Monetary Policy in a Small Open Economy with Credit Goods Production,* Jorge A. Chan-Lau. Analyzes the effects of monetary policy in a small open economy with cash and credit goods production.

98/154: *Are Currency Crises Predictable? A Test*, Andrew Berg and Catherine Pattillo. Explores whether three pre-1997 models for predicting currency crises could have predicted the Asian crisis.

98/155: *Financial Market Contagion in the Asian Crisis*, Taimur Baig and Ilan Goldfajn. Tests for evidence of contagion between the financial markets of Thailand, Malaysia, Indonesia, Korea, and the Philippines.

98/156: *Soft Exchange Rate Bands and Speculative Attacks: Theory and Evidence from the ERM Since August 1993*, Leonardo Bartolini and Alessandro Prati. Presents a model of a soft target zone to capture key aspects of the wide-band ERM intervention policy.

98/158: *Fiscal Effects of the 1993 Colombian Pension Reform,* Sergio Clavijo. Examines the fiscal impact of the Colombian pension reform adopted in 1993.

98/159: *Capital Flows with Debt- and Equity-Financed Investment: Equilibrium Structure and Efficiency Implications*, Assaf Razin and others. Distinguishes between debt and equity flows in the presence of information asymmetry.

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the unemployment gap have fallen, and, consequently, empirical estimates of the traditional Phillips curve equation have consistently overpredicted inflation by a significant margin during the period 1994–97.

Natural Rate of Unemployment

One possible explanation for the inability of a traditional Phillips curve equation to accurately predict inflation is that the natural rate of unemployment may have fallen, and hence, the estimated unemployment gap understates the size of the actual gap. If the natural rate of unemployment has indeed fallen, that would be very good news for the U.S. economy, since a higher level of resource utilization (lower unemployment rate) could be realized without triggering an inflationary response.

Hogan notes that a standard model of the natural rate of unemployment suggests that, in recent years, the natural rate has fallen below 6 percent, and this would have contributed to a more favorable inflation performance. However, the estimates of the natural rate that the model generates, although lower than the natural rate estimates commonly derived in the early 1990s, are still consistently higher than actual recorded rates of unemployment. Hence, there would remain an expectation that inflation should have picked up in recent years, instead of declining slightly.

Favorable Supply Shocks

An alternative explanation for the inability of a traditional Phillips curve equation to accurately predict inflation is the influence of favorable supply shocks. Hogan notes that since 1993 the rise in costs in the United States has been restrained by the effects of declining world commodity prices and a fall in import prices reflecting an appreciation of the U.S. dollar. Cost increases may also have been limited by a pick-up in U.S. labor productivity growth. To account for the effects of potential supply shocks, Hogan added variables including changes in the real price of oil, the dollar price of imported goods, and the real unit cost of labor to the Phillips curve equation. Replicating results found earlier by other researchers, he finds that the import price variable is highly significant, while labor unit costs remain insignificant.

This augmented Phillips curve equation performs much better than the traditional equation in explaining the behavior of inflation since 1993. The equation's predicted value for inflation has an average error close to zero over the period 1994–97 and no tendency to systematically overpredict inflation. This result suggests that recent U.S. inflation performance has been much more the product of fortuitous supply shocks, most notably a fall in import prices, than a fundamental structural change in the U.S. economy. This hypothesis is further bolstered, Hogan observes, by an examination of how the prices of imports have changed over the last eight years. A dramatic fall in the relative price of imports coincides with the period for which the traditional Phillips curve overpredicts inflation. The relative unimportance of the real unit labor cost variable also suggests that rising productivity may not have been, as some researchers have suggested, a critical factor in determining the recent path of U.S. inflation. ■

Copies of IMF Working Paper 98/145, *Explaining the Recent Behavior of Inflation and Unemployment in the United States*, by Vincent Hogan, are available for $7.00 from IMF Publication Services. See page 391 for ordering information.

Camdessus Welcomes Paris Club Debt Relief for Honduras and Nicaragua

In a news brief issued on December 10, IMF Managing Director Michel Camdessus, who was participating in the Consultative Group meeting on the Reconstruction and Transformation of Central America at the Inter-American Development Bank (IADB), welcomed the actions by the Paris Club with respect to the external debt of Honduras and Nicaragua. The text of Camdessus's statement follows.

The actions by the Paris Club represent a clear demonstration of the international community's determination to ensure that external debt payments do not become an obstacle to reconstruction and modernization in Honduras and Nicaragua. As such, a deferral of all payments due to the Paris Club, pending more definitive treatment of their debt, fits into the broader assistance strategy. In this connection, the assistance committed to a Trust Fund to help cover multilateral debt-service obligations of these two countries is also welcomed.

In the case of Honduras, the IMF has already contributed to this overall strategy by ensuring flows of financial assistance through a SDR 47.5 million ($66 million) emergency credit; by making the maximum contribution possible (50 percent of quota) under its policies; and by disbursing the full amount of the emergency loan to support purchases of badly needed imports. In addition, the IMF staff is accelerating discussions with the authorities on an Enhanced Structural Adjustment Facility (ESAF) concessional loan early in 1999, which will provide financial support for strong economic policies for reconstruction and growth. In Nicaragua, which already has in place an ESAF program, we expect to review the economic situation in early 1999, focusing in particular on the emerging larger balance of payments requirements.

