IMF SURVEY

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International Monetary Fund
VOLUME 29
NUMBER 12

June 19, 2000

In this issue

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IMF support focuses on participatory approach, 'inclusive growth'

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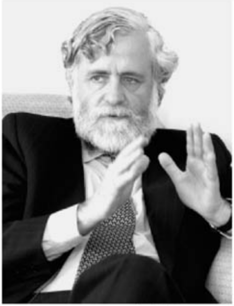

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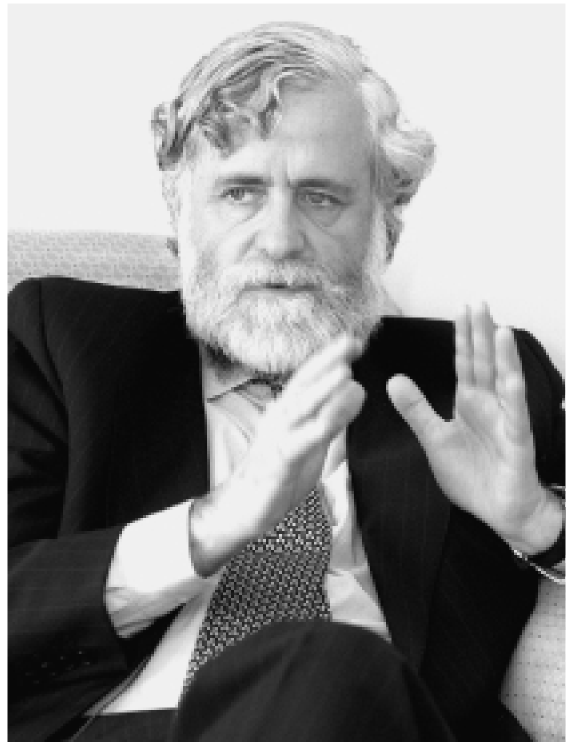

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—Aninat

(Continued from front page) tor and academia—has probably contributed to the development of abilities that help me cope with many of the more operational international development issues that we face today. From a practical point of view, my background helps me to contribute a certain way of decision making and vision within the collective of our management team. But, probably, my work during my six years as finance minister in Chile is most closely related to my work now.

IMF SURVEY: Since you have taken office, how has your perspective of the IMF as an institution changed?
ANINAT: Having been an "outsider" to the IMF—Chile repaid the IMF in full in 1994, during my first year as finance minister, and we did not have an active program during the rest of my term—I confess I viewed the IMF as more monolithic in its way of thinking than I have found it to be in practice. Far more full-fledged, very open discussion goes on in selected committees or in broad groups before final decisions are made by the Executive Board and management. So one way my perception has changed is in recognizing the broader, more analytical, and open way of proceeding here.

IMF SURVEY: How successful has the IMF been in adapting to evolving trends, such as globalization, and to recent financial crises? And do you see a major change in focus in the future for the IMF?
ANINAT: The IMF's most recent and hardest experience was certainly the Asian crisis, which spread to Russia and Brazil. The IMF learned a lot as an institution from this experience. One lesson was the importance of monitoring developments more closely in the financial arena. Another is that we need to work with governments and other agents and recognize when and how these problems arise. I see a very strong mandate for the IMF to focus more deeply on surveillance—macroeconomic and financial monitoring—including in the banking, insurance, and services areas.

The IMF has adapted and evolved through time in a second way: with streamlining and changes in its facilities and with its involvement (along with the World Bank) in the Heavily Indebted Poor Countries (HIPC) Initiative and the Poverty Reduction and Growth Facility (PRGF). Our core task is and will remain centered on the macroeconomic level.

But because the IMF is the main coordinating international decision-making body in the world, it is difficult at this stage of world development for the IMF to simply say "no, we only deal with balance of payments problems and monetary and fiscal diagnosis." The IMF is also a sort of "biological institution"; it has to evolve with the context from inside and outside.

IMF SURVEY: Among your responsibilities are relations with the international and regional organizations. What should be the relationship between the regional organizations and international ones like the IMF?
ANINAT: Shortly after I came on board, I had the welcome opportunity to attend a United Nations coordinating session in Rome, where all UN institutions, dependencies, offices, and units met in a common meeting. I represented the IMF's interests and reviewed the status of our collaboration and cooperation with the UN family. Two issues, in particular, struck me as being of importance. The first was security issues. We need to update our responses and review the new challenges that many of our mission teams face in politically complex regions, as well as in conflict, postconflict, and some of the transition countries.

The second issue is how to make the IMF's mandate and its everyday tasks better known to the international community—not just the UN. Sometimes—and this might sound a little critical—we carry too much of our work and our discussions within closed walls. We need to practice the art of politics, which is nothing less than employing didactics and education. As an organization, we should push to make the world better understand our mandate. We need to publicize our success stories more widely to show what this institution has accomplished for hundreds of countries around the world. In this way, we make institutions, such as the United Nations and others, more sensitive to our needs and perspectives.

IMF SURVEY: How would you assess the prospects for continued development in Latin America?
ANINAT: In the 1970s, Latin America had a moderate but still positive and respectable rate of GDP per capita growth. In the 1980s—which has been rightly called the "lost decade" because of the external debt problems and major macro shocks—average GDP per capita growth for Latin America was zero percent. In the 1990s, we have seen a robust recovery and progress on two main fronts—inflation and growth—as well as a lot of reforms and major technical assistance from the IMF, the World Bank, and other institutions.

The real test of all this progress is starting now—in the years stretching from 2000 to 2010. One big dimension is still lacking in Latin America: the pace of development in social areas. Without progress in this area, vulnerable citizens will be saying in the near future, "well, but what have I specifically gained from these reforms and this institutional reshaping?" We need *inclusive growth*: growth for most or all of the people, antipoverty measures, commitment to these measures, participation—not elite growth. This third stage is decisive for how the Latin American and Caribbean "semi-success" story will end in the medium term.

IMF Survey: People talk about the "Washington consensus" and say the IMF keeps pushing for a one-size-fits-all solution. Is this what you meant when you said you once perceived the IMF as being monolithic?

Aninat: OK, let's start with the Washington consensus. It was an interesting set of propositions and concepts, and clearly a positive one, but with some strategic flaws. First, they should never have called it a "Washington" consensus, because that has provoked a lot of image problems that could have been avoided if we had had a "Mexico," "Brasilia," or "Santiago" consensus.

Second, the Washington consensus was a necessary way of setting better policies, especially in the fiscal, monetary, trade, and direct investment areas. But it stopped short of the next stage of problems that we are focusing on now. Most Latin American governments, for example, now know how to set correct macro policies and what needs to be done to keep the macroeconomy in balance. But no model should be viewed as a closed-ended paradigm, because the world changes.

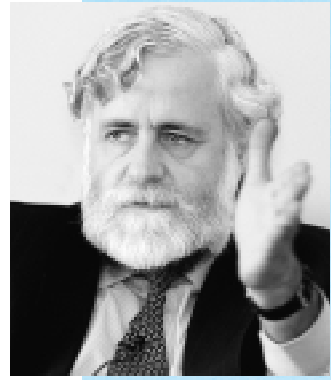
The Washington consensus certainly did not take account of many of the financial problems that have arisen since the Asian crisis—volatility, vulnerability, intense short-term capital inflows and outflows. Nor did it provide any important ideas for integrating the social issues we are now more concerned with into the mainstream

On these social issues, I have been working with [President] Enrique Iglesias from the Inter-American Development Bank on the Social Equity Forum. We expect to meet in the spring of next year in Santiago. The idea is to bring together again some 45 high-level policymakers—including former presidents of the region, academics, and people from the multilateral institutions—to examine what room there is to sharpen our social policies, given existing resources, to bias the results of economic growth more strongly toward better distribution of income and opportunities; better quality of employment creation; and more integration in the social sectors of the economy. The Social Equity Forum is discussing not whether growth is necessary—we all agree on that—or what the mechanics are for achieving faster growth, but the more interesting and very hard-core question: how do we get better-quality growth? People do not only count and live on the traditional measures of GDP; they now prioritize key intangibles, such as security in the streets, social community participation, and educational services.

