# IMF SURVEY

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*$4.9 billion installment*

## Camdessus recommends Executive Board approval of Brazil's revised economic program

*In a statement issued on March 8, IMF Managing Director Michel Camdessus announced his intention to recommend to the IMF Executive Board that it approve the revised economic program for 1999–2001 proposed by the Brazilian government. The text of News Brief 99/10 follows.*

Brazil's program would be supported by the three-year Stand-By Arrangement approved by the Executive Board on December 2, 1998, in an amount totaling SDR 13.0 billion ($18.1 billion), which is part of a package of international financial support totaling about $41 billion [see *IMF Survey*, December 14, 1998, page 385]. Brazil drew SDR 3.4 billion (about $4.6 billion) from the IMF loan in December and would be able to draw a further SDR 3.6 billion (about $4.9 billion) upon the Board's approval.

Brazilian Finance Minister Pedro Malan

The key elements of the new program are a strengthened fiscal adjustment and, in light of the floating of the exchange rate, the adoption of a new nominal anchor for monetary policy. The additional fiscal improvement and a firm monetary policy are expected to contain the impact of the depreciation of the real on prices in the first half of 1999, and to facilitate a decline of the annualized monthly rate of inflation to single digits by the end of the year. Although real GDP is now expected to decline by 3½–4 percent in 1999, it is expected that the program will lay the basis for a *(Please turn to the following page)*

## *International Financial Statistics* to publish data for euro area

The start of stage three of European Economic and Monetary Union (EMU)—also known as the euro area—in January 1999 ushered in major changes in the statistical systems of the euro area countries. Changes in monetary and other financial statistics included creation of the euro, the application of a single monetary policy throughout the union, and institutional and regulatory changes that fostered the further integration of the national economies. In the context of these changes, the IMF's Statistics Department has been working closely with euro area authorities to collect statistics that are most useful in the IMF's surveillance of the new institutional and policy environment within the euro area. A comprehensive selection of these statistics will be published for the first time in the April 1999 issue of the IMF's *International Financial Statistics (IFS)*.

The development of harmonized statistics for the euro area has been a joint responsibility of the Statistical Office of the European Communities (Eurostat) and the European Central Bank (ECB). Eurostat has a long tradition of defining harmonized concepts and compiling economic and social statistics for the member states of the European Union. At the same time, the Treaty on the European Union (Maastricht Treaty) requires the ECB to collect, with the assistance of the national central banks, the statistical information needed to implement the single monetary policy. Thus, the ECB assumed full competence for money and banking statistics from the start of stage three of monetary union. The ECB and Eurostat share competence in balance of payments statistics and statistics on financial flows. Government statistics, foreign trade statistics, statistics on prices and other short-term indicators, and national accounts remain the prime responsibility of Eurostat.

### EMU framework

Working closely with the ECB and euro area national central banks, IMF staff formulated *(Continued on page 92)*

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# Brazil revises program

(Continued from front page) sustained recovery in 2000 and beyond, as confidence recovers and external financing constraints are eased.

The current account of the balance of payments is expected to improve substantially, with the deficit being nearly halved in 1999, compared with 1998, and continuing to decline in subsequent years, reflecting in particular the favorable impact of the depreciation of the exchange rate on the trade account. Capital inflows are expected to recover progressively during the year, turning the overall balance of payments into surplus during the second half of 1999.

Notwithstanding the increase in the public debt resulting from the depreciation of the real, the Brazilian government is committed to ensuring by the end of the program period a steady decline of the public debt relative to GDP to a level below that targeted in the original program (46.5 percent of GDP). For this purpose, the targets for the primary surplus of the public sector have been increased by the equivalent of about 0.5 percent of GDP a year, compared with the original program, to a range of 3–3.5 percent of GDP a year during 1999–2001.

The additional fiscal adjustment will be achieved through a range of revenue-raising measures and expenditure cuts, most of which have already been announced by the government. The adjustment effort will be concentrated at the federal level; the states and local governments are expected to contribute to it through the implementation of their debt-restructuring agreements with the federal government and by complying with the requirements of the administrative reform laws. The government is committed to protecting the more vulnerable segments of society by minimizing the impact of the needed budget cuts on programs targeted to the poor and has sought financial support from the World Bank and the Inter-American Development Bank [IDB] for this purpose.

The central bank intends to move as soon as feasible to an inflation-targeting framework for monetary policy and is taking steps to put in place the necessary technical underpinnings. At the same time, steps are being taken to strengthen the operational autonomy of the central bank in pursuing its anti-inflation mandate. While an inflation-targeting framework is put in place, the central bank will keep the growth of its net domestic assets within rates consistent with the target path of inflation and the projected paths of real GDP and the overall balance of payments. The increased focus by the central bank on inflation and the monetary aggregates will require appropriate flexibility in the management of interest rates. With the decisions on interest rates announced on March 3, the central bank has demonstrated its commitment to such flexibility. Interest rates are expected to decline in the course of the year, as inflation abates, to levels significantly lower in real terms than those prevailing before the floating of the real, thus facilitating the targeted decline in the public debt relative to GDP.

The government has reaffirmed its commitment to the wide-ranging program of structural reforms in, among others, the areas of social security, taxation, fiscal transparency, and the financial sector, in most of which significant progress has already been made. It also intends to accelerate and broaden its privatization program.

The revised Brazilian program is expected to continue to receive financial support from the international community, including industrial countries, the World Bank, the IDB, and, of course, the private sector. The Brazilian authorities intend to seek, starting this week, voluntary commitments by their creditor banks to support Brazil. This effort is integral to the success of the program and will be a key factor in the consideration of the program by the Executive Board of the IMF in late March or early April. ■

## Available on the Web

### News Briefs

99/12, March 16. IMF to Consider Resumption of Financial Assistance for Ukraine

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

- 99/16 Hungary, March 4
- 99/17 United Kingdom, March 7
- 99/18 Belgium, March 8
- 99/19 Swaziland, March 8
- 99/20 Bulgaria, March 10
- 99/21 Argentina, March 11
- 99/22 San Marino, March 11
- 99/23 Samoa, March 12

**Letters of Intent and Memorandums of Economic and Financial Policies** are prepared by a member country and describe the policies that the country intends to implement in the context of its request for financial support from the IMF. Recent releases include

- Brazil: Memorandum of Economic Policy, March 8
- Kyrgyz Republic: Letter of Intent, March 10
- Philippines: Supplementary Memorandum on Economic and Financial Policies, March 11

Full texts are available on the IMF's website (www.imf.org).



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# Camdessus highlights benefits of regional integration for Latin America

*Following are edited excerpts of an address by Michel Camdessus, Managing Director of the IMF, at the fortieth Annual Meeting of the Inter-American Development Bank (IDB) in Paris on March 15.*

These last few years have taught us much about the meaning of globalization and the opportunities and risks that it entails. The Latin American experience in this area points up three important aspects:

• Your countries seized the opportunities that came their way, and, beginning in the early 1990s, attracted sizable capital flows that played a key role in the highly desirable acceleration of their growth.

• Owing chiefly to sustained efforts to overcome the debt crisis and to base their growth on macroeconomic stability, public deficit reduction, and structural reforms, your countries fortified themselves to withstand the shocks delivered by the crisis. The extraordinary resilience demonstrated by the region is largely due to the prompt, responsible reaction of policymakers and their effort to implement broad reforms that have provided the region with sound financial systems and a framework of more flexible policies. It is encouraging that investors now seem to be starting to discriminate more clearly among countries, based on their individual economic strengths and the consistent focus of their economic policy.

• The hardest-hit countries—Mexico in 1994–95 and now Brazil—have demonstrated their ability to respond with bold programs capable of attracting vital international support and to create new bases for stronger and more sustainable growth.

## Building confidence

What more, then, can your countries do, when we know you are faced with repairing the damage of horrific natural disasters and adjusting to the slowing of world economic growth, falling export prices, exchange pressures, reduced external financing, and increasing interest rates and spreads? What can be done when, as a result of all this, the prospects for near-term growth have evaporated and a drop in per capita output is expected this year, with a consequent rise in poverty?

