

Genoa meeting

Group of Eight calls for decisive global action to help developing countries, especially Africa



Group of Eight leaders, European Union representatives, African heads of state, and the UN Secretary-General met in Genoa to discuss ways to draw the poorest countries more fully into the global economy.

Emphasizing their determination "to make globalization work for all our citizens and especially the world's poor," the leaders of the Group of Eight stressed on July 22 that the surest way to address the fundamental aspirations of the poorest countries was to draw them more fully into the global economy. The summit meeting in Genoa, Italy, took place following three days of extensive and often violent

street demonstrations by antiglobalization militants.

In a final statement, the Group of Eight—the heads of state and government of eight large industrial countries, including Russia, and the representatives of the European Union—said that "the situation in many developing countries—especially in Africa—calls for decisive global action." The most effective poverty reduction strategy, they said, "is to maintain a strong,

dynamic, open, and growing global economy." The meeting of the Group of Eight was preceded by meetings of the leaders of the Group of Seven industrial countries on July 20 and their finance ministers on July 7 (*IMF Survey*, July 16, page 229).

In a statement following their July 20 meeting (see excerpts, page 245), the Group of Seven stressed that "opening markets (*Please turn to the following page*)

ECOSOC speech

Köhler endorses New African Initiative, promises to provide strong IMF support

Following is an edited version of an address given by IMF Managing Director Horst Köhler before the United Nations Economic and Social Council (ECOSOC) in Geneva on July 16. In his remarks, Köhler endorsed a new initiative of African leaders as the basis for a comprehensive approach to fighting poverty on the continent.

Growth is slowing throughout the world. This may be uncomfortable for the advanced economies, but it will be a hardship for many emerging markets and developing countries and a setback in the fight against world poverty. The advanced economies, in particular, have a responsibility to strengthen the prospects for sustainable growth in their own countries, and thereby to restore momentum in the global economy. Emerging market and developing countries, for their part, should stay the course of structural reform and sound macroeconomic policies.



IMF Managing Director Horst Köhler (left) greets UN Secretary-General Kofi Annan (right) with World Bank President James Wolfensohn.

The slowdown in world economic activity has made it clearer than ever that nations (*Continued on page 248*)

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Genoa meeting

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The slowdown in world economic activity has made it clearer than ever that nations (Continued on page 248)

Group of Eight calls for global action

(Continued from front page) globally and strengthening the World Trade Organization (WTO) as the bedrock of the multilateral trading system is . . . an economic imperative.” For this reason they promised to engage personally and jointly in the launch of a new round of trade negotiations at next November's WTO ministerial conference in Qatar. They also emphasized that “increasing global growth and prosperity depends crucially on a sound and stable international financial system.”

HIPC Initiative

The Group of Seven in its statement (see excerpts below) also welcomed the important progress achieved

in implementing the Heavily Indebted Poor Countries (HIPC) Initiative. The leaders noted that to date 23 countries had benefited from the Initiative, with a total amount of debt relief of over \$53 billion, out of an initial stock of debt of \$74 billion. “This will significantly reduce their debt service, thus freeing resources for social sector expenditure, in particular education and health,” they observed.

The leaders encouraged those HIPCs that had not yet reached their decision points to quickly undertake the necessary economic and social reforms, including the development of a strategy for overall poverty reduction, in cooperation with the World Bank and the IMF. ■

Group of Seven statement

Leaders call for new trade round, strengthened financial systems, and aid to poorest countries

Following are edited excerpts of the Group of Seven statement. The full text is available on http://www.g8italy.it/_en/docs/JYTNI13F.htm

While the global economy has slowed more than expected over the past year, sound economic policies and fundamentals provide a solid foundation for stronger growth. We will remain vigilant and forward looking in implementing measures, as necessary, to ensure that our economies move toward a more sustained pattern of growth, in line with their potential. We pledge to pursue policies that will contribute to global growth by enhancing strong productivity growth in a sound macroeconomic environment, through structural reform, free trade and strengthened international economic cooperation.

In the United States, while growth has slowed sharply, long-term trends remain favorable. Markets are dynamic and flexible, and both monetary and fiscal policies are being actively employed to support recovery, while maintaining price stability. The recently enacted tax cuts should bolster growth.

In Canada, tax cuts and monetary conditions are supporting growth, while structural policies should continue to be aimed at increasing productivity. In the United Kingdom, where the slowdown appears moderate, policies should continue to strengthen the foundations for sustained growth and employment over the medium term, and meet the inflation target.

In the euro area, although economic activity has weakened, growth prospects remain favorable. Tax cuts, as well as structural reforms aimed at further increasing employment, should continue to support sustainable noninflationary growth. The steady

implementation of economic reforms will contribute to further raising the potential for growth.

In Japan, economic activity has further weakened, and prices continue to decline. Against this background, monetary policy should keep providing ample liquidity. Vigorous implementation of financial and corporate sector reforms is needed to lay the foundation for stronger economic growth over the medium term. We welcome the recently announced reform initiatives, which will contribute to this end.

Emerging market economies are unevenly affected by global economic developments. Growth rates in some countries have slowed toward a more sustainable rate, while in others they have decelerated sharply. We welcome the progress achieved in many countries in increasing their resilience against potential crises and the steps taken over the last year to strengthen the international financial system to better prevent crises. However, recent developments in emerging markets point to the need for further progress in reinforcing domestic financial systems and the underlying fiscal positions. Recent measures taken in Argentina and Turkey represent positive steps in this direction. We commend these efforts and encourage the continued implementation of their reform programs in close collaboration with the IMF and other relevant international financial institutions.

High and volatile oil prices are a concern for the world economy, in particular for the most vulnerable developing countries. Increased and diversified energy supplies, improved energy efficiency, expanded infrastructure and stable oil markets are important objectives.

Launching a new trade round

Sustained economic growth worldwide requires a renewed commitment to free trade. Opening markets globally and strengthening the World Trade Organization (WTO) as the bedrock of the multilateral trading system is therefore an economic imperative. It is for this reason that we pledge today to engage personally and jointly in the launch of a new ambitious round of global trade negotiations at the Fourth WTO Ministerial Conference in Doha, Qatar, this November.

Strengthening the global financial system

Increasing global growth and prosperity depends crucially on a sound and stable international financial system. We are united in our determination to continue to strengthen it to prevent financial crises, to limit the impact of those that inevitably do occur, and to tackle financial abuses.

Since the Okinawa Summit, a number of important steps have been taken, including measures increasing the effectiveness of crisis prevention by reinforcing IMF surveillance and encouraging the implementation of the key international codes and standards; involving the private sector in crisis prevention and resolution; streamlining and reforming IMF lending facilities; and enhancing IMF transparency and accountability. These efforts should be maintained.

Looking forward, we endorse our finance ministers' recommendations for action to further strengthen the international financial system and their commitment to foster international consensus in this endeavor. In particular, the international financial institutions and the Group of Seven countries should stand ready to help countries adopt the policies required to ensure sustained access to capital markets. We also support our finance ministers' suggestions to further develop the framework for private sector involvement.