IMF Survey: What answer should we give to those segments of civil society that claim organizations like the IMF are actually threats to the welfare of the poorest people and to the environment? Is the IMF doing enough to respond to its critics?

Aninat: First, we have to remember that the IMF is owned by its 182 member countries. Not one of these countries has said: "No, now I want to be out of the IMF. I reject the programs." So protest organizers are left with a puzzle: Should they direct their protests to the IMF or to the governments and central banks of member countries?

Second, cold statistics do not always provide the complete picture, but they help produce discussions that are objective, rather than subjective. If we avoid passion and look at the main statistics, we see that the world is in much better shape today than it was before the IMF existed or than in the 1960s and 1970s. In terms of inflation, growth, employment opportunities, and mobility of the people throughout the world, we have certainly made progress.



Third, the spirit of cooperation and collaboration needs to be underlined, because if this institution is owned by the world, then we have an obligation to listen with more open ears to what some of the civil society, nongovernmental organizations [NGOs], and labor movements have to say about us. But at the same time, our critics have to understand better what the actual functions of the IMF are and what the institution can and cannot do, based on its mandate, capacity, and resources. There is room for criticism and much room for improvement, but we have to be judged according to a fair standard.

IMF Survey: What would you hope to see come out of the large agenda facing the governors at the upcoming Annual Meetings in Prague?

Aninat: The spring meetings of the International Monetary and Financial Committee and Development Committee reinforced our understanding of the core task of the IMF and the World Bank. I saw a lot of declarations, discussions, and committees working for and supporting the IMF. All active participants called for a stronger IMF.

The task for the Prague meetings is to determine how to get a specific mandate from our governors and finance ministers, enabling us to effectively carry out these new responsibilities. For example, if we are to streamline facilities and make them more operational; if we are to enhance codes and standards; if we are to enter more into activities involving the global capital and financial markets, what political and resource support can our governors provide us? If we have a good solid week of discussions, committee meetings, and assemblies, we will get more precise guidelines of where our constituents want us to go in the coming year and into the longer term.

IMF Survey: One of your responsibilities in the IMF includes standards and financial system supervision and assessment. How do you see the IMF's role evolving in this area?

ANINAT: In this crucial area, we have been pursuing two sets of efforts. One is the use of macroprudential indicators as an active component of surveillance. The other is the Financial Sector Assessment Program [FSAP], which we are carrying out jointly with the World Bank and outside experts. This program is also related to our work on the reports on observances of codes and standards. All of these activities are being conducted in collaboration with international standard-setting bodies. What is the aim? The objective is to build up, gradually but with solid stepping-stones, a new international financial architecture that aims at further reducing the risk of systemic crisis. This work is a natural supplement to our core macro task of surveillance. It is crucial for the years to come.

IMF SURVEY: How effective are the HIPC Initiative and the PRGF in sustaining growth and reducing poverty?

ANINAT: Here we have an important venture by the IMF and the World Bank. The World Bank takes the lead, and naturally so, in the in-depth social work and accompanying sectoral indicators for the HIPCs. The IMF's PRGF provides the macro context within which these new debt-reduction programs, related to poverty issues, are now developed. The PRGF is thus a key instrument.

At the same time, we have to recognize a certain tension, in that these facilities have created a desire of some countries to move even faster on the debt-reduction provisions in the HIPC/PRGF and, at the same time, the need to direct the results of the debt reduction to the reduction of poverty. The IMF and the World Bank now face the special challenge of dealing with these tensions to advance to a deeper stage.

We also have to address some criticisms that have been directed at the new strategy of debt-reduction and poverty-reduction programs. These criticisms relate to areas over which the IMF has rather little control—the issues of ownership and governance in the recipient countries. We have seen a few cases in Latin America and in Africa where some programs have encountered slippages—fortunately now all being corrected and re-addressed. But here the IMF can play only an indirect role: we have to make sure that these macroframeworks are firmly in place, commitments are honored and monitored, and end results match desired aims. But these are not our programs. They are country programs, built with, it is hoped, the large and broad participation of civil society, including NGOs, in the recipient countries. In our dialogue with governments, we have to keep urging them to take stock of further commitments in delicate areas such as governance, participation in design, and focusing of the programs to true end beneficiaries. Basically, some of the criticism directed at the IMF and the World Bank really—and unfortunately—falls back onto some of the recipient countries. That is the plain, hard truth. ■

Köhler confers with Asian policymakers

(Continued from front page) of Finance and Economy Lee Hun Jai, and Bank of Korea Governor Chon Chol Hwan, Köhler commended the Korean government for implementing a structural reform program that has made the economy more open, competitive, and market driven. He cautioned, however, that there was no room for complacency with reform. Köhler also said that Korea's recovery from the exchange rate crisis of late 1997 was remarkable and has left the economy less vulnerable to economic shocks.

Köhler met, on June 4, with Indonesia's president Abdurrahman Wahid. At a press briefing following the meeting, Köhler said that a steady commitment by the government to implement economic reforms will strengthen the ailing rupiah. "The president and I fully agreed," Köhler told the press, "that the introduction of capital controls would be counterproductive," because such a decision would "deter foreign investors" and "hinder a sustained and broad economic recovery." (On June 2, the IMF agreed to resume economic assistance to Indonesia following a review of Indonesia's performance under a three-year Extended Fund Facility Arrangement (see News Brief No. 00/38, available on the IMF's website: www.imf.org).)

Visiting India on the last leg of his journey, Köhler warned against the country's growing fiscal deficit. Acknowledging that India has been one of the 10 fastest growing economies in the world over the past two decades, Köhler said that "there should be no complacency." India's most important short-term objective, Köhler said, should be fiscal consolidation. He also stressed at a press conference the need to strengthen the social sector to reduce poverty. Köhler termed India's objective of achieving an economic growth rate of 8–10 percent "ambitious but valid."

On his return to the United States, Köhler attended a meeting in New York, sponsored by the Institute of International Finance, with representatives of the private financial sector. The discussions focused on closer cooperation between the IMF and the private financial sector. ■

The full texts of News Brief Nos. 00/36, 00/37, 00/38, and 00/39 are available on the IMF's website (www.imf.org).

Council of the Arab States of the Gulf

GCC countries pursue reforms to diversify and to reduce vulnerability to oil price fluctuations

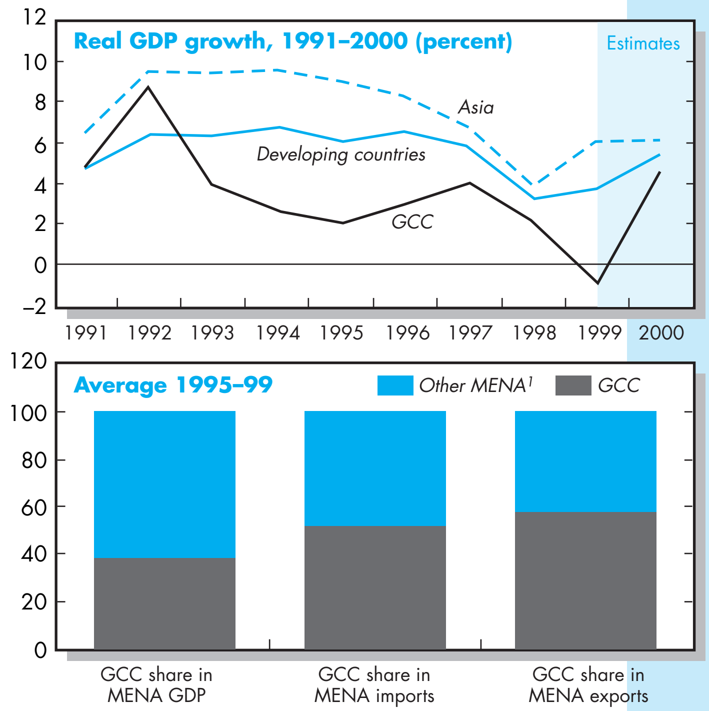
Members of the Council of the Arab States of the Gulf (GCC)—Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates (UAE)—hold a sizable portion of the world's energy resources and are major players in the global financial system. As macroeconomic stability and improvements in health and literacy attest, they have largely used their wealth wisely. But the volatility of their income from oil and gas poses a key test for their policymakers. This article reviews the GCC's performance, weighs the challenges ahead, and outlines the reforms needed to ensure stronger growth and more stable and vibrant economies.