For individual countries, there is no quick fix and no substitute for the kind of prudent, consistent management that inspires market confidence. Such management consists of the relentless defense of macroeconomic stability, the deepening of structural reforms, and the pursuit of a second generation of reforms to win investor confidence through good governance, transparency, and stronger market institutions.

But, in this globalized world, do regional integration efforts have a future? Yes, now more than ever. Take a few moments to think about the creation of the euro. A persistent effort to achieve macroeconomic convergence in a context of initially very different situations and perspectives has steadily created the conditions necessary for the creation of the single currency. Of particular relevance is the benefit that each economy has drawn from these convergence efforts: that of being able to join forces to gradually root out problems created by inflationary imbalances and protectionist demands. This same route is open to your countries as well. Regardless of the final monetary option chosen, the convergence and regional integration of your economies is essential to the strengthening of your countries and their ability to adapt to the new international financial environment. The fruits of these convergence efforts—the difficulties of which I fully recognize—could

• provide further evidence of the region's determination to meet the challenges of a globalized economy and to continue managing their economies in a coherent and stable manner;

• allow policymakers, through an exchange of information and opinions, to better assess the risks facing each country and formulate more appropriate policies;

• help governments consolidate domestic political support for their policies, warding off protectionist or backtracking tendencies; and

• offer a means of assessing the impact that policy changes in one country have on its neighbors, thus limiting the possibility of destabilizing unilateral decisions.

***Macroeconomic policies.*** I have already said enough about macroeconomics. I need only add that just as the IMF makes itself available to the Group of Seven and other groups and regions, it can assist you in your efforts to facilitate a frank and open regional discussion of the economic policies. A convincing first step in this direction was taken last September when finance ministers and central bank governors from Latin American economies with regular access to financial markets met at the IMF to discuss their situations and policy options in the aftermath of the Russian crisis. This experience could be expanded to periodic meetings, with broader representation and with countries possibly organized into subregions to ensure the active participation of all. Such meetings would provide fertile ground for the discussion of novel ideas and for gradual policy convergence.

***Banking.*** You may wish to consider a coordinated regional approach to financial supervision. If any lesson has emerged from the recent crises, it is the necessity of decisively strengthening financial systems. The Basle Core Principles for Effective Banking Supervision represent an important step toward defining global





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standards. I urge Latin America and the Caribbean to put these principles into practice as quickly as possible.

But could you not go one step further? To give a strong boost to confidence in the region, why not consider complementary regulatory measures better attuned to the specific circumstances of the region? The Basle Core Principles recommend a minimum capital adequacy ratio, duly weighted for risk. But as the exposure of banks in the region may be greater than among more diversified international banks, a higher ratio may be needed, and indeed some countries have already come to that decision. Other regulatory issues—such as accounting standards or the proper criteria to assess banks' internal risk-management policies—could also benefit from a regional definition based on international principles, adjusted to regional circumstances. All these aspects could in turn benefit from closer cooperation between national supervisors and renewed efforts on the part of the regional association of supervisors, with ongoing support from the IDB and the IMF.

*IMF Managing Director Michel Camdessus*

**Evidence continues to mount of the close links between export performance, the degree of trade liberalization, and economic development.**

## Trade

Evidence continues to mount of the close links between export performance, the degree of trade liberalization, and economic development. This is a lesson learned long ago in this region, and most countries have remained firmly committed to open trade regimes. However, in times of crisis, the risk of trade tensions increases. Trade policy can never be used as a substitute for macroeconomic policy adjustment, and it is essential that we keep trade liberalization at the forefront of governments' agendas. I have no doubt that countries in the region will continue to eschew protectionism and will avail themselves of existing regional mechanisms, such as MERCOSUR, to preserve and accelerate the liberalization of their economies. Regional trade liberalization initiatives can offer important benefits, but we must avoid the disorderly proliferation of overlapping and sometimes conflicting regional trade arrangements. It is therefore essential that we promote dialogue and make certain that regional initiatives progress in a decisive and nondiscriminatory manner toward the liberalization of trade.

## Role of the IMF

What will the IMF do in these difficult times to help the IDB support its member countries? First, we will continue to fulfill our traditional role and, in particular, to increase our support to the 11 countries that already have or are negotiating programs with us, representing total commitments of as much as SDR 21 billion ($28 billion). This means bringing discussions to a successful conclusion, particularly with Ecuador and Venezuela, and playing a very active role in assisting the victims of Hurricane Mitch.

But beyond this, our mission is to contribute to the international community's efforts to find the most appropriate response to the severe debt problem of the poorest countries and to create a new capability to grant contingent lines of credit to countries that, despite prudent macroeconomic management, are vulnerable to the volatility of financial flows. In this way, we hope to have a catalytic effect, facilitating the creation of the banking lines of defense that [IDB President Enrique] Iglesias mentioned. Indeed, this new approach could be one of the first components of the new architecture of the international financial system, which the Interim Committee will discuss in Washington in April. The objective should be to provide your countries with the stable, equitable framework necessary for sustainable, high-quality growth.

This is a time of great challenges for Latin America and the Caribbean, but with the courage of the people and governments, I am convinced the region will progress to even greater heights and will be strengthened by this crisis. We at the IMF will do all we can, in close cooperation with the IDB, to make that come to pass. ■

## Clinton proposes strengthening of HIPC Initiative

In remarks to a gathering of African government ministers in Washington on March 16, U.S. President Bill Clinton said that debt relief is an issue of truly global importance. He asked the international community to take actions, including sales of gold from the IMF, that could result in forgiving an estimated $70 billion in global debt.

To achieve this goal, Clinton proposed that the Group of Seven industrial countries consider significant enhancements of the Heavily Indebted Poor Countries (HIPC) Initiative at the Cologne summit in June. These include

- a new focus on early relief by international financial institutions;
- complete forgiveness of all bilateral concessional loans to the poorest countries;
- deeper and broader reduction of other bilateral debts, raising the amount of the reduction to 90 percent of total debt;
- commitment by donor countries to provide at least 90 percent of new development assistance on a grant basis to countries eligible for debt reduction;
- new approaches to help countries emerging from conflicts that have not had the chance to establish reform records and need immediate relief and concessional finance; and
- support for gold sales by the IMF and additional contributions by the United States and other countries to the HIPC Trust Fund.



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# New framework is appropriate for credible U.K. monetary policy

Monetary policy in the United Kingdom has been conducted within a framework of inflation targeting combined, since May 1997, with operational independence of the central bank (see *IMF Survey*, March 9, 1998, page 78). An IMF staff study, "Operational Independence and the Conduct of Monetary Policy in the United Kingdom," by Jan Kees Martijn and Hossein Samiei (to be included in a forthcoming IMF Staff Country Report on the United Kingdom) evaluates the experience thus far with this arrangement. While there are some potential weaknesses, the study concludes that the new monetary framework is appropriate for conducting a credible monetary policy.

## Background

The decision in October 1992 to adopt inflation targeting was prompted by unsatisfactory experiences with monetary targeting in the 1980s and exchange rate targeting during the early 1990s. Inflation targeting, according to the IMF staff study, aims to be transparent in both the process and the result achieved by setting measurable objectives, being explicit about the processes that link instruments with targets, and specifying procedures for accountability. By following an explicit rule, inflation targeting helps enhance credibility, strengthening the medium-term focus of monetary policy. It also goes some way toward lowering the politically motivated inflationary bias in economic policy.

Under the inflation-targeting system adopted in 1992, the chancellor of the exchequer made interest rate decisions, taking into account the views of the central bank governor that were discussed in monthly meetings on monetary policy. An important feature of the new framework, which has increased transparency and accountability, was the publication of the *Quarterly Inflation Report*, containing the Bank of England's inflation forecasts, and (starting in April 1994) the minutes of the monthly policy meetings between the chancellor and the governor.