We reaffirm our support for the multilateral effort against abuses of the global financial system and endorse our finance ministers' recommendations to address this challenge. We welcome the efforts several jurisdictions are making to address weaknesses in their anti-money-laundering regimes. We endorse the recent Financial Action Task Force decisions de-listing four jurisdictions and recommending the adoption of additional countermeasures against the most uncooperative ones if they do not take appropriate action by September 30, 2001. The international financial institutions have an important role in helping jurisdictions improve their anti-money-laundering regimes and we urge them to step up their efforts in this regard. We encourage progress in assessing adherence to supervisory and regulatory standards in offshore financial centers. We look forward to the 2001 OECD progress report on harmful tax practices and support the work, as envisaged by our finance ministers, aimed at

addressing such practices. We ask our finance ministers for further work in these areas.

HIPC Initiative

The enhanced HIPC Initiative we launched in Cologne aims to increase growth, reduce poverty, and provide a lasting exit from unsustainable debt by reducing debt on the basis of strengthened policy reforms. We welcome the important progress achieved in implementing the Initiative. At Okinawa, 9 countries had qualified for debt relief. Now, 23 countries are benefiting from the Initiative, with an overall amount of debt relief of over \$53 billion, out of an initial stock of debt of \$74 billion. This will significantly reduce their debt service, thus freeing resources for social sector expenditure, in particular education and health.

We have all agreed as a minimum to provide 100 percent debt reduction of official development assistance and eligible commercial claims for qualifying HIPC countries. We urge those countries that have not already done so to take similar steps, and we underline the need for the active and full participation of all bilateral creditors in providing timely debt relief to HIPCs.

We encourage HIPCs that have not yet reached their decision point to quickly undertake the necessary economic and social reforms, including the development of a strategy for overall poverty reduction in cooperation with the World Bank and the IMF. Economic, structural, and social reforms, improved governance, and a strengthened ability to track poverty-reducing expenditures are necessary to ensure the maximum benefit of debt relief. In particular, we call upon those countries involved in military conflicts to lay down their arms, and implement the necessary reforms. We confirm our willingness to help them take measures needed to come forward to debt relief. We pledge to continue working together to ensure that the benefits of debt relief are targeted to assist the poor and most vulnerable.

President Bush speaks at World Bank



U.S. President George W. Bush (right, with World Bank President James Wolfensohn) spoke at the World Bank on July 17. In his remarks, Bush proposed that up to 50 percent of the funding from the World Bank and other development banks to the poorest countries be provided as grants rather than loans.

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(Continued from front page) are interconnected. Prosperity in the advanced economies cannot be sustained in the presence of widespread poverty. Integration into the global economy has brought unprecedented gains in income and improvements in human well-being for most of the world, but too many have been left behind, in particular, almost all of sub-Saharan Africa. Success in the fight against poverty is the key to stability and peace in the twenty-first century. And nowhere are the battle lines clearer than in Africa.

New African Initiative

Today, we are presented with a window of opportunity. African leaders have been working together on strategies to accelerate economic growth and development and lead the continent out of poverty. These strategies have now been consolidated into a single New African Initiative, which is anchored in the fundamental principles of African ownership, leadership, and accountability in eliminating the homegrown obstacles to sustained growth.

The New African Initiative focuses on four core elements: (1) a clear awareness that peace, democracy, and good governance are preconditions for reducing poverty; (2) action plans to develop health care and educational systems, infrastructure, and agriculture; (3) reliance on the private sector and on economic integration at the regional and global levels; and (4) concrete steps to develop more productive partnerships between Africa and its bilateral, multilateral, and private sector development partners. I see these elements together as forming the basis for a comprehensive approach to fighting poverty in Africa. The IMF stands ready to provide strong support for this African vision and work program.

IMF-African partnership

I am gratified that the New African Initiative recognizes the PRSP [poverty reduction strategy paper] process as a core vehicle for building continent-wide priorities into national poverty reduction programs and coordinating international support. In my view, PRSPs—with their emphasis on country ownership, broad participation, and dealing with the economic and social fundamentals—should continue to be the guiding framework for our partnership with African countries. The PRSP process is still a work in progress, but there are signs that it will bear fruit. Growth performance is holding up and even improving in a number of countries, despite the difficult global environment. Spending on health and education is expected to rise by about 1 percent of GDP this year. And in response to calls by African countries and the donor community, the IMF and the World Bank have begun preparing social impact analyses for eventual integra-

tion into national poverty reduction strategies. [World Bank President] Jim Wolfensohn and I are committed to working with our partners in Africa and the donor community to realize the full potential of the PRSP.

African leaders have underscored the severe demands that this process is placing on their limited administrative capacities. The IMF, the World Bank, and other donors will need to provide increased and better-coordinated technical assistance to support poverty reduction strategies in Africa. Toward the end of this year, the IMF and the World Bank will review the PRSP process, drawing on the views of their membership, other international institutions, donors, and civil society. I am sure this will identify additional areas for improvement.

Respect for country ownership and priorities also underlies our effort to streamline the IMF's conditionality. Conditionality remains essential but needs to focus on the measures that are critical to the macroeconomic objectives of country programs and leave real scope for countries to make choices consistent with their political and cultural traditions. I am pleased that African leaders have chosen to make good governance a central element of the New African Initiative, because it is essential for attracting private investment and making efficient use of scarce public resources.

Trade and regional cooperation

It is time to provide African nations with free access to the markets of industrial countries, in particular in those areas that matter most to poor countries, such as agricultural products, textiles, and clothing. These areas should also be an important focus for a new round of multilateral trade negotiations in the context of the WTO [World Trade Organization]. Developing countries also need to remove their own impediments to trade. In Africa, this should be part of a concept for regional economic cooperation and integration, as a vehicle for improving competitiveness and attractiveness to investors. The IMF has been a major supporter of regional trade and financial integration and is encouraging the harmonization and simplification of complex and overlapping subregional trade arrangements. We will continue providing advice and technical assistance on tax, customs, and trade practices. We will also provide assistance in developing regional surveillance and the harmonization and convergence of macroeconomic policies to help underpin deeper regional integration—the ultimate aim of the new African Union.

Official development assistance

Implementation of the target for the industrial countries to provide 0.7 percent of GNP in official development assistance should be seen as an investment in peace and

prosperity throughout the world. An increase by 0.1 percent from today's average level of 0.24 percent of GNP would amount to over \$10 billion—the magnitude identified as needed to begin a comprehensive program of HIV/AIDS prevention and treatment. Moreover, there should be scope to direct increased aid more to the poorest nations—only one-fifth of total official development assistance flows now go to the least developed countries.

Debt relief

Debt relief is also an integral part of a comprehensive concept for poverty reduction. The IMF and the World Bank have spearheaded an effort under the enhanced HIPC [Heavily Indebted Poor Countries] Initiative that has already provided \$25 billion of debt relief to 19 countries in Africa, cutting their ratios of debt service to exports by about one-half. We are doing our utmost to extend the benefits of this initiative to the remaining eligible countries. In the process, we will strengthen our efforts to meet the special needs of countries emerging from conflict, including interest subsidies on the IMF's

emergency postconflict assistance. I also welcome the decisions of donor countries to forgive 100 percent of their bilateral claims in the context of the HIPC Initiative. But debt relief is not a panacea. Credit is also indispensable for economic development, and, in the longer run, it will be crucial for poor countries to win the trust of investors in their ability and willingness to repay what they borrow. That is why the IMF will continue working closely with the World Bank and other partners in helping African countries create sound domestic financial sectors and, eventually, integrate into international financial markets.