Background

The GCC countries are endowed with sizable energy resources. As a group, they account for 44 percent of the world's proven reserves of crude oil and 15 percent of natural gas reserves. Their crude oil production and exports represent about one-fifth of the world's total output and one-fourth of exports. The GCC countries are also key players in the global international financial system, with large private and official assets invested in major financial markets. They are also major contributors to development assistance (either bilaterally or through multilateral institutions). On a regional level, the GCC countries account for a large share of output and total trade in the Middle East and North Africa (see chart) and are an important source of employment from the region and of transfers of worker remittances.

Benefiting from favorable terms of trade in the 1970s and much of the 1980s, the GCC countries used their sizable oil income to build modern physical infrastructures, improve the living standards of their populations, and accumulate financial wealth. Life expectancy in the GCC countries surpasses the world average; literacy rates exceed 70 percent; school enrollment covers 90 percent of the school-age population; the physician-population ratio is about seven times better than the world average; and infant mortality is less than half the world average. These achievements have been facilitated by abundant financial resources and small populations, but the GCC countries have also managed their oil-based economies relatively successfully compared with other mineral-producing developing countries. Early in their economic development, the GCC countries liberalized their trade and exchange regimes, opened their capital markets, and imported foreign labor, thus avoiding many of the costly distortions experienced by other developing countries. Their pegged exchange rate regimes (mostly to the U.S. dollar) provided a nominal anchor for their economies and helped them maintain low inflation rates. In the same vein, the open-door policy to foreign labor provided the skills needed to help develop non-oil activities at internationally competitive wage rates.

GCC: selected indicators



[1]Middle East and North Africa.

Data: IMF, *World Economic Outlook* and staff estimates

Key challenges

Nonetheless, the GCC countries face many important challenges in the period ahead. The main challenge is to reduce the vulnerability of their economies to fluctuations in international oil prices, enhance growth, and provide employment for their growing populations. While these challenges may appear similar to those faced by other developing countries, the economic setting in the GCC countries is in several ways distinctive.

Economic diversification and growth. Although the hydrocarbon sector in the GCC countries is a source of wealth and abundant energy, excessive reliance on it has made these economies vulnerable to fluctuations in international oil prices. During 1992–99, oil and gas accounted for 30 percent of GDP, 70 percent of export earnings, and 65 percent of government revenue. Fluctuations in oil prices have led to large swings in government expenditures, nominal GDP, and export earnings. Recognizing the need to address the adverse impact of these fluctuations, the GCC countries have sought to diversify their productive base. Simultaneously, some countries have accumulated sizable financial assets to provide for future generations (Kuwait, Oman) and help cushion the budgetary impact of a drop in oil revenue.

In general, diversification efforts have focused on areas where the GCC countries have a comparative advantage, such as petrochemicals and energy-intensive industries (aluminum, iron, and cement). Also, a number of GCC countries have striven to maximize the value added in particular niches, such as entrepôt trade (UAE), financial services and tourism (Bahrain and the UAE), and light industry (Saudi Arabia). In almost all of these countries, traditional sectors—such as trade, construction, and services—continued to develop in response to growing demand from the domestic household sector.

Despite these efforts, growth performance over the past twenty years has been lackluster. As a group, the GCC countries recorded an average growth rate of about 2.5 percent during 1980–99—half the average growth rate achieved by all developing countries. As a result, the GCC's real per capita GDP declined over this period, while it rose by 60 percent for all developing countries. (There are, of course, variations among GCC countries—over the past five years, Qatar and Oman recorded above average growth, reflecting the development of natural gas, and the United Arab Emirates has had growth in non-oil activities.) Several factors account for the GCC's generally weak performance: ceilings imposed on crude oil production under the Organization of Petroleum Exporting Countries; constraints on government expenditure in the face of fiscal imbalances (which dampened growth in non-oil activities); obstacles to private sector initiative and development; and low private investment inflows due to restrictions imposed on foreign ownership of companies.

Labor market dilemma. Another feature of the GCC's economic development has been its reliance on a large expatriate workforce, drawn mainly from the Indian subcontinent, the Philippines, and neighboring Arab countries. With small populations and a large demand for labor at all skill levels, all the GCC countries embraced an open-door policy with regard to expatriate labor. Nascent industries and domestic services could tap the world market for skilled and unskilled workers at internationally competitive wage rates, but unchecked reliance on foreign workers aggravated labor market segmentation. Foreign workers dominated private sector activities, while GCC nationals were concentrated in the public sector. This situation became unsustainable when public sector hiring reached fiscal and efficiency limits and unemployment increased among GCC nationals.

Faced with the dilemma of either restricting the entry of foreign workers and mandating the employment of nationals (with potentially adverse implications for competitiveness, given the wage differential between nationals and expatriate workers) or maintaining the open-door policy and facing the social consequences of higher unemployment among nationals, most GCC countries opted for a middle-of-the-road course. They sought to reduce foreign labor through quotas and indicative targets and used incentives and training to encourage private sector employment of GCC nationals.

Medium-term reform strategy

The GCC governments know they face long-term challenges that will require removing impediments to investment. Reforms will need to address restrictions on foreign ownership of companies, disengaging government from commercial activities, and giving the private sector a leading role in the economy. Most GCC countries have embarked on medium-term plans to privatize state-owned enterprises (including in telecommunications, transportation, electricity, infrastructure, and utilities). They are opening their economies to foreign direct investment, streamlining regulations and reducing red tape, strengthening their

IMF and the GCC

Relations between the IMF and the member countries of the Council of the Arab States of the Gulf (GCC) have strengthened considerably over the past two years. In March 1999, former IMF Managing Director Michel Camdessus participated for the first time in a meeting of the GCC ministers of finance in Riyadh, Saudi Arabia. At that time, oil prices were at their lowest level in more than a decade, and the focus was very much on the appropriate policy response to deal with this situation. The discussion also sought to develop a strategy to deal with the vulnerability of the GCC economies to oil price fluctuations. The Riyadh meeting also recommended that regular IMF-GCC sessions include governors of central banks and be held twice a year—once in the region and once during the IMF Annual Meetings.

This year, the meeting took place in Riyadh on May 27, with the IMF represented by First Deputy Managing Director Stanley Fischer, two Executive Directors representing the GCC countries, and staff from its Middle Eastern Department. As a result of higher oil prices and progress on economic reforms, the GCC countries are now in a much better position than in previous years. The meeting addressed the implications of oil price fluctuations for fiscal policy and management and outlined the conditions under which instruments such as oil revenue stabilization funds could be used.

At the IMF-GCC meeting in Riyadh in May: (from right) IMF First Deputy Managing Director Stanley Fischer; Secretary-General of the GCC Jamil Ibrahim Al-Hujailan; and Minister of State, Finance, and Industry of United Arab Emirates Mohamed Khalfan bin Kharbash.

financial systems, and fostering private sector development. Recently, Saudi Arabia has introduced far-reaching legislation on foreign investment that permits full foreign ownership of companies and real estate. It has also invited international oil companies to invest in the gas sector and related activities. Other GCC countries are considering similar reforms.

The GCC countries have the necessary ingredients for a successful private sector–led growth strategy. Their economies are closely integrated with the world economy and are well endowed with energy and financial resources; their price and exchange systems are virtually free from distortions; and their financial systems are strong and well supervised. Accelerated and deepened reforms, together with continued adherence to prudent fiscal and monetary policies, would help boost investment and growth. Enhancing the skills of the local labor force would also allow the private sector to absorb a growing share of GCC nationals.

Fiscal policy. Fiscal policy plays a central role in the GCC countries because of the pegged exchange rate arrangements and the relatively important share of the public sector in these economies. Dependence on oil and gas as a major source of fiscal revenue, however, exposes public finances to instability. When governments respond to large swings in oil prices and revenue through abrupt variations in public spending, this instability is also transmitted to the private sector. The finite nature of oil and gas resources also poses another difficulty in conducting fiscal policy. Careful decisions need to be made on how much oil income to spend and how much to save. These issues should be addressed in a medium-term framework with the twin objectives of determining what constitutes a sustainable level of consumption—from the viewpoint of providing for future generations—and establishing institutional mechanisms to smooth out budget revenue and government expenditure.