Moreover, the staffs of the IMF, World Bank, and IADB will prepare a comprehensive assessment of the external debt situation of Nicaragua and Honduras and related requirements for debt relief in the context of the HIPC [heavily indebted poor countries] Initiative early next year.

Visit to Ecuador, Central America

Camdessus Gives Assurances of IMF Support to Economies Devastated by Hurricane Mitch

From November 13 to November 20, IMF Managing Director Michel Camdessus visited five Latin American countries—Ecuador, Nicaragua, Panama, El Salvador, and Honduras. Of these countries, Honduras and Nicaragua were most affected by the devastation caused by Hurricane Mitch.

The Managing Director began his visit in Ecuador, where he held discussions with the authorities that focused on, among other issues, the economic impact of the El Niño weather phenomenon and the sharp decline in world oil prices. In addition to holding discussions with government officials and leaders of the main political parties, the Managing Director met with representatives of the business and banking communities, trade unions, indigenous groups, and civic leaders.

In Nicaragua, where the IMF has been providing support since March 1998 through a program under the Enhanced Structural Adjustment Facility (*IMF Survey*, April 6, page 107), Camdessus was able to assess the devastation caused by the hurricane through a visit to a shelter for fishermen who had lost their homes on the shores of Lake Managua, during which he reviewed the needs of the dispossessed with community leaders. He then discussed with President Arnoldo Alemán ways to develop a national consensus for a reconstruction program. Camdessus had productive meetings with members of the national assembly, business and labor leaders, and with Cardenal Obando y Bravo. He also met with President Jacques Chirac of France, who was visiting the country. During his visit to Panama City, he delivered the keynote speech to the convention of the Federation of Latin American Banks (*IMF Survey*, November 30, page 375) and discussed the country's economic program with President Ernesto Pérez Balladares and his economic team.

Honduras was the country most affected by the devastation caused by Hurricane Mitch. In the course of his visit, Camdessus was able to see firsthand areas of the capital city of Tegucigalpa where whole communities had been obliterated by mud and sand brought down by flooded rivers. Initial estimates are that losses of inventories and fixed assets amount to some 40 percent of GDP. Real GDP growth could fall to 3 percent in 1998 and turn negative in 1999, from 5–6 percent a year in pre-hurricane projections. The Managing Director assured President Carlos Roberto Flores and other Honduran authorities that the IMF and its staff were committed to supporting the country in addressing the crisis. In addition to meeting government officials, Camdessus met a number of community groups and nongovernmental organizations. He also participated with Archbishop Oscar Andrés Rodriguez in a Workshop on National Unity, where he made a presentation on transparency and social development.

During a visit to Nicaragua to assess the damage done by Hurricane Mitch, IMF Managing Director Camdessus (right) and French President Chirac meet with Nicaraguan President Alemán.

Following the Managing Director's visit, the IMF Executive Board approved, on December 7, a $66 million loan to Honduras under the IMF's emergency assistance policy to help meet the immediate needs of the government's recovery and rehabilitation program (see press release, page 397).

The issue of whether the IMF might assist in providing debt relief for Nicaragua and Honduras was raised during the Managing Director's meetings with the press in both countries. He explained that while debt reduction was an element in the overall strategy for recovery, it could account for only a small part of the much larger financing requirements for reconstruction in the wake of the hurricane. The effective implementation of appropriate economic policies and the efficient and transparent use of international aid were essential for continued international financing, he stressed. In calling for a major reconstruction effort in both countries, he said that the objective was to build more modern and equitable societies, rather than merely rebuild the previous systems.

The Managing Director's final stop was in El Salvador, where hurricane damage, though significant, was relatively less extensive than in Honduras and Nicaragua. The Managing Director discussed with President Armando Calderón the good economic performance of the country in recent years under successive Stand-By Arrangements with the IMF. ■

Photo Credits: Denio Zara and Padraic Hughes for the IMF, pages 385–87 and 396; Oswaldo Rivas for REUTERS, page 393; B. Kavashkin, G. Slevis, and A. Sabalyauskas for Sovfoto/Eastfoto/PNI, page 399.

Corporate Debt in East Asia

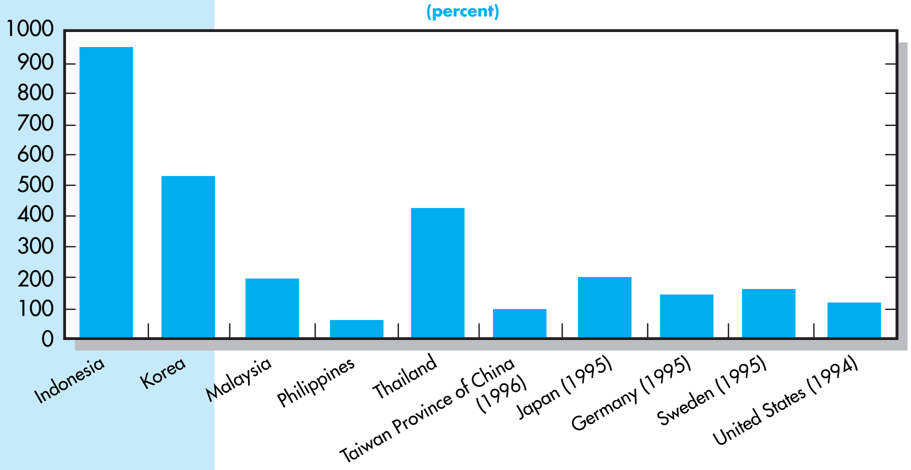
Comprehensive Framework and Government Involvement Are Key to Successful Restructuring