The IMF is cooperating actively in preparations for the Conference on Financing for Development. I am confident that it can make a real difference for poverty reduction in Africa, and in the world, by concentrating in two areas: identifying gaps in the institutional framework to fight world poverty while making the most of existing mechanisms; and helping build a wider public constituency, especially in the advanced economies, for necessary actions on trade and aid. ■

Conference in Tokyo

Asian policymakers examine country ownership and effectiveness of IMF conditionality

The IMF has put forward proposals to refocus and streamline the conditions attached to its lending. In the 1990s, the IMF had expanded the range of its conditionality to ensure that borrowing countries undertook the reforms needed to restore financial stability and sustainable economic growth. Following the Asian crises of 1997–98, both internal IMF assessments and outside criticism concluded that some aspects of this expansion should be reexamined.

As a part of this conditionality review, the IMF has organized a series of public events to seek a wide range of views on its proposals. Following a successful launch of the series in Berlin (see IMF Survey, July 2), a joint IMF-Japanese Ministry of Finance conference in Tokyo on July 10 brought policymakers from the Asia-Pacific region, civil society representatives, and IMF officials together for an exchange of ideas.

Participants at the Tokyo conference agreed that conditionality needed to ensure that IMF loans are used for the intended purpose and lead to stronger growth and sounder finances in the borrowing country. Conditionality is a two-sided commitment: it gives the borrowing country assurance that funds will be available as long as it meets agreed conditions, and it gives the IMF assurance that lending is achieving the desired purpose and that funds will be repaid.

In theory, conditionality can also serve a number of subsidiary functions, according to Japan's Deputy Vice Minister of Finance for International Affairs Haruhiko

Kuroda and Hitotsubashi University's Takatoshi Ito. When political gridlock blocks adjustment and reform efforts, the IMF can act as an arbitrator and move the reform process ahead through its conditionality. Moreover, the IMF seal of approval can give private investors assurances that reforms will be carried out. Thus, conditionality can help draw private capital inflows at an early stage. And, finally, many IMF programs are put in place during crises, which tend to offer a window of opportunity during which reforms, including some not critical to addressing the immediate crisis, can be carried out under the banner of IMF conditionality.

Some problems

In the view of many participants, however, conditionality in practice does not always confer the benefits claimed for it. Conditions perceived to be so stringent that they are unlikely to be implemented can undercut the credibility of IMF programs and hamper a program's ability to serve as a "catalyst" or "window of opportunity." These failures were apparent during the Asian crisis, according to Ito. Many viewed IMF conditionality during the Asian crisis, he said, as akin to asking a sick man to demonstrate his fitness by carrying out a tough regimen of exercise. It reminded Ito of the aging Chairman Mao taking his famous swim in the Yangtze River in the hope of convincing his people that he was not as weak as they believed.



Takatoshi Ito



Amando Tetangco

Another problem with conditionality, according to Kuroda and Ruogo Li, Assistant Governor of the People's Bank of China, is that many structural reforms take a long time to carry out, while the duration of a typical IMF program is only a few years. Reform of the U.S. auto industry, following the difficulties it encountered in the 1970s, took a couple of decades, Li noted, not a couple of years. In contrast, IMF programs expect “too much, too soon” from borrowing countries. The compressed time-frame often does not allow for adequate consultation of various groups in society or for careful consideration of alternate reform strategies.

Moreover, according to Li, IMF programs are not flexible enough to make room for the kind of gradualist structural reform strategy that China has pursued to great benefit. Li said that in implementing its conditionality, the IMF should not be “too rigid,” heeding Deng Xiaoping’s advice that it does not matter if the cat is black or white, as long as it catches mice.

Yoko Kitazawa of the Japan Network on Debt and Poverty questioned the need for conditionality during the Asian crisis. It was primarily a liquidity crisis, she said, and could have been resolved through the provision of credit.

Case histories

The case histories that participants presented tended to take the view that conditionality does not always deliver promised benefits. Amando Tetangco, Deputy Governor of the Philippine Central Bank, noted that with over 20 IMF programs in the past 40 years, the Philippines was a “veteran” in negotiations with the IMF. While acknowledging the overall benefits of IMF assistance and conditionality, particularly in making the Philippines more resilient to the Asian crisis, Tetangco said that the sheer number of conditions in some programs had been overwhelming. The 1998 program had over 100 conditions in 8 areas of structural reforms. Some conditions, such as the passage of a bill reforming the country’s power sector, dealt with critically needed structural reforms. In his view, other conditions, such as the strengthening of securities laws, were not essential to helping the Philippines through the Asian crisis and were, in any event, likely better handled by the multilateral development banks.

Indonesia’s Boediono, currently an advisor to the Coordinating Agency for Poverty Reduction, was a key member of the team that negotiated the country’s programs with the IMF during the Asian crisis. He thought it “quite possible” things might have turned out differently in Indonesia had conditionality in the initial IMF programs been confined to areas central to dealing with the immediate crisis. Other conditions, such as dismantling the clove monopoly and rationalizing the national car and airplane industries could have been postponed, said Boediono, “until our head was above water.”

Hafiz Pasha, of the United Nations Development Program, was Pakistan’s Finance Minister when an IMF Enhanced Structural Adjustment Facility arrangement was put in place in 1997. Pasha observed that while there were some achievements under it, the program did not fully take into account the lack of institutional capacity to implement aspects of the program, such as the contemplated ambitious changes in tax administration. Moreover, he said, the IMF puts great faith in ownership of programs by “bureaucrats and technocrats,” but it is ownership by the people, particularly those with political roots, that is critical. He added that because many countries choose to negotiate with the IMF under a “cloak of secrecy,” suspicion is created among broad segments of the populace.

According to Mohamed Ariff, Executive Director of the Malaysian Institute of Economic Research, often it is not the conditions themselves that provoke conflict but the manner in which they are imposed. Many perceive the conditions as “externally imposed” and put in place “when one’s pride is already hurt” by a crisis. A package arrived at through consensus building and broad consultation would likely be more durable than one achieved through IMF “arm-twisting” of a few members of the country’s government. Noriyuki Suzuki of the International Confederation of Free Trade Unions called for labor union and civil society participation in formulating IMF-supported programs. The Asian Development Bank’s Shoji Nishimoto emphasized the need to involve other international financial institutions in areas of structural reform where the IMF lacked the needed expertise.

Defense of conditionality

Not everyone was a critic of conditionality. Hubert Neiss, Chair for Asia at Deutsche Bank and the Director of the IMF’s Asia and Pacific Department during the Asian crisis, mounted a vigorous defense of the IMF-supported programs put together in Asia during recent and earlier crises. A comprehensive program needs to be put together when a crisis erupts, Neiss explained, because a crisis always reflects “multi-dimensional” problems. Recovery thus requires simultaneous measures in many different areas. Moreover, private markets and the international community start to focus on all the deficiencies of a country’s economic policies once a crisis emerges. Thus, a strategy of “stabilize first, reform later” does not help restore market confidence or ensure support from official lenders.