## Central bank independence

Under the new framework, the operation of monetary policy improved, and inflation appeared to be under control. However, some observers suggested that the new regime did not include sufficient protection against the inflationary bias: the government remained in control of the policy process, and no institutional safeguards existed against the use of unsustainable, politically motivated policy decisions.

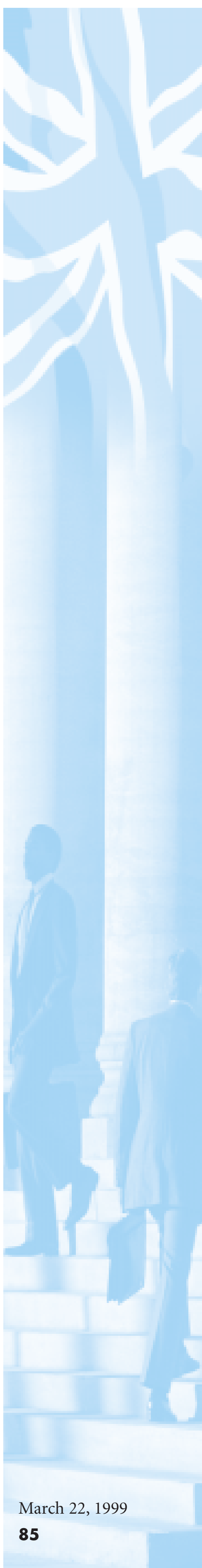
In May 1997, the U.K. government took a crucial step to remedy this deficiency by giving operational independence to the Bank of England. At the same time, it adopted an explicit and symmetric point inflation target of 2½ percent and established the Monetary Policy Committee, consisting of Bank of England staff members and outsiders from the private sector and academia.

Under the new arrangement, the chancellor of the exchequer sets the inflation target in the annual budget, and the Monetary Policy Committee sets interest rates to achieve the target. In an effort to increase accountability, the *Quarterly Inflation Report* presents the views of Monetary Policy Committee members and the rationale for monetary policy decisions, as well as an assessment of developments and prospects. The report also presents projections for inflation and GDP over a two-year horizon. The minutes of the meetings, including the members' votes, are published two weeks after the meetings take place. Moreover, if inflation deviates by more than 1 percentage point in either direction from the target, the governor is required to explain the reasons in an open letter to the chancellor.

The new framework implicitly recognizes that adopting a pure inflation target may limit the scope for macroeconomic stabilization and that the goal of stabilizing prices should not be at the expense of excessive fluctuations in output. The U.K. system attempts to deal with this problem. First, the focus on expected, rather than actual, inflation requires that the policy authority incorporate the behavior of other variables, including output, in its decisions, which helps in stabilizing demand shocks. Second, the new Bank of England remit stipulates that, without prejudice to the inflation target, the Monetary Policy Committee is expected to set interest rates so as to "support the general policies of the government, including its objectives for growth and employment." This allows for stabilization of output as a secondary objective.

## Transparency in the new framework

An important feature of the new monetary policy framework is increased transparency, in particular through the *Quarterly Inflation Report* and the minutes of the Monetary Policy Committee meetings. However, while transparency has been strengthened in many respects, the IMF study suggests that the credibility of inflation forecasting may have been weakened as a result of the transfer of decision making to the central bank. During 1992–97, before it was granted operational independence, the central bank, in effect, acted as an advisor to the government on monetary policy decisions and drew up independent forecasts. Since the Monetary Policy Committee took over the job of mon-



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etary policy decision making, the analysis and the inflation forecasts in the *Quarterly Inflation Report* no longer represent an independent assessment of monetary policy decisions. As a result, a situation in which the forecasts suggest that the two-year-ahead inflation target would be missed seems highly unlikely, because then the report would be questioning the committee's own policy decisions. The problem is compounded, the staff study notes, by the Bank of England's decision not to present an assessment of the likely future path of the interest rate. Instead, its primary inflation forecasts are made under the explicit assumption of unchanged interest rates, although, as the study notes, there is no reason to suppose that a policy that holds interest rates unchanged and delivers a two-year-ahead inflation of 2.5 percent is necessarily superior to other policies.

One way to strengthen the framework would be for the Bank of England to replace the assumption of unchanged interest rates in the inflation report with a more realistic and explicit discussion of the likely future path of the interest rate—a practice followed by the New Zealand Reserve Bank. Obviously, the bank would have to make it clear that it was not committing itself to a particular path, so that it could revise its projection at a later date without loss of credibility as new information became available.

**The potential drawbacks of decoupling monetary from fiscal policy should not be overrated.**

## Optimal policy mix

A fundamental implication of central bank independence is the separation of responsibility for monetary and fiscal policies. Most analyses of central bank independence, the staff study notes, do not take due account of the possibility that policy coordination may weaken, thus potentially offsetting the benefits of the lower inflation bias. At the same time, the study acknowledges, when independence accompanies a general move toward more stable policies, the impact on macroeconomic stabilization is likely to be positive. The issue has gained increased significance in recent years, since the United Kingdom has not only adopted a more stability-oriented monetary policy but has also moved toward a more rules-based fiscal policy. Although both objectives may be worthwhile in their own right, given the interaction between the two policies, the question can be raised as to whether the new arrangement can deliver a desirable policy mix. The study notes that the framework does not wholly preclude policy coordination. Both fiscal and monetary policy have an explicit and appropriate medium-term focus under current policy rules. The absence of attempts to fine-tune limits the need for day-to-day policy coordination. Also, the treasury has publicly emphasized that fiscal policy should support monetary policy in promoting stability.

Nevertheless, several features of the new regime could impair effective policy coordination:

- The nature of the "policy game" is not yet clear. On the one hand, the yearly announcement of the fiscal budget and the inflation target by the chancellor of the exchequer and the more frequent decisions on monetary policy tend to put the government in a leading position. On the other hand, the inflation target is unlikely to be adjusted frequently and, given its independence, the central bank could decide to ignore the government's preferences.
- The bank and the treasury may develop different views of economic development and, therefore, of future inflation, thus possibly ending up working at cross purposes.
- The new rules for fiscal policy are likely to affect the degree of automatic fiscal stabilization. Given that fiscal policy tends to affect aggregate output more rapidly than changes in official interest rates, this uncertainty complicates forward-looking monetary policy.
- Policymakers' strategies under the current framework are still unclear. In particular, considerable uncertainty remains on the different policy stances of the members of the Monetary Policy Committee and on their strategic interaction.

Given the historical inflation bias in the United Kingdom and the often poor policy coordination, the study suggests that the potential drawbacks of decoupling monetary from fiscal policy should not be overrated. Some of the uncertainties are likely to be resolved over time as policy practices are established based on the new framework and policymakers gain understanding of each other's strategies. Also, given the record so far on policy coordination, the new, partly rules-based framework is likely to be an improvement in promoting overall macroeconomic stability. Still, adequate exchange of information between the chancellor and the Bank of England—including, for example, the advanced announcement of tax and expenditure measures that are likely to be included in the budget—would clearly help policy coordination. Moreover, a more transparent approach to inflation forecasting by the bank and its likely future interest rate policies would help the fiscal authorities determine the extent to which fiscal policy needs to be used for macroeconomic management.