High levels of corporate debt are inhibiting recovery in the east Asian countries that are digging out from the regional crisis. Onerous debt-servicing costs threaten the solvency of corporations; credit to small enterprises is crowded out as banks feel obliged to roll over loans to large heavily indebted borrowers; and the adverse effect of higher interest rates on highly leveraged corporate balance sheets limits the scope for monetary policy. Moreover, the debt overhang is self-perpetuating: the recession prevents corporations from deleveraging by retaining earnings or issuing equity, but the high level of debt is prolonging the recession.

Governments in east Asia are taking steps to restructure corporate debt, but the challenges debt restructuring poses are formidable. A recent study, *Corporate Debt Restructuring in East Asia: Some Lessons from International Experience*, by Mark Stone of the IMF's Asia and Pacific Department, derives some general principles for debt restructuring from past experience and applies the lessons learned from these experiences to east Asia.

East Asian and Other Countries: Corporate Debt-Equity Ratio, 1998

(percent)



Data: IMF, *Corporate Debt Restructuring in East Asia: Some Lessons from International Experience*

Comprehensive Frameworks

Corporate debt restructuring aims at a timely and orderly transformation and reduction of debt. The goal is to enhance profitability, reduce leverage, and restore credit to viable enterprises. To ensure that creditors and debtors have incentives to restructure debt, the approach must be tailored to individual economic, institutional, and political circumstances The approach can range from a case-by-case effort led by banks to a comprehensive framework requiring government involvement.

For the east Asian countries, a case-by-case approach to corporate debt restructuring led by banks is not feasible, because banks have limited experience with loan workouts, low capital adequacy ratios, and a history of government influence and poor supervision. Further, the legal, tax, and regulatory infrastructure needed for debt restructuring was not in place when the crises erupted.

A comprehensive debt restructuring framework involving the active participation of the government is called for when, as in east Asia, corporate debt problems are widespread or have macroeconomic consequences, when market failures inhibit the debt restructuring process, and when banks are short of the capital and expertise needed to work out debt on a large scale. Extensive financial reform is also needed in these circumstances, because bank and corporate balance sheets are intertwined. Further, a workable bankruptcy law is essential to give debtors an incentive to cooperate.

Comprehensive corporate debt restructuring consists of four segments:

- establishment of the appropriate macroeconomic, tax, and legal environment;
- formulation of the debt restructuring framework;
- triage, or the separation of the viable corporations for debt restructuring from the nonviable ones that should be shut down; and
- financial engineering, involving debt reduction and debt-equity conversions.

Formulation of the appropriate framework is, according to Stone, the most complex part of comprehensive debt restructuring. Frameworks may be divided into four overlapping categories that may be implemented at the same time. The categories in ascending order of government involvement are:

- *Government mediation*. Mediation between corporations and banks or between banks is warranted if banks cannot effectively lead bank restructuring, owing to market failures or other factors—such as excessive negotiating powers by either debtors or creditors, a lack of cooperation, or a lack of incentives for banks or corporations to work out debt arising from poor supervision and bad governance.
- *Government schemes*. Financial incentives to facilitate debt restructuring through a preset government-financed scheme can be useful if corporate debt problems are pervasive and impose negative externalities on the economy at large—such as a credit squeeze or cutoff of external financing. However, the government must trade off the fiscal costs of the scheme against the benefits of more expedient restructuring for the players involved and the lowering of negative externalities.

• *Direct bank recapitalization by the government*. This approach is warranted if corporate debt problems are pervasive enough to undermine the health of the banking system and if banks are willing and able to work out debt on their own.

• *Government asset management corporation*. If the number of troubled corporations is large, microeconomic factors severely inhibit debt restructuring, and bank-led debt restructuring is infeasible, a government-financed asset management corporation may be warranted. Such a corporation can buy bad loans, provide equity to banks and corporations, negotiate with debtors, and take an active financial and operational role in restructuring. An asset management corporation can also serve as an out-of-court bankruptcy mechanism, if bankruptcy courts are ineffective.

General Lessons

Stone derives several general lessons applicable to east Asia from a review of corporate debt restructuring undertaken by various countries since the 1980s—Mexico in the early 1980s and again in 1995–97, Chile during the early and mid-1980s, the United Kingdom, where the "London Approach" has been in use since 1989, Hungary during 1991–95, and Poland during 1993–96.