Neiss also provided examples where IMF-supported programs had provided a window of opportunity to usher in reforms that aided countries’ longer-term prospects. In the Philippines, the dismantling of sugar and coconut monopolies under an IMF-supported



Hafiz Pasha



Hubert Neiss

program in 1983–84 is now applauded as a useful structural reform. The Indian government initiated broad structural reforms amid the country's 1991 balance of payments crisis, and these are now credited with setting the stage for a much-improved growth performance. Even in Indonesia during the Asian crisis, the strong implementation of the program for a while under the Habibie government showed that comprehensive programs can work if the political leadership stands behind them.

Korea's Deputy Finance Minister for International Affairs Yong-Duk Kim noted that his country's experience during the Asian crisis also represented a "successful IMF case"—one in which a comprehensive economic program was put in place during the crisis. He attributed that success to President Kim-Dae Jung's strong political leadership and a concerted attempt to build national consensus by keeping groups such as labor unions apprised of negotiations with the IMF. And, he noted, the program dealt appropriately with the factors that had triggered the crisis.

IMF response

While in listening mode for the most part, IMF officials often interjected to respond to the views of Asian policymakers. Jack Boorman, Director of the IMF's Policy Development and Review Department, acknowledged that the perception of a large number of conditions attached to IMF programs "has caught the public imagination" and led to a clamor for a shorter list. But sometimes appearances deceive: introducing a value-added tax (VAT), for instance, involves dozens of separate steps, each of which is treated under IMF programs as a separate condition. Listing the introduction of the VAT as a single condition would shorten the list but not change the underlying conditionality.

And not every structural reform takes time, Boorman suggested; some reforms can be accomplished in a few years, and perhaps it is these that should be carried out under the window of opportunity offered by a crisis and the associated IMF-supported program. Boorman was somewhat skeptical about the ability to push through very strong reform programs in peaceful times through IMF surveillance or technical assistance or under the influence of peer pressure. The inability of these mechanisms to foster reforms was one reason behind the expansion of IMF conditionality in the first place.

While acknowledging the need for broad involvement of society in the negotiations leading to an economic program, Boorman and IMF First Deputy Managing Director Stanley Fischer cautioned that ownership of a program cannot be universal. Boorman noted that the process of reforms inevitably "generates winners and losers, some unexpectedly" so there will always be opposition to reforms from groups that expect to be, or end up

being, hurt. Fischer added that some civil society groups may lack strong credentials as democratic or representative groups; it is unclear that involving them in negotiations would lead to better or more popular programs.

Fischer and Boorman also questioned whether a strategy of "stabilize first, reform later" was realistic. If private capital is fleeing the country during a crisis because of a lack of reforms in some critical areas, then carrying out those reforms becomes an essential part of the stabilization process. Boorman noted that markets sometimes expect a country to carry out oft-postponed reforms during the crisis because the feeling is: "If they don't do it now, when will they do it?"

In his summing up, Fischer stated that IMF conditionality, while indispensable, should focus on the steps needed to restore macroeconomic stability and market confidence. Some conditions, such as targets on fiscal deficits, clearly met this criterion, whereas others might be the subject of some dispute. The requirements for restoring market confidence, he acknowledged, were sometimes difficult to identify before the fact. But even if disagreements persist about the appropriateness of conditionality on structural policies, the IMF could not walk away from structural issues altogether. For instance, because the IMF should steer clear of lending to corrupt governments, it cannot avoid using governance-related conditions. Fischer suggested that, despite differences of opinion on structural conditionality, a practical way to move ahead would be to put the burden of proof on the IMF to justify why a particular structural measure was critical to the goals of the program.

Fischer noted that "results-based conditionality" (conditionality on outcomes rather than on policy instruments) deserved further examination. It could help avoid micromanagement by the IMF and give the governments greater flexibility in exploring alternate policies to achieve agreed goals, but by moving the locus of conditionality away from variables directly controlled by governments, would reduce the assurance provided to governments that they would continue to receive funding if they pursued agreed policies.

Fischer agreed that there was an "element of justification" in the charge that some IMF-supported programs attempt too much, too soon. Hence the IMF ought to take more time to negotiate programs. Moreover, the IMF and governments should try harder to line up public support behind the program. But he cautioned that despite these measures to improve the "ownership" of IMF-supported programs, they might well remain unpopular because they often involve taking painful steps that governments have long postponed. It is only when the benefits of the programs become apparent that they become popular: "Programs will be owned if they succeed," said Fischer. ■



Jack Boorman



Stanley Fischer

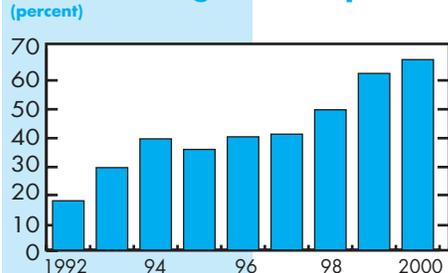
IMF report confirms dominant U.S. position as recipient of international capital flows

During the year ending May 2001, deteriorating global economic conditions and prospects, and the effect of these developments on corporate earnings, led to a reappraisal of financial risk, a rebalancing of portfolios, and asset repricing in a wide range of financial markets, according to the IMF's latest *International Capital Markets* report, released on July 12.

Mature markets

The report was discussed at a press conference the same day by Garry J. Schinasi and Donald J. Mathieson, Chief of the Capital Markets and Financial Studies Division,

Chart 1. U.S. current account deficit as share of global surpluses
(percent)



Data: IMF, *International Capital Markets*, 2001

and Chief of the Emerging Markets Studies Division in the IMF's Research Department, respectively. Schinasi said that there had been a dramatic shift in market sentiment during the year. "Early in 2000," he said, "market participants were mainly concerned about what would happen to their portfolios if the U.S. economy started overheating and inflationary pressures started picking up. By the end of 2000, and in early 2001, this sentiment had shifted completely to the other side, as market participants had become concerned about the extent of the slowdown in the U.S. and global economies, as growth in the United States had slowed unexpectedly sharply, and as an expected pickup in growth in Europe and Japan was failing to materialize."

Looking ahead, Schinasi identified two key risks concerning asset prices:

- It is still an open question whether all the excesses of the past have been removed from global equity markets.

- It is also difficult to gauge whether asset prices are fully reflecting economic fundamentals. The main source of financial risk and vulnerability in the period ahead is uncertainty about the depth and duration of the ongoing slowdown in the global economy.

Global capital flows

A striking feature of international capital flows during the year was the dominant position of the United States as a recipient of flows, according to the report. In 2000, the United States attracted 64 percent of world net capital exports, compared with 60 percent in 1999 and an average of about 35 percent during 1992–97 (see Chart 1, this page). Net inflows to the United States exceeded \$400 billion, the report states, including a record level of foreign portfolio investment that could have nearly financed the U.S. current account deficit on its own.

As in previous years, overseas investors (particularly in Europe) bought large quantities of U.S. equities and corporate bonds and cut back on purchases of U.S. treasury securities. Gross foreign purchases of U.S. equities were particularly strong, rising to \$3,600 billion—a sixfold increase since 1996. This sustained international appetite for private U.S. assets was maintained despite the deterioration in the U.S. economy and financial markets, the report states. This reflected investors' optimism (at least initially) about future prospects for the U.S. economy. In addition, many investors apparently believed that the current correction in U.S. financial markets would be short-lived.