## Conclusions

Inflation targeting combined with operational independence of the central bank, as exists in the United Kingdom, is noteworthy, the IMF study observes, in that it incorporates features that are in line with evolving views on best practices and have, therefore, not been subject to empirical scrutiny. After evaluating the U.K. experience during its first year and a half, the study concludes that despite some potential weaknesses, it provides a suitable framework for a focused and credible monetary policy that is effective in reducing the inflationary bias in policymaking. ■



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# Eichengreen calls for strengthening foundations of international monetary system



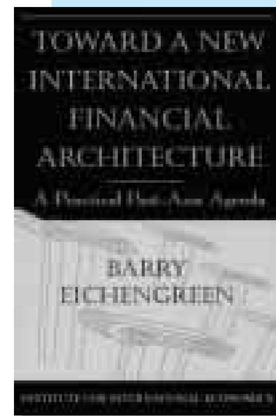
Presenting his new book, *Toward a New International Financial Architecture: A Practical Post-Asia Agenda*, at the Institute for International Economics (IIE) in Washington on February 25, Barry Eichengreen rejected approaches to the reform of the international monetary system that were either excessively timid or singularly unrealistic. Pointing out that measures in the former category (such as more reliance on market discipline) would not produce the necessary concrete changes, while those in the latter (a world currency) would never be enacted, he laid claim to the more sparsely populated middle ground with a limited set of pragmatic measures.

Eichengreen—Professor of Economics and Political Science at the University of California, Berkeley—noted that his reform proposals flow from his basic beliefs about the system. On the one hand, the world is right to conclude that the events in Asia constitute a prototype for future financial emergencies, providing an illustration of what happens when "high-tech" international finance collides with weak domestic financial systems. On the other hand, global capitalism is not in crisis. Rather, while greater financial liberalization offers compelling benefits—and seems in any case inevitable—financial markets are liable to overshooting, sharp corrections, and, in the extreme, crisis, because of asymmetric information and coordination problems.

Eichengreen offers some recommendations to strengthen the international monetary system through crisis prevention, crisis management, and reform of the IMF. He posits that since stability at the international level is not possible without its counterpart at the domestic level, the international community needs to address a wide range of nitty-gritty national issues, including bank and securities market regulation, bankruptcy laws, corporate governance, data dissemination, and auditing and accounting standards. But until a country's banking system is strengthened through adherence to internationally accepted bank standards for risk management and supervision, Eichengreen advocates the taxation of all short-term capital inflows to limit the debt buildups that can trigger financial crises.

Another recommendation, dealing with crisis management, is the promotion of orderly debt restructuring. The incorporation of new clauses into bond and bank loan contracts would be the most important step in this direction, Eichengreen said. Adding clauses that allow for majority voting, burden sharing, collective representation, nonacceleration, and minimum legal threshold provisions to bonds is the sane alternative to devastating defaults or billion-dollar bailouts.

Eichengreen also recommended that most developing countries with open capital accounts avoid fixed exchange rates, since fixed exchange rate regimes can trigger crises once the currency becomes overvalued. A noteworthy aspect of the evolution of the debate on the international financial architecture has been the widening of the focus from financial engineering to the previously ignored topic of exchange rate regimes.




The reform of the IMF is integral to all of these recommendations, Eichengreen said. While the private sector must take a lead role in developing new standards, the IMF would not only actively consult with these groups in developing the criteria, urge members to adopt them, and monitor compliance, but it would also offer its members both "the stick" of a frank and public assessment of their compliance with the internationally accepted standards of financial practice and "the carrot" of concessional interest rates to countries that are complying. The IMF should also encourage short-term taxes on capital inflows in countries without sufficiently strong financial systems and forcefully press for more flexible exchange rate regimes in its developing country members with open capital accounts. Finally, not only should the IMF offer the carrot of concessional interest rates to encourage members to design their international bond contracts so as to promote orderly debt restructuring, but it should also become an honest broker and helpful coordinator between debtors and creditors when financial crises inevitably do occur. Eichengreen called on the IMF "to become less of a fireman and more of a policeman."

**The debate on reform has fostered a flurry of architectural metaphors.**

The debate on the reform of the international monetary system has fostered a flurry of architectural metaphors, with the current proposals ranging from interior decoration to radical renovations. Eichengreen, noting he had the perspective of someone who lives in an earthquake zone, called his recommendations "a strengthening of the foundations of the system." He warned that there is a need for a broad consensus to emerge soon around pragmatic proposals to avoid having the crucial work on bolstering the international financial architecture run out of steam and be abandoned. ■

Lynn Aylward
IMF External Relations Department

Copies of *Toward a New International Financial Architecture: A Practical Post-Asia Agenda*, by Barry Eichengreen, are available for $18.95 each from the Institute for International Economics, 11 Dupont Circle, NW, Washington, DC 20036. Tel: (202)857-3616.



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*Asian crisis and tax policy*

# Tax reforms could foster recovery by facilitating corporate restructuring

Globalization and technological innovation have shaped the 1990s. They have spurred unprecedented capital flows and permitted virtually instantaneous capital mobility. Massive capital inflows have been linked to the sustained high growth rates that fueled the "Asian miracle," and it was the sudden reversal of these flows that triggered the Asian crisis.

Few aspects of macroeconomic policy have been immune to the implications of globalization and technological innovation. Clearly, tax policy has struggled to keep pace with the extent and rapidity of these changes, and tax-induced distortions appear to have had a role in encouraging or intensifying the Asian crisis. David C.L. Nellor, Assistant Director in the IMF's Regional Office in Tokyo, in his study *Tax Policy and the Asian Crisis*, argues that tax policy was part of a general policy stance feeding the bubble that ultimately triggered the crisis and that tax policy has an important role to play in fostering the recovery.

David Nellor

Drawing on the lessons learned from the Asian crisis, he recommends removing tax distortions—particularly those that promote foreign currency funding—and implementing a series of tax reforms that could facilitate the key task of corporate restructuring. More broadly, he adds, more attention needs to be paid to the complex, but critical, areas of tax administration and international and regional cooperation on tax issues.

**Tax systems in the Asian crisis countries offered particularly favorable treatment to foreign funding and borrowing.**

## Tax policy and capital flows

For the most part, capital flows reflect an efficient, and desirable, use of global capital. But in some instances, Nellor observes, capital moves to countries to exploit inconsistencies in macroeconomic policy. In some Asian economies in the lead-up to the crisis, a combination of effectively fixed exchange rates and attractive interest rate differentials offered nonequilibrating arbitrage—in effect, a "one-way" bet—that encouraged short-term capital inflows to take advantage of a seemingly high-profit, low-risk situation. Resident and nonresident investors borrowed foreign currency at low rates, converted that foreign exchange into local currency, and drew higher yields from local investments. Investors, confident of the fixed exchange rate arrangement, assumed the foreign-exchange-rate-denominated debt could be repaid at the original exchange rate. When investors perceived that this guarantee could not be sustained, it prompted a rush for the exits that precipitated the crisis.

In aggregate, capital flows grew sharply in the years before the crisis, but among them, "net other flows"—including lending by banks and residents related primarily to interest rate differentials and exchange rate prospects—grew disproportionately. The volume of these flows quintupled in Thailand between 1993 and 1995 and accounted for more than three-fourths of all private capital flows. In the Philippines, "other" flows constituted 90 percent of all private capital flows in 1996.

Did tax policy encourage these foreign-exchange-related flows? Nellor finds that "other" flows—particularly those channeled through banks—did receive favorable tax treatment. A recognition of the benefits of globalization encouraged countries to use tax breaks to attract capital at the same time that rapid technological changes were diminishing their ability to tax income on capital effectively. Countries rationalized that heightened competition, or the need to compensate investors for perceived infrastructure or other disadvantages, necessitated tax breaks for direct investment as well as financial flows. The export orientation of these economies and the vigorous use of tax incentives and discretionary privileges took tax competition to a new level, according to Nellor. And tax competition compounded the task of tax administration, which was already failing to keep pace with the scale and complexity of capital flows.

Tax breaks created "a myriad of tax arbitrage possibilities" that encouraged investors to reduce their tax burdens by shifting deductible expenses and taxable income. And tax incentives of various types proved both difficult to administer and easy to abuse. Tax competition was also a difficult issue to address in Asia's existing regional arrangements, which had traditionally focused on trade and investment policy matters, and lacked the institutional mechanisms needed to coordinate a regional approach to tax competition.