A recent IMF-GCC meeting (see box, page 198) discussed the conditions under which oil revenue stabilizations could achieve these objectives. Most GCC countries have tried to smooth out budget revenues and expenditures by building assets during periods of high oil prices and drawing on them when oil prices decline. Nevertheless, most GCC countries have experienced large swings in government spending, especially investment, in response to oil price fluctuations. These have complicated fiscal management and transmitted oil shocks to the private sector. Formal oil stabilization funds operating on well-defined principles could help governments resist pressure for additional spending during oil booms and eliminate the need for abrupt expenditure cuts when oil prices decline. This would make fiscal policy more predictable and strengthen private sector confidence.


Abdelali Jbili

Addressing the challenges

Overall, the GCC countries are making decisive progress in addressing the challenges facing their economies. With increased support for economic reform from the political leadership, these countries are taking major steps to open their economies to foreign investment, enhance the role of the private sector, and improve the business environment. These reforms will need to be broadened and sustained over the medium term to raise growth and employment creation to their full potential. Continued pursuit of sound macroeconomic policies will be essential to maintaining financial stability and enhancing credibility, while greater attention will need to be devoted to reducing the vulnerability of public finances to fluctuations in oil prices. The IMF has continued to support the GCC's reform efforts through policy advice in the context of bilateral consultations, regional meetings, technical assistance, and economic research. ■

Abdelali Jbili
IMF, Middle Eastern Department

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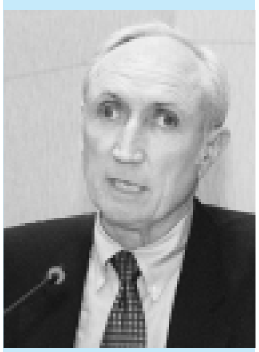
Central banking seminar

A well-regulated financial sector is key, but solutions must be tailored to country needs


Stanley Fischer


David Stephen


Edward Kane


Hiroshi Nakaso

Financial risks, System Stability, and Economic Globalization was the title of the IMF's eighth central banking seminar. The seminar, organized by the IMF's Monetary and Exchange Affairs Department in collaboration with the IMF Institute, was held in Washington on June 5–8. In addition to staff members from the IMF and the World Bank, participants were drawn from private financial firms, academia, regulatory and supervisory agencies, and central banks. Officials from over 35 countries were represented. A volume of the proceedings will be published by the IMF later in the year. IMF First Deputy Managing Director Stanley Fischer and Deputy Managing Director Eduardo Aninat provided opening and closing remarks, respectively.

The topics covered included internal rating processes and models in the measurement and management of credit risks; calculation of counterparty credit exposure when credit quality is correlated with market prices; assessment of a financial system's ability to withstand financial stress; approaches to regulation and corporate governance in financial firms; welfare costs of systemic risk, financial instability, and financial crises; changes in banking behavior during financial crises; long-run versus short-run effects of too-big-to-fail policymaking; international capital mobility and domestic financial system stability; safety-first monetary and financial policies for emerging countries; fiscal support in financial sector restructuring; international cooperation for financial system stability; and the role of the IMF in assessing financial sector soundness.

The financial sector and the IMF

Describing the changing role of the IMF in the financial sector, Fischer noted the growing importance of international standards in this area. He touched on other issues that the IMF and its members were addressing as understanding of the central role of the financial sector developed.

The crises that swept through emerging market countries in recent years, Fischer said, left no one in any doubt about the importance of a strong and well-regulated financial sector in dealing with capital flows. But in reexamining the proper role of the IMF in the wake of these crises, it was fair to ask how the institution should incorporate structural and other policies into its normal activities without moving too far away from its central mission in macroeconomic policy. He nevertheless underscored the rationale for the IMF's involvement in financial sector issues, namely, that the effectiveness of the economic policies the IMF supports depends enormously on the state of the financial sector.

Financial risks and internal models

One big challenge to private financial firms, Aninat noted, is better understanding and improvement in managing risks in the markets and sectors in which they operate. They must also be prepared to comply fully with relevant standards and regulations.

To the extent that internal models of firms yield satisfactory results, financial firms would no doubt be given greater freedom, in time, in setting their own rules for risk management. However, Aninat said, seminar participants had underscored that these models, although important, were part of a process. Also, the models and processes have to be adapted to the data and technical manpower infrastructure available to financial firms in different countries.

David Stephen and Michael Fischer, both of Credit Suisse/First Boston Corporation, and Charles R. Monet of J.P. Morgan and Company described internal risk management models and processes currently being used in their firms.

Rules versus market discipline

Participants agreed with David Llewellyn of Loughborough University, United Kingdom, that regulators should not rely solely on rules, as market discipline was often at least as important as—and sometimes even more so than—regulation in promoting good governance in financial firms. In a spirited discussion, participants debated the basic question of how quickly the scales should be tilted in favor of market discipline. In addition, they emphasized that regulators needed to be made accountable, so that their decision making truly reflected the public interest. Hence, as Edward Kane of Boston College emphasized, the incentive structure within regulatory agencies was very important.

Policy actions

Participants concurred that, given the potential welfare costs of financial crises, as elaborated by Koichi Hamada of Yale University, countries should build up their capacity to identify vulnerabilities and develop measures to handle crises in order to reduce the severity and duration of crises. The need for vigilance was perhaps most critical for banking system crises, which could be especially serious, according to Omotunde E.G. Johnson of the IMF and Heikki Koskenkylä of the Bank of Finland, often resulting from a major reallocation of resources, associated with social costs that were not easily recoverable.

Liquidity and fiscal support programs were thought useful as elements of policies addressing financial crises, but countries were urged to put in place measures that reduced moral hazard and protected the ability of the central bank to maintain long-run price stability. In this light, Hiroshi Nakaso of the Bank of Japan and others suggested that countries should create an environment in which owners are fully responsible for a bank and the consequences of its performance. Some useful approaches to banking system restructuring would include making sure that owners lose their capital before the government steps in and that management of a bank benefiting from fiscal intervention be removed.

Participants agreed with Akira Ariyoshi of the IMF that international capital mobility was a fact of life but that liberalization needed to take into account country circumstances. There were benefits of capital mobility for financial system stability; but there were risks and costs as well, including the need to take measures against "overheating" from capital inflows and sudden outflows and the increased complexity of financial risk management in a world of international capital mobility. Countries should, therefore, develop an appropriate macroeconomic framework and prudential policies, as emphasized by Ariyoshi, Latifah Merican Cheong of Bank Negara Malaysia, and Felipe Morande of the Central Bank of Chile.

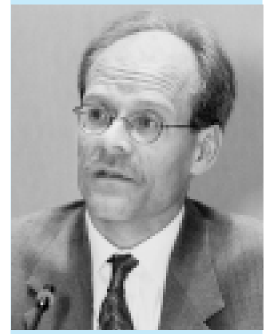
Cooperative efforts

The value of cooperation in the assessment of financial sector soundness and vulnerabilities was stressed throughout the seminar. In this context, the discussion on standards—led by Ydahlia Metzgen, Carl-Johan Lindgren, both of the IMF; André Icard of the Bank for International Standards; and Eduardo Fernandez-Arias of the Inter-American Development Bank—brought out many basic issues, including who sets the standards, what happens when countries disagree, and whether the standards were not sometimes set at levels hard to attain by some emerging countries. Also, there was some concern that standards may be proliferating, that they may often be too costly to implement, and that they may not—even when applied faithfully—guarantee financial system stability. There was, however, also an appreciation that standards emerged out of a process of consensus and that they were typically applied flexibly—especially when they were of a quantitative nature.