There was a net international capital outflow from Europe, as euro-area investors increased their net purchases of foreign portfolio assets, particularly equities. At the same time, foreign investors sold significant amounts of European shares received through cross-border mergers and acquisitions.

The report notes that although net capital flows provide useful insight about balance of payments financing and net funding requirements, they can

Members' use of IMF credit

(million SDRs)

	During June 2001	January–June 2001	January–June 2000
General Resources Account	1,703.92	9,372.65	1,967.09
Stand-By	1,651.60	9,261.53	1,320.99
SRF	0.00	4,007.28	0.00
EFF	52.32	111.12	646.10
CFF	0.00	0.00	0.00
PRGF	19.00	302.89	148.47
Total	1,722.92	9,675.54	2,115.56

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.

Data: IMF Treasurer's Department

Photo credits: Enrico Oliverio for AFP, page 245; Martial Trezzini for AFP, page 245; Denio Zara, Pdraic Hughes, Pedro Márquez, and Michael Spiloto for the IMF, pages 247, 249, 250, 251, and 259; and Marko Skřeb, page 260.

considerably understate the volume and volatility of international portfolio rebalancing. Gross flows more closely reflect international transactions and are more relevant in terms of their impact on market prices and volatility. Since 1980, the report observes, gross flows have risen sharply to about six times the level of net flows (see Chart 2, page 253). This suggests that countries and regions with small net capital flows can still experience substantial gross inflows and outflows of capital. It may also help explain why they may experience considerable volatility in asset prices despite relatively small net financing needs.

The report also discusses the implications for financial markets of structural changes under way in the major government securities markets. For example, the market for U.S. treasury securities is predicted to shrink fairly rapidly, given current projections for surpluses, and U.S. financial markets are already adjusting to this new reality. Private substitutes are being used for pricing and hedging and, to a lesser extent, as collateral. Schinasi said that a “key unresolved issue is how dollar markets will perform and behave during a period of turbulence if U.S. treasuries can no longer be relied upon as a secure, safe haven during times of stress.”

Emerging markets

In 2000, emerging market issuance of international bonds, equities, and syndicated loans rose to the highest level since 1997 (see Chart 3, this page), but access to the international capital markets was increasingly “on-off” in nature, the report comments. Increased asset price volatility in mature markets and the prospects of a global slowdown in growth, combined with turbulence in key emerging markets, made it difficult for emerging markets to achieve sustained access.

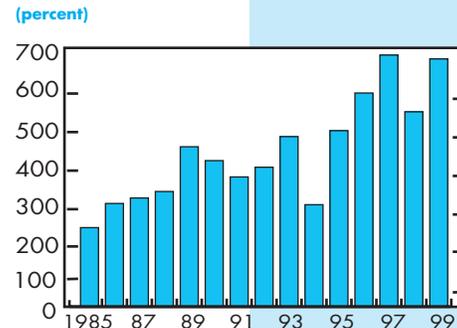
There was also in 2000 a sharp break in the high positive correlation between gross and net flows to

emerging markets that had been a feature of the 1990s. In discussing this development at the press conference, Donald Mathieson said that “gross issuance of international bonds, equities, and syndicated loans rose for the third year in a row to reach \$216 billion, an increase of 32 percent—the highest level since 1997, just before the Asian crisis.” In contrast, “net capital flows actually declined from \$72 billion to \$32.2 billion, a decline of 55 percent.” The report attributes this divergence primarily to oil price increases, which led fuel-exporting countries to accumulate claims (mainly deposits) on international banks. The decline in foreign direct investment, Mathieson said, was due to a slowdown in privatizations and in mergers and acquisitions.

Another important issue in emerging markets, Mathieson said, was financial sector consolidation. “One of the key issues is how to create sufficient market discipline and official supervision for institutions that are becoming too large to fail,” he said. “Experience in the mature markets suggests that this may need to involve the removal of entry restrictions—in some cases on foreign institutions—the establishment of clear exit rules, and prompt corrective action toward distressed institutions, as well as the creation of supervisory teams that are capable of monitoring the activities of large, complex institutions.”

The final chapter of the report provides a staff appraisal of the issues raised in previous chapters, as well as a discussion of the staff’s views on important risks and vulnerabilities in global capital markets and the broader implications of changes in the structure of major government securities markets and consolidation in emerging market systems. ■

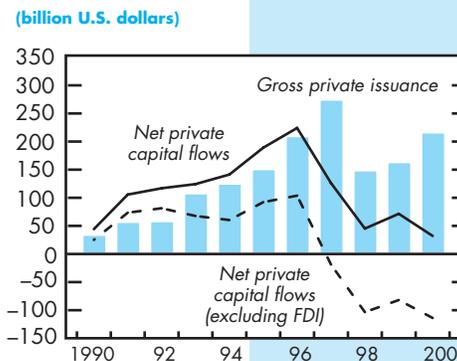
Chart 2. Global capital flows, gross relative to net¹



Data: IMF, *International Capital Markets*, 2001

¹Ratio of the sum of absolute values of gross inflows and gross outflows to the sum of absolute values of current account balances.

Chart 3. Net private capital flows and gross private issuance to emerging markets



Data: IMF, *International Capital Markets*, 2001

Selected IMF rates

Week beginning	SDR interest rate	Rate of remuneration	Rate of charge
July 16	3.55	3.55	4.17
July 23	3.52	3.52	4.14

The SDR interest rate and the rate of remuneration are equal to a weighted average of interest rates on specified short-term domestic obligations in the money markets of the five countries whose currencies constitute the SDR valuation basket. The rate of remuneration is the rate of return on members’ remunerated reserve tranche positions. The rate of charge, a proportion 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/cgi-shl/bur.pl?2001).

General information on IMF finances, including rates, may be accessed at www.imf.org/external/fin.htm.

Data: IMF Treasurer’s Department

The complete text of *International Capital Markets: Developments, Prospects, and Key Policy Issues* and the transcript of the July 12 press conference are available on the IMF’s website: www.imf.org. The published version of the report will be available in August from IMF Publication Services (\$42.00; academic rate: \$35.00).

July 30, 2001

With limited oil resources, Oman faces challenges of economic diversification, structural reform

Continued high dependence on oil, limited oil resources, and a rapidly rising young domestic labor force have heightened the need to further diversify the Omani economy. Thus, the discovery of natural gas resources in the early 1990s stimulated a new diversification drive in recent years based on a bold and ambitious outward-oriented, gas-based industrial growth strategy, while further promoting the development of the service sector. This strategy is also supported by broad structural reforms and prudent fiscal and monetary policies. This article looks at the achievements and the challenges ahead for the Omani economy in the pursuit of this strategy.

Background

In contrast to some of its neighboring countries, Oman—a member of the Cooperation Council of the Arab States of the Gulf (GCC)—has limited crude oil resources that are projected to last less than 20 years based on current proven reserves and production levels. (Oman, together with Bahrain, Kuwait, Qatar,

Saudi Arabia, and the United Arab Emirates, all oil-exporting countries, established the GCC in the early 1980s to foster close economic cooperation and regional integration.) However, since the commercial development of oil began in the mid-1970s, Oman has used these limited resources—within a liberal trade and exchange system—to create a modern physical and social infrastructure. An open-door policy to foreign labor has also provided the skills at internationally competitive wages to help develop non-oil activities. In addition, Oman's prudent use of its oil revenue has also contributed to the accumulation of financial wealth administered by the State General Reserve Fund—a government savings fund established in 1980 to replace dwindling oil resources.