A healthy and stable economic and institutional environment is crucial to the success of corporate debt restructuring, according to the author. Preconditions include:

• *Macroeconomic stability*. Debt restructuring makes the need for entrenched macroeconomic stability more urgent, because stable prices, interest rates, and exchange rates are needed to give debtors, creditors, and potential investors enough certainty to value and close transactions. Macroeconomic stability proved to be a precondition for debt restructuring in Mexico in 1995 and in the transition countries.

• *Financial reform*. Banks should have enough capital to give them the leverage to write off debt without widening spreads and to negotiate with large creditors on equal terms. At the same time, supervision should be improved to ensure that banks have incentives to work out debt. Limits on banks' exposure to their largest borrowers can help establish an arm's-length relationship. Financial reform accelerated restructuring in Mexico in the 1980s and in Poland.

• *Removal of tax and regulatory disincentives to restructuring*. Taxes that penalize debt forgiveness and loan-loss provisioning and restrictions on foreign ownership should be removed, and legislation to remove impediments to debt-equity swaps should be enacted. New incentives should be temporary to avoid erosion of the tax base and have sufficient safeguards to prevent abuse.

• *Bankruptcy procedures*. Effective procedures are needed to work out debt outside a formal framework and ensure that credit is not absorbed by nonviable firms. The absence of effective bankruptcy procedures slowed restructuring in transition countries and in Mexico in 1995.

• *Corporate governance* must be brought up to international standards. Effective governance is needed to push managers not only to restructure debt but to operate profitably and thereby avoid future reschedulings. Accurate, timely, and accessible financial information on corporations is essential.

Debt Restructuring Framework

International experience also offers lessons for the circumstances under which each framework is appropriate and points out the pitfalls to be avoided.

• *Government mediation* is appropriate if debt restructuring is limited and the environment is supportive. This approach offers flexibility and adaptability but requires a credible government mediator, macroeconomic stability, and the appropriate regulatory setting—all of which are attributes of the United Kingdom, where the London Approach has been successful.

• *Government schemes* can be useful if the level of debt is high enough to impose negative externalities, such as a credit squeeze or a cutoff of external financing, or if market or regulatory failures slow the debt restructuring process. There are important pitfalls, however, including politicization and overly generous and long-lasting incentives, as in Chile.

• *Bank recapitalization* is warranted under similar conditions as for government schemes but where banks are better qualified to work out debt. However, recapitalization creates a fresh moral hazard problem: banks may have the incentive to gamble the new capital on risky loans in the expectation that they will again be recapitalized if these loans do not pay off, as in Bulgaria and Hungary. Thus, recapitalization should be complemented by measures that improve bank supervision and governance, as in Poland, especially if banks end up owning a large share of the corporate sector. Tying bank recapitalization to specific measures to restructure corporate debt, again as in Poland, can be helpful.

• An *asset management corporation* is warranted to address systemic debt restructuring if bank-led debt restructuring is infeasible, but this approach has its own pitfalls. An asset management corporation should not try to attain multiple goals but should aim at maximizing loan recovery, avoid politicization, and be sufficiently funded. The government should avoid recapitalizing banks through the asset management corporation by paying above-market prices for bad loans, as in Chile and Mexico in 1995–97, because this is not transparent.

Corporate Debt Restructuring in East Asia

The systemic crisis of the corporate sector in east Asia originated in the interaction between an aggressive export-oriented growth strategy initiated in the 1970s and the system of corporate governance and financing. Government-controlled banks directed loans to chosen export-oriented industries, while regulatory barriers constrained the issuance of bonds, limiting the role of foreign banks. Bank borrowing was dominated by a small number of conglomerates, dominated in turn by a handful of owners unconstrained by international standards of corporate governance.

Changes in policy coupled with international capital market integration in the 1980s increased the riskiness of corporate balance sheets. At the same time, high domestic growth and the lifting of restrictions on foreign borrowing triggered a surge of capital inflows that resulted in overleveraging of poorly supervised banks and corporations. Corporations were lulled into a false sense of security by stable exchange rates pegged to the U.S. dollar and did not hedge their foreign currency exposure.

The regional crisis that began in mid-1997 buffeted corporate balance sheets and cash flow. Domestic banks were no longer willing or able to provide financing. Corporations were further squeezed by the drop-off of capital inflows, which also resulted in large exchange rate depreciations that increased the cost of servicing foreign debt. At the same time, higher interest rates raised domestic debt-servicing costs, and profits were hit by falling demand. As a result, already high corporate debt-equity ratios in east Asia rose to levels well above the international norm (see chart, page 394).

Recognizing that the high level of corporate debt is inhibiting recovery, governments in east Asia are taking the first steps toward debt restructuring. Reviewing the experiences of Indonesia, Korea, Malaysia, and Thailand, Stone finds that these efforts have concentrated on improving the macroeconomic and institutional setting: financial markets have been stabilized in most countries; financial sector reform, including bank recapitalization, is well under way; corporate governance and accounting standards have been enhanced; tax and legal disincentives for debt restructuring are being removed; and bankruptcy procedures have been revised. Several countries have established government schemes to improve incentives for debt restructuring, and all of them are recapitalizing banks. They have also set up an asset management corporation and created frameworks involving various degrees of government mediation.