Seminar participants discussed a key IMF initiative to strengthen countries' financial systems in the last couple of years, namely, the Financial Sector Assessment Program (FSAP). As described by Stefan Ingves, Director of the Monetary and Exchange Affairs Department, the FSAP is undertaken in conjunction with the World Bank. After the assessment is made, IMF staff then prepare Financial System Stability Assessment reports, which feed into IMF surveillance of member countries' economies. ■

Omotunde E.G. Johnson
IMF Monetary and Exchange Affairs Department

Latifah Merican Cheong



Stefan Ingves

Available on the web (www.imf.org)

News Briefs

00/35: Kazakhstan Repays the IMF Ahead of Schedule, June 1
00/36: Excerpted Remarks on Regional Initiatives in Asia by IMF Managing Director Horst Köhler, June 2
00/37: IMF Managing Director Horst Köhler's Visit to Beijing, China, June 2
00/38: IMF Completes First Review of Indonesia Under Its Extended Arrangement, June 2
00/39: IMF Managing Director Horst Köhler Meets Private Financial Sector Representatives, June 8
00/40: IMF Completes Second Honduras Review and Approves $21 Million Loan, June 2
00/41: IMF Concludes Cameroon Midterm Review Under PRGF, June 7
00/42: IMF Completes Romania Review, Approves Extension and $116 Million Credit, June 7
00/43: IMF Completes Albania PRGF Review and Approves $3 Million Credit Tranche, June 9
00/44: IMF Managing Director Horst Köhler to Visit Cameroon, Mozambique, Nigeria, Senegal, and South Africa, June 13
00/45: IMF Managing Director Horst Köhler Meets Argentine President Fernando de la Rúa, June 13

Public Information Notices (PINs)

00/39: Sudan, June 9
00/40: Italy, June 13

Speeches

Address by Margaret Kelly to the Ad Hoc Committee of the Whole, Special Session of the UN General Assembly, Women 2000: Gender Equality, Development, and Peace for the Twenty-First Century, June 5 (see page 202)

"The IMF and the Financial Sector"—Introductory Remarks by Stanley Fischer, Seminar on Financial Risks, System Stability, and Economic Globalization, June 5

"Growth and Stability in Latin America and the Caribbean: Challenges for the Epoch of Globalization," lecture by Eduardo Aninat

Press Briefings

Transcript of Press Briefing by Thomas Dawson, Director of IMF External Relations Department, June 13

Other

Brazil: Memorandum of Economic Policies and Technical Memorandum of Understanding, June 1
Liberia: Concluding Statement of the May 2000 IMF Staff Visit, June 7
Experience with Basel Core Principles Assessments, June 8
IMF's Financial Activities Update, June 9
Finland: Concluding Remarks on 2000 Article IV Consultation, June 12
IMF's Financial Resources and Liquidity Position, 1998 to May 2000, June 13

Women 2000

IMF support aims to enhance participation by women in social and economic development

On June 5, Margaret Kelly, Director of the IMF's Human Resources Department, addressed the Special Session of the United Nations General Assembly, "Women 2000: Gender Equality, Development, and Peace for the Twenty-First Century." She focused on the progress the IMF has made in fostering the participation of women in economic and social development since the Fourth World Conference of Women in Beijing (see IMF Survey, *September 25, 1995, page 286). Excerpts of her remarks follow (the full text is available on the IMF's website: www.imf.org).*

Kelly: "Gender issues cannot be isolated from the national economic context of developing countries."

While the basic mandate of the IMF, as set out in its Articles of Agreement, has remained unchanged, the focus has been broadened to ensure that all members of society, including women, benefit from the positive effects of sustainable, high-quality growth. The evidence shows that this effort is already bearing fruit.

Policies and financial support

The IMF's primary contribution to sustainable economic and human development, including gender equality, is through its work to promote macroeconomic stability and high-quality growth. High-quality growth encompasses policies that reduce poverty and improve equality of opportunity for all of society's members, in particular its most vulnerable segments, which frequently consist of women and children.

Women and children suffer first and suffer most in times of economic duress. Women are typically the first to lose employment and be forced into marginal and unprotected economic activities. Female children are the first to be withdrawn from school to save resources and contribute to the family economy. In times of food insecurity, women experience higher levels of malnutrition. In short, gender issues cannot be isolated from the national economic context of developing countries. Poverty reduction and crisis prevention are thus key to improving the lives of women, and pro-poor policies are inherently pro-woman.

Social spending and safety nets

Relying on the expertise of the World Bank, the United Nations, and regional development banks that have the primary mandate on social issues, the IMF has sought to ensure that social issues are well integrated into IMF-supported programs and IMF policy advice. Programs have indeed promoted universal access to social services and increased spending on basic social services where it was low. More specifically, in countries with IMF-supported programs, we have seen an improvement in female primary and secondary school enrollments, in births attended by skilled professionals, in the immunization rate for children under 12, and in access to safe water and sanitation.

The use of social safety nets to mitigate the short-run adverse effects of adjustment and reform programs on poor groups has been an important aspect of the IMF's policy advice and program design. The IMF staff has, in most cases, relied largely on the World Bank and, to some extent, regional development banks to take the lead in the design of social safety nets for IMF-supported programs. The IMF's job is to ensure that the macroeconomic frameworks and, in particular, government budgets make adequate provision for the financing of cost-effective social safety nets and critical social services. Effective social safety nets are particularly important to women who bear the brunt of job loss, decreases in food consumption, and cuts in basic social services.

Labor markets

Access to paid jobs is critical for the advancement of women, in both developing and developed countries. The IMF supports policies that promote flexibility in labor markets, so as to increase employment opportunities, as well as measures, such as training, that increase productivity and thereby wages. At the same time, we also support the Core Labor Standards for which the International Labor Organization is the responsible institution. These include freedom of association and the right to collective bargaining, and freedom from discrimination, forced labor, and exploitative child labor.

Within the IMF, we are responding, both directly and indirectly, to the call in the 1995 Beijing Platform for Action to "ensure women's equal access to and full participation in power structures and decision making"; first, through our training programs for senior officials from member countries (in which women are well represented) and, second, by increasing the role and representation of women in the IMF itself, particularly in core departments and at the senior management level.

We are all aware that much more remains to be done. But I can assure you that the IMF is committed to ensuring that our economic policy advice takes into account its impact on women and other vulnerable groups in society, and we will continue to improve both our policy advice and assistance to member countries to ensure that women are able to participate fully in economic and social development. ■

Official lender-of-last-resort facilities prevent banking system failure

When a financial institution is confronted with an unexpectedly large increase in the demand for liquidity—that is, when there is a significant run on its deposits—and the institution cannot raise funds on the market quickly enough to offset its losses, it may, as a last resort, turn to the central bank for an emergency loan. Because of recent financial crises around the world—including Mexico in 1994–95, Asia in 1997–98, and Russia in 1998—there has been a resurgence of interest in such emergency liquidity support and its use as a component of public financial safety nets.

An IMF Working Paper, *Emergency Liquidity Support Facilities*, by Dong He, an Economist in the IMF's Monetary and Exchange Affairs Department, discusses the operational aspects of official emergency liquidity support. The paper argues that properly defined lending procedures, clearly laid-out authority and accountability, and disclosure rules will promote financial stability, reduce moral hazard, and protect the lender of last resort from undue political pressure.

To avoid moral hazard associated with lender-of-last-resort operations, some central banks maintain a policy of "constructive ambiguity" as to what they will do, how they will do it, and when they will do it. That is, the access to emergency liquidity support facilities is made uncertain, something to be determined ad hoc in each situation. Dong He argues that, although there may well be good reasons to maintain ambiguity over the conditions for assistance, there are important advantages to developing—and for transition economies to follow—a rules-based approach by setting out ahead of time the necessary conditions for support, while maintaining that meeting such conditions is not sufficient for receiving support.

Based on an analysis of selected central bank legislation and regulations and observation of country practices, the paper seeks to draw some lessons by addressing a number of operational questions: Should the operational rules of emergency lending facilities be specified in advance? Should emergency lending operations be disclosed after the fact? What should the terms and conditions for such support be? Should the operational rules of emergency lending be different during normal times from those during a systemic crisis (that is, when the effects of shocks to one or more banks spill over to other banks and are transmitted, in domino fashion, beyond the banking system to the entire financial system and the macroeconomy)?