Although the government's efforts toward economic development have led over time to an increase in the non-oil sector's contribution to GDP, exports, and government revenue, the Omani economy has remained highly vulnerable to oil price fluctuations (see Chart 1, page 255). This vulnerability was evident in 1998 when world oil prices collapsed, and Oman lost the equivalent of 14 percent of GDP in crude oil export earnings. At this time, crude oil still contributes some 40 percent to GDP and accounts for more than 70 percent of fiscal and export receipts. Strains in the employment market for Omani citizens also emerged in the 1990s owing to a rapidly increasing young local labor force, which, until recently, had found jobs mainly in the government sector. These developments highlighted the need not only to intensify the diversification efforts but also to adopt broad structural reforms to boost the role of the private sector and promote growth and employment while maintaining prudent fiscal and monetary policies.

Oman: recent key economic reforms

Administrative reforms

- Amending the commercial company law to eliminate the sole agency monopoly.
- Establishing the commercial court for more rapid processing of commercial litigations.
- Restructuring the Public Telecommunications Authority into a closed company and liquidating the Public Authority for Agriculture.
- Establishing a one-stop service for prospective local and foreign investors.

Financial sector

- Expanding repo facilities to the interbank market.
- Restructuring the Muscat Securities Market into three separate bodies dealing with regulations, trading and exchange, and depository registration.
- Adopting a new banking law.

Foreign investment

- Reducing income tax disparity between Omani and foreign companies by raising the single rate for Omani companies from 7.5 percent to 12 percent, and lowering the rates for foreign companies from 15–50 percent to 5–30 percent.
- Redefining “foreign” company as one with more than 70 percent foreign ownership instead of the current 49 percent.
- Allowing foreign firms to own buildings and lease land and permitting 100 percent ownership of companies in most sectors.

Renewed diversification drive

Since the mid-1990s, the Omani authorities have put in place a private sector–led growth strategy that aims at promoting non-oil activities and strengthening the export base centered on the development of the country's natural gas resources. These resources are projected to last for some 45 years based on current proven reserves and production levels. As part of the diversification strategy, the authorities are also promoting the service industry, such as entrepôt activities and tourism, as well as fisheries and mining. This strategy reflects Oman's vision for its future, which seeks to promote a balanced and sustainable development across the country, advanced human resource development, and an efficient and competitive private sector. Oman has also

recently joined the World Trade Organization as another step toward global integration.

The authorities have made important progress over the past few years in implanting this growth strategy. A major achievement was the completion last year of the liquefied natural gas (LNG) plant. Its full output capacity of 6.6 million tons has been presold through long-term contracts to Korea, India, and Japan. LNG exports, which reached some \$0.5 billion in 2000, are estimated to double this year as export volume continues to rise under current contracts. Another important achievement was the completion in southern Oman of the Salalah Container Port, which, within months of its inauguration in late 1998, has become one of the world's 20 busiest and most efficient ports. The private sector has played an important role in the development of these two key projects. The LNG project is a joint venture between foreign partners, who own 49 percent of the project, and the government, while the Salalah Port is majority-owned and operated by the private sector.

The LNG and Salalah Port projects have had a positive effect on the economy on several fronts. During the construction period, they boosted total investments, which peaked at 24 percent of GDP by 1998 from about 14 percent in the early 1990s, accelerating real GDP growth. In the following year, completion of these projects and the lagged effect of lower global oil prices led to negative real GDP growth; however, as LNG exports came on stream (see Chart 2, this page), growth recovered substantially. The external current account balance did not deteriorate significantly despite rising imports associated with these projects, since oil output increased steadily during much of the 1990s. The LNG project in particular contributed to an increase in the stock of Oman's external debt of about \$2.3 billion between 1995 and 2000. Nevertheless, given the initial low level of Oman's indebtedness, the external debt has remained within a manageable level, reaching the equivalent of 35 percent of GDP by the end of 2000 (see Chart 3, this page). However, with the exception of possible dividend income and revenue from the sale of condensates, the LNG project is not expected to benefit the budget significantly for about a decade because of corporate tax holidays granted to the project.

In the period ahead, large gas-based industrial projects, such as an aluminum smelter and production facilities for petrochemicals and fertilizers, are expected to boost diversification further. The authorities have already started the construction of the required infrastructure—two gas pipeline networks and the new industrial port of Sohar in northern Oman—to support the development of these large projects as well as smaller-scale industries.

The diversification strategy is also expected to create job opportunities for a young Omani population—more

than 50 percent are under 18 years old. Although the economy has continued to generate more jobs than can be fulfilled by Omani nationals, the policy challenge facing the authorities is to bridge the gap between their qualifications and wage expectations and the requirements of the market. To this end, the authorities are relying on a mix of market-based and mandatory mechanisms, such as quotas—albeit applied flexibly—to create these job opportunities. Moreover, large resources have been earmarked for human capital development over the next five years, and private universities have been allowed to operate, while the government has provided clear signs that it will no longer be the first source of employment for nationals.

Structural reforms and macroeconomic policies

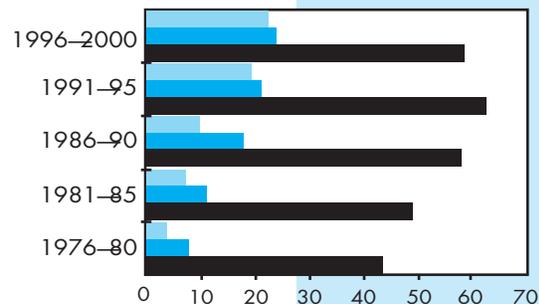
In the past few years, Oman has adopted key structural reforms to support the diversification strategy currently under way. These include lifting impediments to foreign direct investment, creating a level playing field for foreign and local companies, streamlining regulations to improve the business climate, and privatizing state-owned companies and government services. In addition, the financial system has been strengthened, including corporate governance, and the legal system modernized (see box, page 254). The Oman Center for Investment Promotion and Export Development, established in the second half of the 1990s, has provided the institutional support to promote non-oil activities and exports.

The power generation and telecommunications sectors are currently at the forefront of the privatization efforts. The government corporatized the General Telecommunications Organization in July 1999 and is in the final stages of choosing a foreign strategic partner to

Chart 1. Non-oil sector contribution to GDP, exports, and government revenue

(percent; period average)

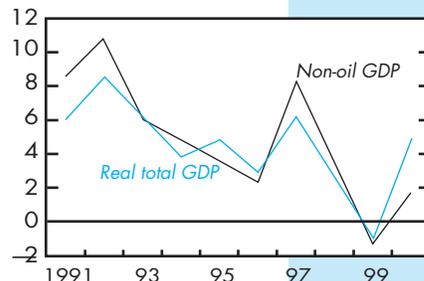
■ Non-oil exports/total exports
■ Non-oil revenue/total revenue
■ Non-oil/GDP



Data: Omani authorities

Chart 2. GDP growth in real terms

(percent)