Ultimately, the tax systems in the Asian crisis countries afforded special treatment to capital, with particularly favorable treatment extended to foreign funding and borrowing. Many countries also permitted high levels of leverage that reduced the tax base and, given administrative constraints, exempted some forms of capital returns that were proving difficult to capture. While the quantitative impact of exemptions is difficult to measure, Nellor suggests that the scale of these distortions and the degree of leverage argue for the removal of these distortions, albeit with due attention



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to the state of a country's capital account, the health of its corporate sector, and revenue considerations.

### Tax policy and structural issues

The Asian crisis had several striking structural elements, notably a weakening in bank asset quality, excess real estate capacity, asset price inflation, and ineffective corporate governance. High rates of credit growth—in the Philippines, for example, private sector credit grew 51 percent in 1996—contributed to these developments. Tax policy appears to have abetted these structural weaknesses in a number of respects:

- Favorable treatment of foreign currency lending encouraged credit growth. (Demand for credit may have been promoted by weak corporate governance reflected in excessive leverage. The absence of thin capitalization rules may also have played a role.)
- The inability in some countries to treat specific provisions for bad loans as a deductible business expense may have discouraged banks from managing their assets appropriately. Even in those countries that did permit such deductions, prudential rules were weaker than internationally accepted standards.
- Extensive incentives for fixed capital investment combined with the failure of the tax system to capture capital gains meant that the tax system encouraged asset acquisition and possibly contributed indirectly to asset price inflation.

### Tax policy and recovery

One of the critical steps in resuming sustainable growth in Asia is corporate restructuring. The scale of leverage, maturity mismatches, exchange rate developments, and demand and price conditions make a compelling case for corporate restructuring. Indeed, the importance of getting assets back to work has prompted countries to reexamine corporate laws, bankruptcy provisions, and tax policies. If the tax system, Nellor notes, is to support corporate restructuring, a number of aspects should be addressed, namely:

- *Foreign exchange gains and losses.* Large, and unfavorable, exchange rate movements have resulted in substantial foreign exchange losses, typically in the nonbank corporate sector. In the absence of a standard income tax treatment for such losses (or gains), a financial accounting treatment, which would require that monetary assets and liabilities be translated at the closing exchange rate on the balance sheet, offers perhaps the best rule for taxation. Losses in some Asian corporations are so large, however, that use of an accrual system might trigger extensive bankruptcies. In these circumstances, Nellor advises that it might be appropriate to employ a special rule to provide a favorable loss carryover when the accrual system is used.
- *Valuation of assets.* Physical assets should be revalued following large currency depreciations. Setting foreign exchange losses against revaluation gains would be appropriate and may help to limit some of the problems noted above.
- *Restructuring.* In general, tax laws should be neutral with regard to the mergers or restructurings that shareholders choose to pursue. In particular, tax provisions that act as disincentives to restructuring should be removed to help overcome the crisis. As long as the restructurings are not undertaken to avoid taxes, gains or losses realized in this process should not be viewed as taxable events
- *Insolvency-related debt restructuring.* Debt forgiveness creates taxable income equal to the debt forgiven. But insolvent companies should be permitted to enter into bankruptcy proceedings under tax laws that permit debt forgiveness income to be spread over a period of time.
- *Treatment of specific provisions of banks.* More meaningful bank balance sheet information is an integral step in restoring growth in Asia. The true costs of doing business should be reflected in these balance sheets, including specific provisions being made for bad loans. Recognizing specific provisions as deductible expenses for tax purposes should encourage full recognition of bad or doubtful loans.

### Lessons for tax policy

In the precrisis years, Asian tax policies typically favored returns on capital and encouraged a dependence on volatile short-term capital flows. Nellor recommends that these distortions be removed and that tax policies be scrutinized to ensure neutrality regarding business decisions. As Asia looks to the future, and to economic recovery, it should also revise its tax systems to facilitate corporate restructuring.

Beyond the vital immediate tasks of removing distortions and promoting effective corporate restructuring, there are broad and complex issues that will require longer-term and coordinated action. Nellor cautions that tax administration, like financial systems, needs to be strengthened if capital account liberalization is to be effective. And given trends in the global economy, tax reforms will increasingly entail external (regional or international) coordination as well as internal administrative or legislative action. ■

Copies of IMF Policy Discussion Paper 99/2, *Tax Policy and the Asian Crisis*, by David C.L. Nellor, are available for $7.00 each from IMF Publication Services. See page 92 for ordering information.

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**As Asia looks to the future, it should revise its tax systems to facilitate corporate restructuring.**



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*Bretton Woods delegate*

# IMF Executive Board pays tribute to Abol Hassan Ebtehaj

*Abol Hassan Ebtehaj (1953)*

Abol Hassan Ebtehaj, the last surviving head of delegation to the Bretton Woods conference and first Director of the IMF's Middle Eastern Department, died in London on February 24. Ebtehaj, who was born in the Islamic Republic of Iran in 1899 and would have been 100 years old in November, was one of the founding fathers of the Bretton Woods institutions. As Governor of Iran's central bank, the Melli Bank, he led the Iranian delegation to the Bretton Woods conference in July 1944. He went on to serve as his country's first Governor for the IMF and the World Bank and, in this capacity, attended the inaugural Governors' meeting in Savannah, Georgia, in March 1946. He remained Governor through 1950, when he became Iran's ambassador to France.

In 1952, the IMF's second Managing Director, Ivar Rooth, appointed Ebtehaj as his Advisor on Middle East and Related Areas. During 1953–54, Ebtehaj served as the first Director of the IMF's Middle Eastern Department.

After he left the IMF, Ebtehaj continued his distinguished career in Iran, where he served for five years as head of the National Plan Organization. He was an early proponent of international cooperation, good governance, and efficient uses of his country's economic resources, establishing a reputation at home and abroad for his outspoken opposition to the use of bilateral foreign assistance to support military rather than economic development. He was able to secure from the World Bank substantial support for his development plans before leaving government in February 1959. He then undertook a successful career in private banking and insurance and, as an internationally respected economist and businessman, was a regular participant in the Annual Meetings of the IMF and the Bank. In 1994, at the time of the Annual Meetings in Madrid, Ebtehaj attended the commemoration of the fiftieth anniversary of the Bretton Woods conference.

Ebtehaj is survived by his wife, Azar, to whom the Managing Director has sent a message of condolence on behalf of the Executive Board and the management of the IMF, as well as by a daughter, Shahrzad, and a son, Davar. ■

*Data release*

# IMF joins with other organizations to publish joint statistics on external debt

*On March 15, the IMF, the Bank for International Settlements (BIS), the Organization for Economic Cooperation and Development (OECD), and the World Bank announced the joint publication of the first of a new series of quarterly releases of statistics for 176 developing and transition countries, in response to requests for dissemination of more timely external debt indicators. The statistics are hosted at www.oecd.org/dac/debt and are also accessible through each agency's website. The IMF's website is www.imf.org. Following is the text of News Brief 99/11.*

The aim of this initiative is to facilitate access to a single set of data that brings together information currently compiled and published separately by the contributing institutions on components of countries' external debt. The publication also includes data on international reserves.

This is a project of the Inter-Agency Task Force on Finance Statistics, which coordinates work on finance statistics. It is chaired by the IMF and comprises, in addition to the four above-mentioned organizations, the United Nations, the European Central Bank, and Eurostat [the Statistical Office of the European Communities].

The statistics are mostly from creditor and market sources, but also include data provided by debtor countries. Particular emphasis is placed on debt due within a year. Also, to help analysts, flow data (where available) are provided in addition to stock data. There remain differences between the series in their coverage, frequency, and the time lag before publication, and the data do not yet provide a completely comprehensive and consistent measure of total external debt in each country. Nevertheless, they bring together for the first time the best international comparative data currently available on external debt.

The coverage, definitions, and limitations are explained in a methodological note on the website. Currently, the figures cover essentially all countries and territories on the list of aid recipients of the Development Assistance Committee of the OECD, including practically all non-OECD countries, as well as the Czech Republic, Hungary, Korea, Mexico, Poland, and Turkey. Data for offshore financial centers are separately distinguished.