The process of debt restructuring itself is now in train in east Asia. It remains to be seen, Stone concludes, whether a more active government role will be needed to enhance restructuring incentives. ■

Copies of IMF Paper on Policy Analysis and Assessment (PPAA) 98/13, *Corporate Debt Restructuring in East Asia: Some Lessons from International Experience*, by Mark R. Stone, are available for $7.00 from IMF Publication Services. See page 391 for ordering information.

IMF Announces Senior Staff Appointments

IMF Managing Director Michel Camdessus has appointed G.E. Gondwe as Director of the IMF's African Department, Ernesto Hernández-Catá as Associate Director of the African Department, and Yusuke Horiguchi as Associate Director of the Asia and Pacific Department. All three appointments are effective December 9, 1998.

G.E. Gondwe, Director of the African Department.

Ernesto Hernández-Catá, Associate Director of the African Department.

Yusuke Horiguchi, Associate Director of the Asia and Pacific Department.

Gondwe, a national of Malawi, received his degree in economics at Makerere College of the University of London. He held various positions at the Reserve Bank of Malawi, becoming General Manager in 1969. Between 1970 and 1972, he served as Under-Secretary at the Ministry of Finance and from 1972 to 1973 was Secretary to the Treasury. He became an Executive Director at the African Development Bank in 1973, was appointed Vice President of the Bank in 1976, and its Acting President in 1979. Gondwe joined the IMF in 1980 as an Advisor (Assistant Director) in the Administration Department, became a Senior Advisor in the same Department in 1983, and was appointed Deputy Director of the African Department in 1984. Gondwe succeeds Evangelos A. Calamitsis, who retired on November 30, 1998.

Hernández-Catá, a U.S. national, received his Ph.D. in economics in 1974 from Yale University. In 1971, he joined the IMF's Western Hemisphere Department, where he held various positions until 1987, except for 1976–79, when he served in the Board of Governors of the U.S. Federal Reserve System. Reappointed in the IMF's Research Department as Advisor in 1987, he served as Deputy Director in the Research Department in 1991, in the European II Department in 1992, in the Western Hemisphere Department in 1994, and in the African Department in 1997.

Horiguchi, a national of Japan, received his Ph.D. in economics from Rice University in 1971. After working at the Organization for Economic Cooperation and Development, he joined the IMF in 1978 and held various positions in the African, European, and Western Hemisphere Departments prior to his appointment as Senior Advisor in the Central Asian Department in 1991. He became Deputy Director of the European II Department in 1994, and Deputy Director of the European I Department in 1997. As Associate Director, Horiguchi will join Hubert Neiss, Director of the Asia and Pacific Department. ■

From the Executive Board

Following are excerpts of recent IMF press releases. Full texts are available on the IMF's website (www.imf.org) under "news" or on request from the IMF's Public Affairs Division (fax: (202) 623-6278).

Haiti: Emergency Assistance

The IMF approved Haiti's request for emergency financial assistance related to natural disasters. The assistance, equivalent to SDR 15.2 million (about $21 million), will support the government's economic recovery program and associated relief and rehabilitation efforts in the aftermath of Hurricane Georges.

In late September, Hurricane Georges struck Haiti, causing extensive damage. An estimated 240 people died and tens of thousands were left homeless. The main destruction occurred in rural areas, as heavy flooding and high winds caused substantial damage to crops and livestock, as well as to economic and social infrastructure, including bridges, roads, irrigation systems, hospitals, and schools. The slow rehabilitation of the infrastructure and the lack of such agricultural inputs as seeds threaten a quick recovery of agricultural production.

In fiscal year 1998/99, the authorities plan to maintain prudent macroeconomic policies and make further progress in the structural area, while dealing with the damage caused by Hurricane Georges. The 1998/99 program, also being monitored by IMF staff, is predicated on 2 percent output growth and aims at maintaining inflation at about 8 percent and keeping an adequate level of official international reserves, while incorporating 0.8 percent of GDP of public spending for hurricane relief and reconstruction.

The authorities are committed to implementing their fiscal program, which would provide for urgent reconstruction expenditures while maintaining fiscal discipline. On the revenue side, they are committed to taking steps to strengthen tax and customs administration and tighten the administration of tax exemptions. On the expenditure side, to help make room for hurricane reconstruction expenditures, the authorities intend to limit government spending to revenue collection and programmed financing, restrict the use of ministerial discretionary accounts, phase in civil service wage increases consistent with donor-backed sectoral policy reforms, tighten procedures for hiring government employees, and restrict low-priority, non-hurricane-related capital outlays.

Haiti joined the IMF on September 8, 1953, and its quota is SDR 60.7 million (about $84 million). Haiti's outstanding use of IMF financing currently totals SDR 28 million (about $38 million).

Press Release No. 98/58, November 30

Honduras: Emergency Assistance

The IMF approved Honduras's request for emergency financial assistance related to natural disasters. The assistance, equivalent to SDR 47.5 million (about $66 million), will support the government's economic recovery program and associated relief and rehabilitation efforts in the aftermath of Hurricane Mitch.