Data: Omani authorities

Chart 3. Total external debt

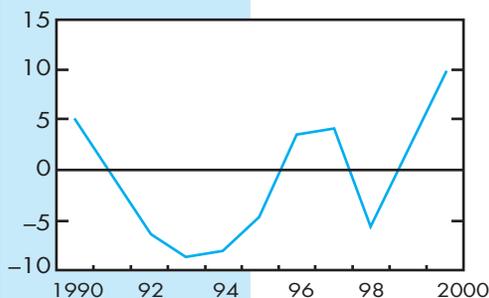
(percent of GDP)



Data: Omani authorities

Chart 4. Overall fiscal balance¹

(percent of GDP)



¹Includes transfers to the State General Reserve Fund, Oil Fund, and investment income on government assets. Data: Omani authorities

Chart 5. External current account balance

(percent of GDP)



Data: Omani authorities

purchase a minority stake in the company. Agreements were recently signed with two independent power projects under a build-own-operate basis. In addition, the privatization of the power system in the Salalah region will be expanded to the transmission and distribution networks. These projects will increase the installed generating capacity by about 40 percent over the next few years. Also, the existing assets of the Ministry of Electricity and Water are expected to be unbundled into several companies this year in preparation for their future privatization. Other sectors targeted for privatization include water and sanitation, cement, hotels, wheat milling, and airport services and maintenance.

The Omani authorities have also supported their development strategy by maintaining a prudent fiscal policy. During the second half of the 1990s, government spending remained

virtually unchanged in absolute terms, while non-oil revenue grew on average by 6 percent a year as a result of increases in fees and charges and improvements in revenue collection. Consequently, the overall fiscal balance (including oil transfers to the State General Reserve Fund) has recorded a surplus since 1996, except in 1998 when world oil prices collapsed (see Chart 4, this page). Following the recovery in oil prices since mid-1999, the fiscal balance has moved back into surplus, with the authorities using the windfall oil gains to repay short-term external and domestic debt incurred in 1998 and to build up government foreign assets, supporting a sharp improvement in the external current account balance (see Chart 5, this page). Meanwhile, monetary policy has continued to focus on supporting the exchange rate peg—which in practice has been fixed to the U.S. dollar since the mid-1980s, contributing to low inflation.

Conclusion

Overall, the structural reforms currently under way in Oman are going in the right direction to sustain the growth momentum and increase investor confidence. However, these reforms and the development strategy in progress will reduce the country's reliance on oil only gradually, while imports and external debt might increase in the period ahead on account of the planned industrial projects. Thus, the continuing challenge will be to maintain the country's strong fiscal position—through revenue diversification, reduction in nonpro-

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ductive expenditures, and adoption of a medium-term fiscal strategy based on a conservative oil price for both revenue and expenditure. Other challenges Oman must face are to build on the progress already made in diversifying the economy while creating job opportunities for Omani nationals through a flexible and market-based labor policy, as well as education and training.

Addressing these challenges is particularly important at a time when the current deceleration in world growth and the possible related downward pressure on oil prices will, in all likelihood, contribute to a less favorable global environment. ■

Ugo Fasano
IMF Middle Eastern Department

Stand-By, EFF, and PRGF Arrangements as of June 30

Member	Date of Arrangement	Expiration date	Amount approved	Undrawn balance
(million SDRs)				
Stand-By Arrangements				
Argentina ¹	March 10, 2000	March 9, 2003	10,585.50	5,774.97
Brazil ¹	December 2, 1998	December 1, 2001	13,024.80	3,554.05
Croatia	March 19, 2001	May 18, 2002	200.00	200.00
Ecuador	April 19, 2000	December 31, 2001	226.73	75.58
Estonia	March 1, 2000	August 31, 2001	29.34	29.34
Gabon	October 23, 2000	April 22, 2002	92.58	79.36
Latvia	April 20, 2001	December 19, 2002	33.00	33.00
Nigeria	August 4, 2000	August 3, 2001	788.94	788.94
Pakistan	November 29, 2000	September 30, 2001	465.00	210.00
Panama	June 30, 2000	March 29, 2002	64.00	64.00
Papua New Guinea	March 29, 2000	September 28, 2001	85.54	18.89
Peru	March 12, 2001	March 11, 2002	128.00	128.00
Serbia/Montenegro	June 11, 2001	March 31, 2002	200.00	150.00
Sri Lanka	April 20, 2001	June 19, 2002	200.00	96.65
Turkey ¹	December 22, 1999	December 21, 2002	15,038.40	8,105.28
Uruguay	May 31, 2000	March 31, 2002	150.00	150.00
Total			41,311.83	19,458.06
EFF Arrangements				
Bulgaria	September 25, 1998	September 24, 2001	627.62	0.00
Colombia	December 20, 1999	December 19, 2002	1,957.00	1,957.00
FYR Macedonia	November 29, 2000	November 28, 2003	24.12	22.97
Indonesia	February 4, 2000	December 31, 2002	3,638.00	2,786.85
Jordan	April 15, 1999	April 14, 2002	127.88	91.34
Kazakhstan	December 13, 1999	December 12, 2002	329.10	329.10
Ukraine	September 4, 1998	August 15, 2002	1,919.95	1,017.73
Yemen	October 29, 1997	October 28, 2001	72.90	26.40
Total			8,696.57	6,231.39
PRGF Arrangements				
Albania	May 13, 1998	July 31, 2001	45.04	4.71
Armenia	May 23, 2001	May 22, 2004	69.00	59.00
Benin	July 17, 2000	July 16, 2003	27.00	16.16
Bolivia	September 18, 1998	June 7, 2002	100.96	37.10
Burkina Faso	September 10, 1999	September 9, 2002	39.12	22.35
Cambodia	October 22, 1999	October 21, 2002	58.50	33.43
Cameroon	December 21, 2000	December 20, 2003	111.42	95.50
Central African Rep.	July 20, 1998	January 19, 2002	49.44	24.96
Chad	January 7, 2000	January 6, 2003	42.00	20.80
Djibouti	October 18, 1999	October 17, 2002	19.08	13.63
Ethiopia	March 22, 2001	March 21, 2004	86.90	69.52
FYR Macedonia	November 29, 2000	December 17, 2003	10.34	8.61
Gambia, The	June 29, 1998	December 31, 2001	20.61	6.87
Georgia	January 12, 2001	January 11, 2004	108.00	90.00
Ghana	May 3, 1999	May 2, 2002	228.80	157.75
Guinea	May 2, 2001	May 1, 2004	64.26	51.41
Guinea-Bissau	December 15, 2000	December 14, 2003	14.20	9.12
Guyana	July 15, 1998	July 14, 2001	53.76	28.88
Honduras	March 26, 1999	March 25, 2002	156.75	64.60
Kenya	August 4, 2000	August 3, 2003	190.00	156.40
Kyrgyz Republic	June 26, 1998	July 25, 2001	73.38	28.69
Lao People's Dem. Rep.	April 25, 2001	April 24, 2004	31.70	27.17
Lesotho	March 9, 2001	March 8, 2004	24.50	21.00
Madagascar	March 1, 2001	March 1, 2004	79.43	68.08
Malawi	December 21, 2000	December 20, 2003	45.11	38.67
Mali	August 6, 1999	August 5, 2002	46.65	33.15
Mauritania	July 21, 1999	July 20, 2002	42.49	18.21
Moldova	December 15, 2000	December 20, 2003	110.88	92.40
Mozambique	June 28, 1999	June 27, 2002	87.20	33.60
Nicaragua	March 18, 1998	March 17, 2002	148.96	33.64
Niger	December 14, 2000	December 21, 2003	59.20	50.74
Rwanda	June 24, 1998	January 31, 2002	71.40	19.04
São Tomé & Príncipe	April 28, 2000	April 28, 2003	6.66	4.76
Senegal	April 20, 1998	April 19, 2002	107.01	28.54
Tajikistan	June 24, 1998	December 24, 2001	100.30	28.02
Tanzania	March 31, 2000	April 3, 2003	135.00	75.00
Vietnam	April 13, 2001	April 12, 2004	290.00	248.60
Yemen	October 29, 1997	October 28, 2001	264.75	94.75
Zambia	March 25, 1999	March 28, 2003	254.45	199.51
Total			3,474.25	2,114.37
Grand total			53,482.65	27,803.82

¹Includes 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 own currency.