This publication is part of an evolutionary process. The contributing institutions are currently working on improving the comprehensiveness, quality, and timeliness of the statistics. ■

*See table (facing page) for a list of available data series and a brief description.*



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## Joint statistics on external debt

| Data Series | Source | Description |
|---|---|---|
| **External debt—all maturities** | | |
| A Bank loans[1] | BIS | Loans from banks resident in 18 major industrial countries and 6 offshore centers |
| B Debt securities issued abroad[2] | BIS | Money market instruments, bonds, and notes issued in international markets by both public and private sector borrowers |
| C Brady bonds[2] | World Bank | Bonds issued to restructure commercial bank debt under the 1989 Brady Plan |
| D Nonbank trade credits[1] | OECD | Official and officially guaranteed nonbank export credits from 21 OECD countries |
| E Multilateral claims (IBRD, IDA, IMF)[2] | World Bank/IMF | IBRD loans and IDA credits from the World Bank and use of IMF credit |
| F Official bilateral loans (DAC creditors)[2] | OECD | Concessional (aid) and other loans provided mainly for developmental purposes by the 21 member countries of the OECD Development Assistance Committee |
| **Debt due within a year[3]** | | |
| G Liabilities to banks | BIS | Liabilities to banks that are headquartered in 18 major industrial countries and that report their claims on a worldwide consolidated basis. The data include holdings of short-term securities, which are also included in line H. |
| H Debt securities issued abroad | BIS | Money market instruments, bonds, and notes issued in international markets by both public and private sector borrowers. The data include securities held by foreign banks, which are also included in line G. |
| I Nonbank trade credits | OECD | Official and officially guaranteed nonbank export credits from 21 OECD countries |
| **Memorandum items** | | |
| J Total liabilities to banks (locational)[1] | BIS | Liabilities to banks resident in 18 major industrial countries and 6 offshore centers (line A plus banks' holdings of debt securities, which are partly included in line B, plus other claims that are not loans or debt securities) |
| K Of which: officially guaranteed trade credits[1] | OECD | Officially guaranteed export credits from banks in 21 OECD countries, included in lines A and J (lines D + K = total export credits) |
| L Total liabilities to banks (consolidated) | BIS | Liabilities to banks that are headquartered in 18 major industrial countries and that report their claims on a worldwide consolidated basis, both short-term (line G) and long-term liabilities |
| M International reserve assets (excluding gold) | IMF | Monetary authorities' holdings of SDRs, reserve position in the IMF, and foreign exchange assets |

Note: Amounts outstanding at the end of each period (stocks).
[1]Adjusted for changes in exchange rates to the U.S. dollar during the period.
[2]Flows are available.
[3]Liabilities with an original maturity of one year or less, plus repayments due within the next 12 months on liabilities with an original maturity of over a year, plus arrears.

Data: Joint BIS-IMF-OECD-World Bank statistics on external debt (www.oecd.org/dac/debt)





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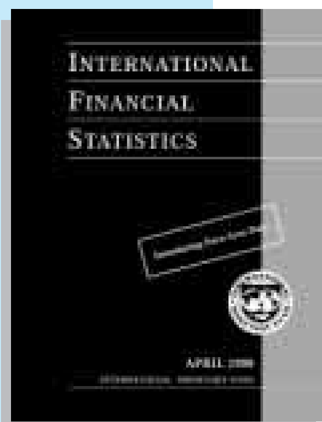
# Data for euro area in *IFS*

*(Continued from front page)* a framework for euro area monetary, exchange rate, international liquidity, and other financial statistics that reflects EMU's unique conditions, serves the needs of the IMF in carrying out its oversight of the economies of its member countries, and informs the public. The framework links—whenever possible—to the statistics for countries outside the euro area. The country pages for euro area countries present some of these new statistics in the April 1999 issue of *IFS*, and a new *IFS* page is introduced for the euro area as a whole.




An important statistical change arising from the creation of the "Eurosystem"—the central banking system of the union, comprising the ECB and the national central banks—is denomination of data in euros. Nearly all the data on the euro area *IFS* page are in euros, whereas country data are denominated in euros from January 1999 onward, but data prior to January 1999 continue to be denominated in the pre-euro-era national currencies.

Another important element of the IMF's euro area statistics is the use of two criteria to determine residency—the traditional national residency criterion and an alternative euro-area-wide residency criterion, in which all positions within the euro area are classified as domestic positions. The use of the national residency criterion helps maintain links with the historical data for each country and facilitate comparison with the statistics of non-euro-area countries, while the use of the area-wide residency criterion better reflects the integrated economic conditions that prevail within the union.

## Reserve statistics

Important changes also affected international reserves statistics. Under the new definition, reserves can include only claims on non-euro-area countries denominated in currencies outside the euro area. *IFS* pages present these data and two memorandum items—claims on euro area residents in non-euro-area currencies and euro claims on non-euro-area countries—that permit a conceptual linkup between the reserves data in stage three (that is, after January 1, 1999) and the national definitions of reserves prior to 1999.

The criteria in the Maastricht Treaty involved a very precise and comparable measurement of government finance, inflation, national accounts, and others. The conceptual basis for this measurement has been found largely in the European system of accounts developed by Eurostat. In addition, Eurostat assumed leadership for the development of a harmonized index of consumer prices. Work on improving the comparability and timeliness of economic statistics is continuing and involves, among other things, the development of a system of short-term indicators (such as orders, output, and employment), a quarterly index of labor costs, and the harmonization of the national accounts at constant prices. ■

## Recent Publications

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

171: *Monetary Policy in Dollarized Economies*, an IMF staff team led by Tomás Baliño, Adam Bennett, and Eduardo Borensztein

### Working Papers ($7.00)

99/16: *Interest Rate Arbitrage in Currency Baskets: Forecasting Weights and Measuring Risk*, Peter Christoffersen and Lorenzo Giorgianni

99/17: *Large Capital Flows: A Survey of the Causes, Consequences, and Policy Responses*, Alejandro López-Mejía

99/18: *Are There International R&D Spillovers Among Randomly Matched Trade Partners? A Response to Keller*, David T. Coe and Alexander W. Hoffmaister

99/19: *Taxation in Latin America: Structural Trends and Impact of Administration*, Parthasarathi Shome

99/20: *Credit Allocation and Financial Crisis in Korea*, Eduardo Borensztein and Jong-Wha Lee

99/21: *Does Higher Government Spending Buy Better Results in Education and Health Care?* Sanjeev Gupta, Marijn Verhoeven, and Erwin Tiongson

99/22: *The Stock Market Channel of Monetary Policy*, Ralph Chami, Thomas F. Cosimano, and Connel Fullenkamp

### IMF Staff Country Reports ($15.00)

99/4: Mongolia—Selected Issues

99/5: Senegal—Statistical Appendix

99/6: Colombia—Selected Issues and Statistical Appendix

99/7: Panama—Recent Economic Developments

99/8: Burundi—Statistical Annex

99/9: Namibia—Statistical Appendix

99/10: Paraguay—Recent Economic Developments

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*UNCTAD update*

# FDI flows to Asian crisis countries prove resilient

Flows of foreign direct investment (FDI) into the five countries most seriously affected by the Asian crisis (Indonesia, Korea, Malaysia, Philippines, and Thailand) declined by about $2 billion in 1998, according to updated information gathered by the United Nations Conference on Trade and Development (UNCTAD) (see also *IMF Survey*, November 16, 1998, page 358). Within the group, however, individual countries turned in strikingly different performances (see table).

Flows into Korea and Thailand almost doubled over the 1997 level, while flows into the Philippines remained stable. Indonesia and Malaysia, hardest hit by the Asian crisis, also fared less well than their neighbors in FDI terms. In a press release issued on March 4, UNCTAD reported that flows to Malaysia had declined from $5.1 billion in 1997 to $3.6 billion in 1998, while Indonesia had suffered divestment for the first time since 1974. Total inflows to the region in 1998 amounted to $15.4 billion, substantially more than the average of flows recorded during 1991–95 ($10.8 billion) and only $2.1 billion less than the peak of $17.5 billion recorded in 1996 and 1997.