The devastation caused by the hurricane has been unprecedented in terms of loss of life, personal property, infrastructure, and the economy. First approximations by the authorities indicate losses of inventories and fixed assets—including infrastructure—amounting to about 40 percent of GDP. Real GDP is estimated to fall to 3 percent in 1998 and turn negative in 1999, compared with pre-hurricane projections of real GDP growth of about 5–6 percent a year.

The authorities' prompt response to the crisis has focused on addressing—with substantial help from the international community—the immediate priorities of providing food, shelter, and health care to the homeless and displaced persons; taking measures to preserve public health; repairing essential infrastructure; and beginning cleanup and reconstruction work. At the same time, the authorities are beginning to adopt measures aimed at limiting the effects of the disaster on inflation and interest rates and setting the stage for economic recovery. A revised central government budget for 1999 is being formulated to take account of the changed outlook for government revenue and the new spending requirements, while every effort will be made to limit domestic financing in part by reallocating spending to emergency needs.

As soon as the immediate priorities have been addressed, the authorities are determined to resume discussions aimed at finalizing an economic program that could be supported

Members' Use of IMF Credit
(million SDRs)

	Nov. 1998	Jan.–Nov. 1998	Jan.–Nov. 1997
General Resources Account	**1,139.90**	**15,229.67**	**7,099.60**
Stand-By Arrangements	347.75	7,580.49	4,270.94
SRF	0.00	5,125.00	0.00
EFF Arrangements	792.15	5,492.63	2,721.05
SRF	0.00	675.02	0.00
CCFF	0.00	2,156.55	107.60
ESAF Arrangements	**28.54**	**740.52**	**637.72**
Total	**1,168.44**	**15,970.19**	**7,737.32**

Note: SRF = Supplemental Reserve Facility
EFF = Extended Fund Facility
CCFF = Compensatory and Contingency Financing 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 30	3.85	3.85	4.12
December 7	3.69	3.69	3.95

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).

Data: IMF Treasurer's Department

under the Enhanced Structural Adjustment Facility (ESAF) and that is focused on the consolidation of macroeconomic stability, on increasing prospects for private investment, and on deepening structural reforms to address constraints to growth.

Honduras joined the IMF on December 27, 1945, and its quota is SDR 95.0 million (about $133 million). Honduras's outstanding use of IMF financing currently totals SDR 33 million (about $45 million).

Press Release No. 98/60, December 7, 1998

The Extended Fund Facility provides assistance for adjustment programs over longer periods than under Stand-By Arrangements.

Stand-By, EFF, and ESAF Arrangements as of November 30, 1998

Member	Date of Arrangement	Expiration Date	Amount Approved	Undrawn Balance
			(million SDRs)	
Stand-By Arrangements			**19,834.17**	**4,042.06**
Bosnia and Herzegovina	May 29, 1998	May 28, 1999	60.60	36.36
Cape Verde	February 20, 1998	April 19, 1999	2.10	2.10
Djibouti	April 15, 1996	March 31, 1999	8.25	1.95
El Salvador	September 23, 1998	February 22, 2000	37.68	37.68
Estonia	December 17, 1997	March 16, 1999	16.10	16.10
Korea[1]	December 4, 1997	December 3, 2000	15,500.00	2,175.00
Latvia	October 10, 1997	April 9, 1999	33.00	33.00
Philippines	April 1, 1998	March 31, 2000	1,020.79	823.42
Thailand	August 20, 1997	June 19, 2000	2,900.00	700.00
Uruguay	June 20, 1997	March 19, 1999	125.00	125.00
Zimbabwe	June 1, 1998	June 30, 1999	130.65	91.45
EFF Arrangements			**24,414.26**	**15,536.23**
Argentina	February 4, 1998	February 3, 2001	2,080.00	2,080.00
Azerbaijan	December 20, 1996	December 19, 1999	58.50	17.56
Bulgaria	September 25, 1998	September 24, 2001	627.62	523.02
Croatia, Republic of	March 12, 1997	March 11, 2000	353.16	324.38
Gabon	November 8, 1995	March 7, 1999	110.30	49.63
Indonesia	August 25, 1998	November 5, 2000	4,669.10	2,566.70
Jordan	February 9, 1996	February 8, 1999	238.04	35.52
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	398.06
Panama	December 10, 1997	December 9, 2000	120.00	80.00
Peru	July 1, 1996	March 31, 1999	300.20	139.70
Russian Federation[1]	March 26, 1996	March 25, 2000	13,206.57	7,426.86
Ukraine	September 4, 1998	September 3, 2001	1,645.55	1,400.00
Yemen	October 29, 1997	October 28, 2000	105.90	87.90
ESAF Arrangements			**4,580.98**	**2,301.00**
Albania	May 13, 1998	May 12, 2001	35.30	29.42
Armenia	February 14, 1996	February 13, 1999	101.25	33.75
Azerbaijan	December 20, 1996	December 19, 1999	93.60	23.40
Benin	August 28, 1996	August 27, 1999	27.18	18.12
Bolivia	September 18, 1998	September 17, 2001	100.96	84.13
Burkina Faso	June 14, 1996	June 13, 1999	39.78	6.63
Cameroon	August 20, 1997	August 19, 2000	162.12	81.06
Central African Republic	July 20, 1998	July 19, 2001	49.44	41.20
Chad	September 1, 1995	April 28, 1999	49.56	8.26
Congo, Republic of	June 28, 1996	June 27, 1999	69.48	55.58
Côte d'Ivoire	March 17, 1998	March 16, 2001	285.84	202.47
Ethiopia	October 11, 1996	October 10, 1999	88.47	58.98
The Gambia	June 29, 1998	June 28, 2001	20.61	17.18
Georgia	February 28, 1996	February 27, 1999	166.50	27.75
Ghana	June 30, 1995	June 29, 1999	164.40	68.50
Guinea	January 13, 1997	January 12, 2000	70.80	23.60
Guyana	July 15, 1998	July 14, 2001	53.76	44.80
Haiti	October 18, 1996	October 17, 1999	91.05	75.88
Kenya	April 26, 1996	April 25, 1999	149.55	124.63
Kyrgyz Republic	June 26, 1998	June 25, 2001	64.50	53.75
Macedonia, FYR	April 11, 1997	April 10, 2000	54.56	27.28
Madagascar	November 27, 1996	November 26, 1999	81.36	54.24
Malawi	October 18, 1995	December 31, 1998	45.81	15.27
Mali	April 10, 1996	August 5, 1999	62.01	10.34
Mongolia	July 30, 1997	July 29, 2000	33.39	27.83
Mozambique	June 21, 1996	August 24, 1999	75.60	12.60
Nicaragua	March 18, 1998	March 17, 2001	100.91	84.09
Niger	June 12, 1996	September 1, 1999	57.96	9.66
Pakistan	October 20, 1997	October 19, 2000	682.38	454.92
Rwanda	June 24, 1998	June 23, 2001	71.40	59.50
Senegal	April 20, 1998	April 19, 2001	107.01	89.18
Tajikistan	June 24, 1998	June 23, 2001	96.00	78.00
Tanzania	November 8, 1996	November 7, 1999	161.59	38.76
Uganda	November 10, 1997	November 9, 2000	100.43	43.52
Yemen	October 29, 1997	October 28, 2000	264.75	176.75
Zambia	December 6, 1995	December 5, 1998	701.68	40.00
Total			**48,829.40**	**21,879.29**