Nature and scope of support

Emergency liquidity support may be defined as the discretionary provision of liquidity by the authorities to a financial institution (or the market as a whole) in distress. The objectives of such support, according to Dong He, are to prevent illiquidity at an individual bank from unnecessarily leading to its insolvency, and to avoid deposit runs that spill over from one bank to another.

Dong He: When there are questions about a bank's solvency, it is important for the public to know that an emergency lender exists.

Banks' assets are largely illiquid term loans (that is, they cannot be readily converted into cash), whereas their liabilities are predominantly unsecured short-term deposits, which banks must pay out in full on a first-come, first-served basis. If a bank experiences a run on its deposits, it may be obliged to sell some of its assets quickly at very low prices. To avoid such a drastic step, Dong He says, a bank that has no other recourse may approach the central bank for emergency liquidity support.

Dong He explains that banks are subject to spillover effects, or "contagion," because they typically lend heavily to each other. Thus, when one bank is subject to a run, it will have to recall its interbank loans immediately, which may cause the other banks to become illiquid. A second problem related to contagion, Dong He notes, is that of asymmetric information. With incomplete information, depositors have difficulty distinguishing sound from unsound banks.

Terms and conditions of support

The basic precondition for emergency liquidity support, Dong He says, is that the failure of a troubled institution, if it were not to receive liquidity assistance, would damage the stability of the financial and monetary system. Other preconditions that typically apply are that the institution is deemed to be solvent, has adequate collateral of acceptable quality, and is prepared to take remedial actions to address its liquidity problems. In exceptional circumstances, a failing institution may not meet these criteria, but it is nonetheless decided that the institution must be granted emergency support because of its systemic significance. In such circumstances, Dong He observes, decisions to lend should be part of a general crisis management strategy and should be made jointly by the monetary, supervisory, and fiscal authorities. This joint decision making will ensure a clear demarcation of responsibility and accountability.

Risks and constraints of emergency support

The possibility that the failure of a troubled financial institution, without liquidity support, will damage the stability of the financial and monetary system highlights the importance of emergency liquidity support. However, emergency support operations are themselves risky business, Dong He explains.

In providing support, the central bank takes credit risks that would be unacceptable to all other lenders in the market. Sometimes a borrowing institution turns out to be unviable and must eventually be closed. On the one hand, an emergency loan provides time for the authorities to arrange for an orderly closure of the failing institution; on the other hand, if lending to a failing institution becomes prolonged, it can also make it possible for uninsured depositors and other general creditors to exit the institution before it is closed. To minimize these costs, Dong He says, emergency liquidity support must be provided on a short-term basis only and should be confined to systemic problems. If the central bank considers providing support in nonsystemic cases, the institutions should be solvent and have acceptable collateral.

One way to ensure that institutions are genuinely turning to the central bank as a last resort—that they are truly unable to raise the necessary liquidity on the market—is to provide the emergency support at a penalty interest rate. One difficulty with this approach, Dong He notes, is that it is not always easy to determine what interest rate and penalty to charge, particularly when there is a breakdown of the market. Moreover, because of adverse selection (or perverse incentives), some problem banks may not be deterred by penalty interest rates. A second approach is to impose harsh conditions on the borrowing bank in exchange for the support. Dong He notes that many central banks have relied on a combination of both approaches to ensure that troubled institutions are turning to them only as a last resort. It is generally agreed that banks that receive support should be supervised more closely, their activities should be restricted, and an exit strategy should be designed so that banks that prove unviable can be closed or resolved in an orderly manner.

Finally, central banks typically have minimal capital and a small revenue base. Lending freely during a crisis, Dong He cautions, may be incompatible with the prevailing monetary regime. Particularly if central banks are making large loans to institutions on the brink of insolvency, they are subject to substantial credit risks, which could complicate monetary management and contribute to inflation. When large-scale support is involved, the fiscal authorities must underwrite the credit risks that the central bank takes on. In any case, Dong He notes, the central bank is responsible for ensuring that extending emergency support does not undermine its monetary and exchange rate policy objectives.

Transparency or ambiguity?

Generally, Dong He observes, central banks try to keep it quiet when they extend emergency support to a troubled financial institution. The health of a banking system depends partly on the public's confidence in the system, and confidence may decline if the public learns that a rescue operation has been mounted. Moreover, if it becomes known to the market that an otherwise sound bank is seeking liquidity support from the central bank, the reputation of the borrowing bank is likely to suffer and the cost of borrowing will rise.

However, Dong He emphasizes, it is a good idea—and will ensure the credibility and accountability of the central bank—to disclose information about a support operation after the fact. Public disclosure can reassure the public that the authorities acted competently and reassure the banking community by clarifying the rules of the game.

When there are questions about a bank's solvency, however, the public can lose confidence in the institution, which may lead to panic and, in turn, to a run on the bank's deposits. In such an environment, it is important for the public to know that an emergency lender exists and that it is willing to provide support. Typically, Dong He notes, difficult decisions on whether to grant or deny credit to an institution seeking help must be made and executed quickly, and the lender must strike a delicate balance between avoiding systemic instability and controlling moral hazard.

Dong He notes that, increasingly, countries are making their policies toward problem banks more transparent. Using a rules-based approach, the lender of last resort spells out its rules for emergency lending to the extent possible. The rules would include sanctions to be

Michel Camdessus honored

On May 30, former IMF Managing Director Michel Camdessus (left) received the Officer of the Legion of Honor decoration. Jean-Claude Trichet, Governor of the Banque de France, presented the award under the Pyramide de Louvre in connection with a high-level conference celebrating the bicentennial of the Banque de France.

imposed on the borrowing bank and its shareholders and managers. Making such rules transparent is beneficial because market participants will know what to expect. This knowledge should reduce moral hazard and encourage other stabilizing private sector behavior—for instance, the holding of assets that are acceptable as collateral.

A rules-based approach would also reduce the risk of politically motivated or impulsive actions by the authorities and make it easier to judge the appropriateness of the authorities' actions. Dong He notes that such a practice is particularly advantageous for developing and transition economies, which typically do not have a mature governance structure and lack well-established checks and balances in the political system. ■

Copies of IMF Working Paper No. 00/79, *Emergency Liquidity Support Facilities*, by Dong He, are available for $7.00 each from IMF Publication Services. See page 199 for ordering information.