In reporting its findings, UNCTAD discussed the incidence of cross-border mergers and acquisitions—used by transnational corporations for investing abroad—to gauge the level of FDI inflows to the five countries. Cross-border mergers and acquisitions in Indonesia, Malaysia, and the Philippines declined in 1998, but rose in Korea and Thailand. The remarkable increase in Korea, from $1.4 billion in 1997 to $6.3 billion in 1998, represented, among other things, substantial changes in regulations related to mergers and acquisitions. The UNCTAD press release noted, however, that because mergers and acquisitions can be financed domestically or from international capital markets, their relationship to FDI inflows is not straightforward.

FDI flows to the five countries as a group were more resilient than either foreign bank lending or foreign portfolio equity investment before and during the financial crisis. UNCTAD offered a number of explanations for this: (1) corporate networks of integrated international production that already existed in Asia allowed some transnational corporations to offset declining domestic sales through increased exports spurred by devaluations; (2) some transnational corporations took advantage of cheaper asset prices; (3) in some cases, parent firms increased investment stakes in their existing affiliates, either to buy some or all shares of distressed joint-venture partners or to alleviate affiliates' financial difficulties in the wake of the crisis; and (4) some transnational corporations increased their capital investments in response to the relaxation of FDI regimes that occurred as a result of the crisis.

Transnational corporations, encouraged by other recent events, have remained active in four of the five most affected Asian countries. In October 1998, the Association of Southeast Asian Nations (ASEAN), to which four of the five crisis countries belong, concluded

### FDI inflows into the five Asian countries most affected by financial crisis
(billion U.S. dollars)

| Country | Annual average 1991–95 | 1996 | 1997 | 1998 |
|---|---|---|---|---|
| Indonesia | 2.3 | 6.2 | 4.7 | –1.3 |
| Korea | 1.0 | 2.3 | 2.8 | 5.1 |
| Malaysia | 4.5 | 5.1 | 5.1 | 3.6[1] |
| Philippines | 1.0 | 1.5 | 1.1 | 1.0[1] |
| Thailand | 1.9 | 2.3 | 3.7 | 7.0 |
| Total | 10.8 | 17.5 | 17.5 | 15.4 |

Note: All FDI flows are on a balance of payments basis.
[1]Estimates as of February 26, 1999.

Data: UNCTAD, FDI/TNC database

### Selected IMF rates

| Week Beginning | SDR Interest Rate | Rate of Remuneration | Rate of Charge |
|---|---|---|---|
| March 8 | 3.50 | 3.50 | 3.75 |
| March 15 | 3.46 | 3.46 | 3.70 |

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 January 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 (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

### Members' use of IMF credit
(million SDRs)

| | Feb. 1999 | Jan.– Feb. 1999 | Jan.– Feb. 1998 |
|---|---|---|---|
| **General Resources Account** | **52.30** | **508.02** | **3,620.67** |
| Stand-By Arrangements | 0.00 | 0.97 | 3,036.27 |
| SRF | 0.00 | 0.00 | 3,000.00 |
| EFF Arrangements | 52.30 | 98.03 | 584.40 |
| CCFF | 0.00 | 409.02 | 0.00 |
| **ESAF Arrangements** | **116.32** | **157.85** | **27.74** |
| **Total** | **168.62** | **665.87** | **3,648.41** |

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



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an agreement to create a competitive investment area within ASEAN in the hope of attracting investment to the region. The agreement creates a more liberal and transparent investment environment and allows a freer flow of capital, skilled labor and professionals, and technology among the members. ASEAN has also granted special incentives and privileges to investors.

UNCTAD projected that FDI flows to the region would be about the same in 1999 as during the rest of the decade, but noted that individual country performances would be likely to vary. The investment climate in Indonesia, it predicted, would probably require more time to recover. Overall, UNCTAD concluded that measures to address the impact of the crisis would continue to be necessary. ■

**Extended Arrangements are designed to rectify balance of payments problems that stem from structural problems.**

## Stand-By, EFF, and ESAF Arrangements as of February 28

| Member | Date of Arrangement | Expiration Date | Amount Approved | Undrawn Balance |
|---|---|---|---|---|
| | | | (million SDRs) | |
| **Stand-By Arrangements** | | | **32,858.97** | **12,612.67** |
| Bosnia and Herzegovina | May 29, 1998 | May 28, 1999 | 60.60 | 36.36 |
| Brazil[1] | December 2, 1998 | December 1, 2001 | 13,024.80 | 9,605.79 |
| Cape Verde | February 20, 1998 | April 19, 1999 | 2.10 | 2.10 |
| Djibouti | April 15, 1996 | March 31, 1999 | 8.25 | 0.98 |
| 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 | 1,450.00 |
| Latvia | October 10, 1997 | April 9, 1999 | 33.00 | 33.00 |
| Philippines | April 1, 1998 | March 31, 2000 | 1,020.79 | 728.41 |
| Thailand | August 20, 1997 | June 19, 2000 | 2,900.00 | 600.00 |
| Uruguay | June 20, 1997 | March 19, 1999 | 125.00 | 10.80 |
| Zimbabwe | June 1, 1998 | June 30, 1999 | 130.65 | 91.45 |
| **EFF Arrangements** | | | **24,176.22** | **14,563.68** |
| Argentina | February 4, 1998 | February 3, 2001 | 2,080.00 | 2,080.00 |
| Azerbaijan | December 20, 1996 | December 19, 1999 | 58.50 | 15.80 |
| Bulgaria | September 25, 1998 | September 24, 2001 | 627.62 | 470.72 |
| 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 | 1,882.40 |
| Kazakhstan | July 17, 1996 | July 16, 1999 | 309.40 | 154.70 |
| Moldova | May 20, 1996 | May 19, 1999 | 135.00 | 72.50 |
| Pakistan | October 20, 1997 | October 19, 2000 | 454.92 | 379.09 |
| 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** | | | **3,896.86** | **1,965.29** |
| Albania | May 13, 1998 | May 12, 2001 | 35.30 | 23.53 |
| Armenia | February 14, 1996 | September 14, 1999 | 109.35 | 20.93 |
| Azerbaijan | December 20, 1996 | January 24, 2000 | 93.60 | 17.55 |
| Benin | August 28, 1996 | August 27, 1999 | 27.18 | 14.50 |
| Bolivia | September 18, 1998 | September 17, 2001 | 100.96 | 84.13 |
| Burkina Faso | June 14, 1996 | September 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 | 161.98 |
| Ethiopia | October 11, 1996 | October 22, 1999 | 88.47 | 58.98 |
| The Gambia | June 29, 1998 | June 28, 2001 | 20.61 | 17.18 |
| Georgia | February 28, 1996 | July 26, 1999 | 166.50 | 27.75 |
| Ghana | June 30, 1995 | June 29, 1999 | 164.40 | 27.40 |
| 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 16, 1999 | 50.96 | 7.64 |
| Mali | April 10, 1996 | August 5, 1999 | 62.01 | 0.00 |
| 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 | 19.22 |
| Niger | June 12, 1996 | August 30, 1999 | 57.96 | 9.66 |
| Pakistan | October 20, 1997 | October 19, 2000 | 682.38 | 417.01 |
| Rwanda | June 24, 1998 | June 23, 2001 | 71.40 | 59.50 |
| Senegal | April 20, 1998 | April 19, 2001 | 107.01 | 71.34 |
| Tajikistan | June 24, 1998 | June 23, 2001 | 100.30 | 60.00 |
| Tanzania | November 8, 1996 | November 7, 1999 | 161.59 | 9.38 |
| Uganda | November 10, 1997 | November 9, 2000 | 100.43 | 43.52 |
| Yemen | October 29, 1997 | October 28, 2000 | 264.75 | 176.75 |
| **Total** | | | **60,932.05** | **29,141.64** |

[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



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# Prices and demand respond to liberalization of trade policy in China



How responsive have China's relative prices and domestic and foreign demand been to the liberalization of foreign trade over the past two decades? Valerie Cerra of the IMF's European I Department and Anuradha Dayal-Gulati of the IMF Institute examine these issues in a recent study, *China's Trade Flows: Changing Sensitivities and the Reform Process.* They find that while in 1979, China's foreign trade functioned according to a crucial plan that determined what was exported and what was imported, today, market forces determine the price of exports and imports and, to a large extent, their composition. Although some restrictions on imports remain, China has become a substantially open economy, with the share of merchandise trade in GDP tripling over the past two decades, from 10 percent in 1979 to 36 percent in 1997.