[1] Includes amounts under Supplemental Reserve Facility.

EFF = Extended Fund Facility

ESAF = Enhanced Structural Adjustment Facility

Figures may not add to totals owing to rounding.

Data: IMF Treasurer's Department

Public Expenditure in Lithuania

Reforms Are Designed to Align Budgetary Practices With Those of EU Countries

In the context of a policy agenda intended to prepare the country for accession to the European Union (EU) and the North Atlantic Treaty Organization (NATO), the Lithuanian government has found it necessary to reform its management of public expenditures. These reforms, designed to align Lithuania's budgetary practices with those of EU member countries, include changes to the budgetary process, improvements in the cost-effectiveness of projects, and completion of a treasury system by the end of 1998.

Lithuania's drive for membership in the European Union and NATO has led to expenditure pressures in the medium term. Accession to these organizations requires that Lithuania upgrade its infrastructure, strengthen its public institutions substantially, and increase its military spending. The direct budgetary costs will depend on the share of the costs falling to the private sector—for example, through user fees—and the extent of EU financial support.

Another area of spending pressures is the pension system, whose financial position has worsened over time partly because of the low retirement age: 56 years for women and 60.5 years for men. Under the current law, it is scheduled to increase by four months for women and two months for men every year, until it reaches 60 years and 62.5 years, respectively. The system dependency ratio—defined as the ratio of pensioners to the working population—increased between 1990 and 1996 to about 56 percent from about 47 percent, as employment fell, the population aged, and more people took early retirement. During the same period, the average replacement ratio—the average pension in terms of the average wage—declined to 31 percent from 36 percent. Finally, health expenditures are likely to increase because the demand for health services increases as the population ages and because the real costs of medicines are rising.

Expenditure Management Reform

Recognizing the link between public sector performance and the overall performance of the economy, the government approved in April 1998 a number of changes to the budgetary process that were designed to strengthen budget preparation, reorient expenditure programs, and allocate spending according to medium-term policy priorities. The resulting regulations have, in part, served as the basis for amendments to the 1999 budget law.

Under the new system, the government intends, first, to increase the one-year time horizon of the state budget to three years. This extension will enable the government to assess the medium-term implications and sustainability of current trends and to adjust its expenditure policy accordingly. Second, specific funds to line ministries and their spending units will be allocated on the basis of a program budgeting concept (at present, allocations to individual spending units are based on increases over their previous budgets for given categories of spending). Expenditure requests—which would detail the annual total as well as the projected quarterly path—from the line ministries and spending units will be analyzed for both spending developments in the current year and expenditure requests for the following year. Initially, for the 1999 budget, three line ministries will be subject to program budgeting.

Vilnius, the capital of Lithuania. The Lithuanian authorities have made improving the cost-effectiveness of major programs and projects a top priority.