Stand-By, EFF, and PRGF Arrangements as of May 31

Member	Date of arrangement	Expiration date	Amount approved	Undrawn balance
			(million SDRs)	
Stand-By			**45,756.43**	**17,337.74**
Argentina	March 10, 2000	March 9, 2003	5,398.61	5,398.61
Bosnia and Herzegovina	May 29, 1998	March 31, 2001	94.42	30.15
Brazil[1]	December 2, 1998	December 1, 2001	10,419.84	2,550.69
Ecuador	April 19, 2000	April 18, 2001	226.73	141.73
Estonia	March 1, 2000	August 31, 2001	29.34	29.34
Korea[1]	December 4, 1997	December 3, 2000	15,500.00	1,087.50
Latvia	December 10, 1999	April 9, 2001	33.00	33.00
Lithuania	March 8, 2000	June 7, 2001	61.80	61.80
Mexico	July 7, 1999	November 30, 2000	3,103.00	1,163.50
Papua New Guinea	March 29, 2000	May 28, 2001	85.54	75.54
Philippines	April 1, 1998	June 30, 2000	1,020.79	475.13
Romania	August 5, 1999	June 7, 2000	400.00	347.00
Russia	July 28, 1999	December 27, 2000	3,300.00	2,828.57
Thailand	August 20, 1997	June 19, 2000	2,900.00	400.00
Turkey	December 22, 1999	December 21, 2002	2,892.00	2,448.56
Uruguay	May 31, 2000	March 31, 2002	150.00	150.00
Zimbabwe	August 2, 1999	October 1, 2000	141.36	116.62
EFF			**9,663.37**	**8,110.06**
Bulgaria	September 25, 1998	September 24, 2001	627.62	261.52
Colombia	December 20, 1999	December 19, 2002	1,957.00	1,957.00
Indonesia	February 4, 2000	December 31, 2002	3,638.00	3,378.00
Jordan	April 15, 1999	April 14, 2002	127.88	106.56
Kazakhstan	December 13, 1999	December 12, 2002	329.10	329.10
Pakistan	October 20, 1997	October 19, 2000	454.92	341.18
Panama	December 10, 1997	December 9, 2000	120.00	80.00
Peru	June 24, 1999	May 31, 2002	383.00	383.00
Ukraine	September 4, 1998	September 3, 2001	1,919.95	1,207.80
Yemen	October 29, 1997	March 1, 2001	105.90	65.90
PRGF			**3,516.41**	**2,016.98**
Albania	May 13, 1998	May 12, 2001	45.04	14.11
Benin	August 28, 1996	August 26, 2000	27.18	10.87
Bolivia	September 18, 1998	September 17, 2001	100.96	56.10
Burkina Faso	September 10, 1999	September 9, 2002	39.12	33.53
Cambodia	October 22, 1999	October 21, 2002	58.50	50.14
Cameroon	August 20, 1997	August 19, 2000	162.12	36.03
Central African Republic	July 20, 1998	July 19, 2001	49.44	32.96
Chad	January 7, 2000	January 7, 2003	36.40	31.20
Côte d'Ivoire	March 17, 1998	March 16, 2001	285.84	161.98
Djibouti	October 18, 1999	October 17, 2002	19.08	16.36
The Gambia	June 29, 1998	June 28, 2001	20.61	13.74
Ghana	May 3, 1999	May 2, 2002	155.00	110.70
Guinea	January 13, 1997	December 20, 2000	70.80	15.73
Guyana	July 15, 1998	July 14, 2001	53.76	35.84
Honduras	March 26, 1999	March 25, 2002	156.75	80.75
Kyrgyz Republic	June 26, 1998	June 25, 2001	73.38	38.23
Madagascar	November 27, 1996	July 27, 2000	81.36	40.68
Mali	August 6, 1999	August 5, 2002	46.65	39.90
Mauritania	July 21, 1999	July 20, 2002	42.49	36.42
Mongolia	July 30, 1997	July 29, 2000	33.39	15.95
Mozambique	June 28, 1999	June 27, 2002	87.20	42.00
Nicaragua	March 18, 1998	March 17, 2001	148.96	53.82
Pakistan	October 20, 1997	October 19, 2000	682.38	417.01
Rwanda	June 24, 1998	June 23, 2001	71.40	38.08
São Tomé & Príncipe	April 28, 2000	April 28, 2003	6.66	5.71
Senegal	April 20, 1998	April 19, 2001	107.01	57.07
Tajikistan	June 24, 1998	June 23, 2001	100.30	40.02
Tanzania	March 31, 2000	March 30, 2003	135.00	115.00
Uganda	November 10, 1997	November 9, 2000	100.43	17.85
Yemen	October 29, 1997	October 28, 2000	264.75	114.75
Zambia	March 25, 1999	March 24, 2002	254.45	244.45
Total			**58,936.21**	**27,464.78**

[1]Includes amounts under Supplemental Reserve Facility.
EFF = Extended Fund Facility.
PRGF = Poverty Reduction and Growth Facility.
Figures may not add to totals owing to rounding.
Data: IMF Treasurer's Department

Members drawing on the IMF "purchase" other members' currencies, or SDRs, with an equivalent amount of their currency.

BIS Annual Report

IMF urged to strike a balance between liquidity injections and moral hazard

The global economy, according to the *Bank for International Settlements 70th Annual Report*, is entering an uncertain period. Some observers think that the economy is at the beginning of a long boom, driven by technology and deregulation and accompanied by continuing low inflation, while others say there is a larger possibility of a downturn. There is also uncertainty about how financial markets will react to possible adverse macroeconomic shocks. Finally, the report notes, it is unclear whether, in this more globalized financial system, policymakers have all the tools required to avert problems and manage them should they arise. One thing is clear, however: liquidity injections, which may be needed to manage one crisis, can encourage unwise behavior and thus lead to the next crisis. The report concludes that "a balance needs to be found between the provision of liquidity by the IMF and the moral hazard that such assistance engenders."

The report cites two central issues surrounding the provision of needed liquidity to emerging markets and points out that little concrete progress has been made with respect to these issues. The first is how the private sector can be encouraged to provide liquidity by rolling over maturing debt and by providing new money when necessary. A temporary suspension of payments, the report suggests, can accomplish the first action—all creditors are treated equally—but it is not likely to encourage new credits. Moral suasion is another possibility, but ultimately, the report concludes, "such arm-twisting comes close to coercion."

Another problem is how to coordinate this financing. Borrowers in emerging markets and lenders in developed countries are becoming more diverse, making it difficult to determine who has the authority, first, to make promises and, next, to follow up on them. This situation makes it more attractive for bond issuers to include collective action clauses, thus increasing the likelihood of orderly debt reschedulings, the report says.

The second central issue is how the public sector, including the IMF, should be involved in providing liquidity to emerging markets. The "rules-based" approach argues that access to IMF monies should generally be for smaller amounts than has recently been provided and that the number of facilities through which the loans are offered should be reduced. Under this approach, the report says, "only limited access to public sector money is consistent with the spirit of burden sharing, and the terms and conditions of that access should be known to everyone in advance." But there may be cases, advocates say, when the public sector deems it important for larger loans to be made, but the approval process for these loans should be more formal and more difficult. The opposing viewpoint is that all crises are different, and ways to manage them need to be found as quickly as possible, arguing for more discretion on the IMF's part. There is also, the report says, a growing consensus that official financing should be linked more closely to crisis prevention and that longer-term and repeated borrowing from the IMF should be discouraged. ■

The *Bank for International Settlements 70th Annual Report* is divided into two parts. The main part, chapters I to VIII, discusses the major developments in the world economy in the past year and policy implications. The second part deals with the activities of the BIS.

The report is available from the Bank for International Settlements, Information, Press and Library Services, CH-4002 Basel, Switzerland, Fax: 41 61 280 91 00, or see the BIS website (www.bis.org).

Selected IMF rates

Week beginning	SDR interest rate	Rate of remuneration	Rate of charge
June 5	4.40	4.40	5.10
June 12	4.43	4.43	5.13

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

Data: IMF Treasurer's Department

Members' use of IMF credit
(million SDRs)

	During May 2000	January–May 2000	January–May 1999
General Resources Account	**221.72**	**1,546.54**	**5,205.48**
Stand-By Arrangements	221.72	1,234.24	4,194.57
SRF	0.00	0.00	3,636.09
EFF	0.00	312.30	567.79
CFF	0.00	0.00	443.12
PRGF[1]	**0.95**	**107.77**	**380.86**
Total	**222.67**	**1,654.31**	**5,586.34**

SRF = Supplemental Reserve Facility
EFF = Extended Fund Facility
CFF = Compensatory Financing Facility
PRGF = Poverty Reduction and Growth Facility
Figures may not add to totals shown owing to rounding.
[1]Formerly ESAF—the Enhanced Structural Adjustment Facility.

Data: IMF Treasurer's Department

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Impact after 2005

Hong Kong SAR projected to see significant effects from China's WTO accession

The possible implications of the People's Republic of China's accession to the World Trade Organization (WTO) have been much discussed. But in projecting the impact on the Mainland, the effects on Hong Kong SAR's economy have generally attracted little attention. A new IMF study by Peter Breuer (a chapter in *People's Republic of China—Hong Kong Special Administrative Region: Selected Issues and Statistical Appendix*) suggests that, by mid-decade, the economy of Hong Kong SAR can expect to see significant effects from the Mainland's WTO accession. The impact will chiefly be felt through the Mainland's liberalization of trade and services, anticipated sharp increases in textile and apparel exports, and accelerating structural reforms. These changes seem likely to affect Hong Kong SAR's economy and its financial and economic relationship with the Mainland.

WTO and the Mainland

Although the last few bilateral negotiations are still going on, China could enter the WTO later this year. The final terms of accession will be defined in part by the remaining negotiations, but the broad outlines of the impact on the Mainland economy are evident in the already-concluded accession agreements with the United States and the European Union.