## Prereform policies

Before the reform movement, China's foreign trade was guided by a central plan that ensured that exports generated sufficient foreign exchange to meet the country's import requirements. Exporters supplied targeted quantities to 12 foreign trade corporations, and all foreign exchange receipts from the sale of these exports were surrendered to the central bank at the official exchange rate, later to be disbursed in fulfillment of the import plan.

The import plan identified imports of food, raw materials, and intermediate goods to fill the gap between domestic production and domestic demand. The foreign trade corporations were not free to determine which goods were to be exported or the price at which these goods were to be procured from domestic manufacturers. Export losses occurred when these corporations were required to buy such goods as electronics or machinery from inefficient producers at relatively high prices and to sell them at lower prices in the international market. Moreover, since imports were intended mainly to fill a demand gap, the foreign trade corporations had to purchase imports at international market prices and sell them at administratively determined domestic prices, often incurring substantial losses.

## 1984–85 reforms

In 1984, the authorities began seriously to liberalize the foreign trade regime, the authors note. First, they relaxed the import plan, freeing more foreign exchange for nonmandatory imports. In 1984, local governments were granted the right to retain a share of the foreign exchange earned in their region and, in 1985, this right was extended to exporting enterprises. Under this system of retention quotas, local authorities and enterprises could purchase from the central bank, at the prevailing exchange rate, foreign exchange equal to 25 percent of their export earnings. This foreign exchange could then be used to purchase imports outside the plan.

Second, the monopolistic position of most foreign trade corporations was abolished, allowing branches of these corporations to act as agents of domestic enterprises, particularly in purchasing imports. The foreign trade corporations now charged a fee for their services, but would not absorb profits or losses on goods traded.

Under the 1984 reforms, about 60 percent of exports fell under a mandatory plan, an additional 20 percent were assigned as value targets to individual provinces, and the remainder were nonplan exports. The procurement price of mandatory exports was fixed, but could be negotiated for nonmandatory exports. Given the large share of mandatory exports routed through the designated foreign trade corporations, however, the 1984 reforms failed to establish a close systematic relationship between relative prices and export volumes.

Importers could choose any foreign trade corporation for procuring nonmandatory imports, as long as they could pay the import price and the corporation's costs. With the decentralization of the foreign trade system, foreign trade corporations proliferated and the agency system for nonmandatory imports became widespread. The increased share of imports channeled through the agency system meant that consumers rather than foreign trade corporations directly absorbed variations in international market prices and fluctuations in the exchange rate.

The value of imports shot up by over 60 percent in 1985 (although exports remained stagnant). Imports surged partly because foreign exchange was available at the depreciated official rate through retention quotas. The sharp deterioration in the trade balance led the government to apply stricter trade controls. Credit was tightened, and import bans, quotas, and licenses were used to restrict imports, whose growth fell during 1986–87.

## Later reforms

Additional wide-ranging reforms in 1988 included increased retention of foreign exchange and a reduction of mandatory exports by about 30 percent. Moreover, access was eased to foreign exchange adjustment centers (established in 1986), in which enterprises were allowed to buy and sell foreign exchange at a depreciated rate known as the swap rate.

To encourage exports, the authorities raised retention quotas for enterprises that exceeded their targets, for priority sectors, and for higher domestic value-added products, such as home electronics (100 percent



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retention) and garments (60 percent retention). Increased retention quotas and liberalized access to foreign exchange adjustment centers meant that the effective exchange rate received by the exporter was a weighted average of the official exchange rate and the depreciated swap rate. The central government continued to subsidize losses on mandatory exports at an ever-decreasing rate until these subsidies were abolished in 1991, along with the entire mandatory export plan.

The 1988 reforms represented a major step toward making exports more responsive to relative prices. Growth in the volume of exports increased to about 13 percent in 1988 from an average of 7 percent in the previous five years. The increase in the retention quota would probably not have provided significant export incentives unless the foreign trade corporations passed on these benefits to manufacturers through higher procurement prices. The abolition of the mandatory export plan and of export subsidies in 1991 created livelier competition among the foreign trade corporations in purchasing products and more attractive prices for export suppliers. Export volumes rose by about 16 percent in 1991 relative to about 7 percent in the previous year.

To limit the impact of foreign trade corporation losses on the central government budget, the scaling back of the import plan was accompanied by a gradual increase in domestic prices. In 1989–90, the domestic prices of steel, nonferrous metals, and several other products were raised to international market prices. In 1991, subsidies for imported food grains and vegetable oils were further reduced. Prices for imported goods in line with international prices are likely to have increased the responsiveness of import volumes to changes in relative prices.

*A freighter docks in Shanghai, China. Liberalization has made exports more responsive to relative prices and increased export volumes.*

## 1994 reforms

In January 1994, the exchange rate was unified at the prevailing swap-market rate, which led to a depreciation in the official exchange rate of about 50 percent. The retention quota system for foreign exchange was abolished, and the tax system was revised to allow a zero value-added-tax (VAT) rating for exports by domestic firms and newly established foreign-funded enterprises. This tax change meant that exporters could claim a refund of the VAT paid on inputs. These reforms led to a vigorous pickup in exports. Domestic enterprises had faced an exchange rate that was the weighted average of the official rate and the swap rate, as noted above. Foreign-funded enterprises, in contrast, were not subject to retention quotas and were allowed to retain the full amount of their export earnings. The unification of the exchange rate in 1994 therefore had a greater effect on export performance of the enterprises that were not foreign funded, contributing to a surplus in this sector.

The 1994 reform eliminated mandatory import planning and reduced quotas and licensing requirements. Tariff rates were reduced for a few products and nontariff barriers were lowered.

## Foreign direct investment policies

In addition to the liberalization of the trade and exchange rate regime, China's open-door policy toward foreign direct investment has been a significant component of its external sector reform. The policy focus of the first phase of foreign direct investment flows, during 1979–85, was to attract foreign investment for natural resource development and the export sector. Nevertheless, foreign investment remained slow until 1983 because of a lack of appropriate labor skills and infrastructure, but a shift in China's investment policies after 1983 hastened these flows. Special tax incentives to encourage foreign investment in technology-intensive industries were introduced. Firms operating in special economic zones were given more generous tariff concessions, more flexible labor relations, liberal land-use rights, lower income tax rates, and tax holidays. Largely as a result of these initiatives, foreign direct investment inflows had increased to over $4 billion by 1991. Since 1992, further liberalization has taken place and open economic zones have proliferated rapidly, typically without approval from the central government. In 1997, net foreign direct investment flows rose to more than $40 billion.

Cerra and Dayal-Gulati suggest that the responsiveness of China's exports and imports to the real effective exchange rate has increased over time, owing to farsighted policy changes. The continued transition to a more market-oriented economy is likely to intensify the responsiveness of domestic enterprises to market signals. ■

Copies of Working Paper 99/1, *China's Trade Flows: Changing Price Sensitivities and the Reform Process,* by Valerie Cerra and Anuradha Dayal-Gulati, are available for $7.00 each from IMF Publication Services. See page 92 for ordering information.



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