The ministry of finance would analyze cost overruns and implementation problems and identify discrepancies between planned and actual spending. These measures are similar to the efforts of a number of member countries of the Organization for Economic Cooperation and Development to improve their planning, budgeting, and implementation strategies and to assess program outcomes. Third, all funds that are traditionally outside the budget—that is, extrabudgetary funds—except the Social Insurance Fund, the Health Insurance Fund, and the Privatization Fund will eventually be included in the budget. Fourth, the budget will provide more information about the stock of debt contracted or guaranteed by the state and about onlending operations. Fifth, to overcome the problem of spending surges at the end of the year, the new budget structure envisages limiting spending by line ministries in the last month of the year. Sixth, to improve the transparency of the budgetary process, more information will be released to the public; for example, the proposed

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budget will be published before it is approved by the parliament.

The ministry of finance is also implementing a computerized treasury system to optimize the financial management of its operations. Through the new system, the ministry of finance will be better able to monitor and control its commitments and to centralize payments. Its establishment has already made available real-time information on the cash and debt positions of the majority of line ministries, actual expenditure payments, and revenue collected by all entities of the consolidated central government. The treasury system is expected to help the ministry of finance classify government operations by economic and functional category on a monthly basis. It will also allow the finance ministry to further strengthen its cash-flow forecasting, which, in turn, should provide a better basis for budget planning and expenditure management.

Lithuania: Summary of Consolidated General Government Operations by Economic Classification[1]

	1993	1994	1995	1996	1997
			(percent of total expenditure)		
Total expenditure	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
Current expenditure	86.4	91.9	86.0	91.5	92.1
Wages and salaries[2]	19.7	25.8	26.5	29.8	25.9
Goods and services[2]	30.2	28.7	26.7	24.0	29.8
Transfers	31.8	32.0	28.4	30.9	31.2
Subsidies	4.7	5.0	3.3	3.9	2.7
Interest payments	0.1	0.4	1.2	2.9	2.5
Capital expenditures	**11.2**	**11.7**	**11.0**	**8.5**	**7.9**
Capital transfers	7.9	8.7	8.5	6.8	5.5
Purchases of fixed assets	3.3	3.0	2.5	1.7	2.4
Net lending	**17.9**	**10.7**	**5.4**	**6.3**	**3.1**

Note: Totals may not add because of rounding.
[1] Including the state budget, municipal budgets, Social Insurance Fund and, from 1997, the Health Insurance Fund.
[2] From 1997, expenditures of the Health Insurance Fund are reclassified from wages and salaries to goods and services.

Data: Lithuanian Ministry of Finance and IMF staff estimates.

Remaining Agenda for Reform

Spending pressures, unless matched by expenditure cuts, are likely to result in growing tax burdens or fiscal deficits that could hinder efficiency and growth. To avoid such an outcome, Lithuania has made it a top priority to improve the cost-effectiveness of major programs and projects. One important aspect of this issue is how spending is divided between current and capital outlays and between wages and other current spending (see table). As in other transition economies of central and eastern Europe, the general government's share of capital outlays in total expenditure has been declining in the last few years (3.3 percentage points between 1993 and 1997), primarily because, in connection with the transition to a market-based system, the government is withdrawing from direct economic activities and responding to political pressure to maintain wages and other public benefits. At the same time, recent trends in the composition of expenditures indicate that current outlays are increasing. Wages and salaries, which have increased by about 10 percentage points since 1993, represent about a third of total expenditures.

The modernization of public infrastructure may require an increase in public capital expenditure. Additionally, increases in the share of government expenditures on capital—human and physical—may be necessary if Lithuania is to improve the long-run output potential of its economy. To some extent, investment in the provision of public goods can be financed through reductions in government net lending and guaranteed lending operations. Expenditure savings could also be realized through a medium-term strategy and realistic schedules for reducing and phasing out Lithuania's remaining subsidies. In developing such a strategy, the government could take into account the need for full commercialization of state enterprises and consider addressing redistributive needs through direct income transfers within the general social insurance and social assistance system. Also, a gradual reduction of the public sector borrowing requirements would lower debt-servicing expenditures.

By increasing the age of retirement—necessary for the long-term financial stability of the pension program and for relieving pressures on the state budget—Lithuania can avoid

- reducing benefit levels substantially,
- increasing the contribution rate, or
- perpetuating the practice of transferring funds, equal to more than 1 percent of GDP a year, from the state budget to the pension system.

Best international practices indicate that the expenditure side of budget preparation should both cover all government spending and prioritize it to improve governance, transparency, and accountability. Bringing all extrabudgetary funds into the budget, including the Social Insurance Fund and the Health Insurance Fund—which together account for 12 percent of GDP—would help Lithuania move forward with these goals.

Lithuania is in a position to establish firm management control over its budget administration and execution. Substituting explicit prioritization for expenditure allocation, which is based largely on a renewal of appropriations from previous budgets, will be a step in the right direction. By introducing explicit quantitative and qualitative goals for the composition of its expenditures into the annual budget, the government can adapt the composition of public spending to its medium-term objectives. ■

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