The U.S.-China agreement calls for reduced tariffs on nonagricultural products by 2005, lower tariffs on agricultural products by 2004, an elimination of quotas and nontariff restrictions on industrial products by 2005, the introduction of a tariff rate quota system in agriculture, and the provision of full trading and distribution rights to foreign firms. Market access would also be significantly expanded in the services sector (notably in the areas of telecommunications, life insurance, securities, and banking). The United States, in return, would eliminate its import quotas under the Multifiber Agreement on Mainland textiles by 2005 and extend to the Mainland Permanent Normal Trade Relations.

IMF staff analysis of the agreement's potential impact suggests that WTO accession will initially stimulate some of the Mainland's imports, such as agricultural goods, automobiles, and petrochemicals. However, it will have little impact on the imports related to the processing trade, since these industries are located largely in free trade zones and are already exempt from tariffs. The Mainland's external current account position will begin to improve in 2005 when its textile and apparel exports are no longer subject to the Multifiber Agreement restrictions. Low labor costs are expected to position Mainland factories as the dominant world source for textiles and apparel. The liberalization of the Mainland's services sector is also expected to attract significant foreign direct investment and accelerate structural reform in the banking and state enterprise sectors.

Hong Kong SAR economy

The services sector has traditionally dominated Hong Kong SAR's economy, accounting for 85 percent of GDP (mostly financial services and trade and tourism). Industry accounts for most of the remaining activity.

Hong Kong SAR's extremely open economy is heavily reliant on entrepôt trade, which accounts for nearly 76 percent of total traded goods flows. Almost all of this entrepôt trade takes place to and from the Mainland. Hong Kong SAR's value-added contribution is much higher on reexports from the Mainland (about 27 percent) than on reexports to the Mainland (about 6 percent). This could prove beneficial if Mainland textile exports rise after WTO membership.

Hong Kong SAR is a substantial source of foreign direct investment in the Mainland (accounting for 40 percent of total foreign direct investment), and the gross exposure of its banks to the Mainland grew steadily in the 1990s, peaking at $40 billion just before the Asian crisis broke. The Mainland has also been a major investor in Hong Kong SAR. In recent years, economic and financial linkages between the economy of the Mainland and that of Hong Kong SAR have deepened. Breuer cites, as one indication of this growing integration, the generally high correlation of their economic cycles and financial markets.

As a separate contracting party to the WTO's predecessor, the General Agreement on Tariffs and Trade, in 1986, and as a founding member of the WTO, Hong Kong SAR's own trade regime has been, and continues to be, exceptionally liberal.

Impact of China's WTO accession

Breuer estimates that China's entry into the WTO will have little impact on the Hong Kong SAR economy before 2005. While the reduction in Mainland tariffs will benefit Hong Kong SAR's domestic exports, the impact will be modest since domestic exports to the Mainland are mostly related to the processing industry and, as noted earlier, are already exempt from tariffs.

This initial modest improvement in the trade account could be offset by higher outflows of foreign direct investment, particularly in the liberalized services sector. Breuer notes that this is expected to be concentrated in the financial, telecommunications, distribu-

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tion, and freight-forwarding sectors. Initially, this will be offset partially by a decline in foreign direct investment in the manufacturing sector, which had been necessitated by the Mainland's previously high tariffs, as investment withdraws.

After the elimination of restrictions under the Multifiber Agreement, however, the Mainland's low production costs are expected to fuel a dramatic increase in Chinese textile and apparel exports. The IMF staff study projects that the Mainland's accession to WTO will accelerate restructuring of the Hong Kong SAR economy, including its textile sector. Offsetting this will be higher investment income from the Mainland and, more significantly, a sharp expansion in Hong Kong SAR's entrepôt trade. The dramatic expansion in textile and apparel exports from the Mainland is expected to greatly increase demand for product design, marketing, and other high-skill areas where Hong Kong SAR's value-added component has traditionally been strongest.

Another area where the impact of China's accession to the WTO could be significant is in Hong Kong SAR's exports of services, which at 20 percent of GDP are one-third larger than exports of goods. As the pace of bank and enterprise restructuring quickens in the Mainland, demand for financial, accounting, and legal expertise is expected to grow. Corporations based in Hong Kong SAR will be well positioned to provide these services. Breuer explains that this is likely to boost Hong Kong SAR's services exports and prompt additional inward foreign direct investment in Hong Kong SAR by foreign firms seeking a base to expand their Mainland operations. While difficult to estimate, the extent of the increased demand is potentially substantial. Over the longer term, the WTO agreement is likely to strengthen the ongoing economic and financial integration of the Mainland and Hong Kong SAR.

The growing integration of the Mainland with the global economy, however, is also likely to reduce the need to use Hong Kong SAR as a portal for trade and finance and increase the competition between Hong Kong SAR and other trade and financial centers for Mainland business. Breuer notes, however, that Hong Kong SAR's ability to adjust rapidly to such changes in the past and its proximity to and knowledge of the Mainland economy will allow it to compete from a position of strength.

While it cautions that any quantitative predictions are subject to wide margins of error, the IMF staff study provides some illustrations of the possible quantitative impact on Hong Kong SAR's economy (see table, this page). Breuer projects a strengthening of the current account between 2000 and 2004 as a result of modest improvement in the trade account and, more

Projected impact of WTO accession on Hong Kong SAR
(1998 data)

	Amount (billion U.S. dollars)	Impact 2000–05[1] (percent of GDP)	After 2005[2]
Domestic exports	**24.3**	**0.1**	**0.5**
To the Mainland	7.2	0.1	0.5
Processing related	5.6	0.0	0.5
Reexports	**149.7**	**1.9**	**9.9**
To the Mainland	52.6	1.8	2.3
Processing related	23.1	0.0	2.3
From the Mainland	89.2	0.1	7.6
Processing related	78.1	0.0	7.6
Retained imports	**61.5**	**0.1**	**0.3**
From the Mainland	5.4	0.1	...
Nonretained imports	**122.8**	**1.8**	**8.1**
To the Mainland	49.4	1.7	2.1
Processing related	21.7	0.0	2.1
From the Mainland	70.2	0.1	6.0
Processing related	61.6	0.0	6.0
Trade balance	**-10.3**	**0.1**	**2.0**
Domestic	-37.2	0.0	0.3
Entrepôt	26.9	0.1	1.8

[1]This calculation assumes Mainland nonprocessing imports increase by 9.7 percent (based on a 7.7 percent cost reduction of imports due to a 9 percent reduction in tariffs, and a price elasticity of demand of -1.3 percent), Mainland nonprocessing exports increase by 2.3 percent (based on the same tariff and elasticity assumptions and assuming a nonprocessing import content of exports of 20 percent); Hong Kong SAR domestic exports have an import content of 50 percent, and Hong Kong SAR's value added is 6 percent on reexports to the Mainland and 27 percent on reexports from the Mainland.

[2]This calculation assumes that elimination of the Multifiber Agreement results in a 20 percent increase in the Mainland's processed textile and a 100 percent increase in the Mainland's processed apparel exports, implying a 16 percent increase in Mainland processing exports. For simplicity, we assume the Mainland's ordinary exports of textile and apparel products do not change.

Data: *IMF Staff Country Report No. 00/48: People's Republic of China—Hong Kong Special Administrative Region: Selected Issues and Statistical Appendix*

crucially, increased services exports. However, lower value-added services and manufacturing will continue to shift to the Mainland, necessitating a redeployment of labor (and investments in retraining) in Hong Kong SAR.

From 2005 onward, according to Breuer, Hong Kong SAR will benefit from higher Mainland growth and rising income from WTO-related investments in the Mainland. But he also notes that these changes will necessitate adjustments in Hong Kong SAR's domestic economy, which are likely to occur quite rapidly. The overall impact on growth and the balance of payments, however, is expected to be positive. Finally, Breuer observes, there will be an upside and a downside to economic integration. Hong Kong SAR stands to benefit from the Mainland's dynamism but will also be more vulnerable to shocks emanating from it. ■

Copies of IMF Staff Country Report No. 00/48, *People's Republic of China—Hong Kong Special Administrative Region: Selected Issues and Statistical Appendix*, are available for $15.00 each from IMF Publications Services. See page 199 for ordering details.

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