Emerging market and transition economies face special challenges in globalized economy

What risks and opportunities does globalization pose for emerging market economies? Are capital flows on balance harmful or beneficial? Should external borrowing be restrained in emerging Asia? How risky is financial liberalization, and how costly are financial crises in emerging markets? The seventh annual Dubrovnik Economic Conference on June 28–29 addressed all of these issues. Organized by the Croatian National Bank, the Dubrovnik conference serves as an annual gathering of experts from multilateral financial institutions, academia, central banks, governments, and the private sector to exchange views on emerging market economy issues. This year's discussions examined lessons from the tumultuous 1990s but also noted that recent turmoil in Turkey, Argentina, and elsewhere underscores how vital and topical these issues remain.

Historically, financial crises have tended to follow liberalization efforts, and these crises have imposed huge costs—often in excess of 10 percent of GDP. Charles Wyplosz from the Graduate Institute of International Studies in Geneva and the Centre for Economic Policy Research in London asked whether

financial liberalization creates financial fragility. Analyzing the effects of financial liberalization in 8 Organization for Economic Cooperation and Development and 19 developing countries, Wyplosz concluded that financial liberalization creates more disturbance in developing countries than in developed ones; capital account liberalization is more disruptive than, say, current account liberalization; and the effects of these financial crises are long lasting. Clearly, liberalization has positive effects in the long term, but countries need to be aware of the dangers of instability in the medium term and should liberalize with utmost caution, Wyplosz said.

If liberalization is risky, how should emerging markets be regulated? Curzio Giannini of Banca d'Italia suggested the wisest approach is “broad in scope, soft in method.” In other words, he argued for soft laws that can broadly be defined as rules that affect behavior but are usually not legally binding. Extending coverage of financial regulation and supervision to emerging markets should not be dictated, he added.

Available on the web (www.imf.org)

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- 01/71: Czech Republic, July 25
- 01/72: Cameroon, July 26

Speeches

IMF Managing Director Horst Köhler, “A Global Partnership for African Economic Development,” United Nations Economic and Social Council, Geneva, July 16 (see page 245)

Transcripts

- Press Conference on the IMF's 2001 *International Capital Markets* report, July 12 (see page 252)
- Press Briefings, Thomas Dawson, External Relations Department Director, July 13, July 25
- Conference call with journalists (on program for Turkey), IMF First Deputy Managing Director Stanley Fischer, July 13

Letters of Intent and Memorandums of Economic and Financial Policies*

- | | |
|---------------------|-------------------|
| Turkey, July 12 | Cameroon, July 24 |
| Tajikistan, July 16 | Lesotho, July 24 |

Concluding Remarks for Article IV Consultations*

France, July 11

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Social Impact Analysis of Economic Policies, July 19*

Report on the Observance of Standards and Codes*

Czech Republic, July 25

Other

- Quarterly Report on the Assessments of Standards and Codes, Issue 1, July 12*
- 2001 *International Capital Markets* report (advance copy), July 12 (see page 252)
- IMF Financial Activities, July 13,
- IMF Financial Activities, July 20
- Investor Relations Programs: Report of the Capital Markets Consultative Group (CMCG) Working Group on Creditor-Debtor Relations, July 20*

*Date posted

Liberalized or regulated, emerging markets seem to be prone to crises, and Craig Burnside of the World Bank set out to find what causes financial crises. One main culprit, he contended, is that governments tend to issue sizable contingent liabilities—such as various forms of guarantees—to the financial sector. Not only may contingent liabilities incur significant fiscal costs (when those contingencies are realized), but their very issuance may increase the probability of a crisis. In Burnside's view, a government issuing sizable contingent liabilities needs to factor in all possible outcomes, including the probability of a crisis, when it considers appropriate policies and possible costs.

The consequences of financial crises are usually measured in terms of fiscal costs, but Michael Hutchinson and Ilan Neuberger, both from the University of California at Santa Cruz, looked into the output costs of currency and balance of payments crises. Using a panel data set for 32 countries over 1975–97, they concluded that serious currency and balance of payments crises reduce output over two to three years by about 5–8 percent cumulatively. Emerging market economies, which are dependent upon private capital markets, seem more sensitive to crises than developing economies. These currency and balance of payments crises are typically followed by abrupt reversals in capital inflows, and these reversals require substantial real sector adjustment and output loss, the authors found.

Latin America

Can the choice of monetary policy make a difference for the real economy? And, if so, how can an appropriate regime be chosen? Frederick Mishkin of the Graduate School of Business at Columbia University and the National Bureau of Economic Research, in a paper co-written with the IMF's Miguel Savastano, explored suitable monetary policy strategies in emerging market economies, based on case studies from Latin America. In their view, monetary policy strategy should sidestep the traditional debate between fixed and floating rates and focus instead on whether a particular policy regime appropriately constrains discretion in monetary policymaking.

Given the weak links between monetary aggregates and inflation, Mishkin and Savastano argued that monetary targeting is not an appropriate strategy. For countries, the pertinent choice is between hard exchange rate pegs and inflation targeting, with the decision ultimately dependent upon the country's institutional environment. Hard pegs allow much less discretion and are thus the preferred option for countries with weak institutions. By contrast, inflation targeting requires good prudential supervision and a sustainable fiscal policy. But the authors cautioned that no monetary policy strategy can solve other basic

problems, such as large fiscal deficits and weak financial systems.

With the eyes of most financial experts focused on Argentina these days, the presentation of Miguel Kiguel of Banco Hipotecario drew a lot of attention. Evaluating Argentina's economic performance in the past decade and analyzing its main structural reforms, Kiguel argued that the problems the country faces today are very different from those it faced a decade ago. In the 1980s, Argentina grappled with high inflation, significant government intervention in the economy, and constant economic and social deterioration. After stabilizing the economy and implementing a series of privatizations, the biggest challenge the authorities now face is restoring and sustaining growth after three years of recession. Growth is essential, Kiguel emphasized, if Argentina is to manage its huge debt. And for growth, he said, Argentina still needs to strengthen its fiscal solvency, improve its saving rate, achieve more flexibility in the goods and labor markets, and increase its international trade.

Transition economies

Transition economy issues, which preoccupied the first five Dubrovnik conferences, were a significant feature of this conference as well. Examining debt developments in these economies, Ricardo Lago from the European Bank for Reconstruction and Development (EBRD) noted that while external debt has accumulated very rapidly among transition countries as a group, there is great variability among individual countries. Some are managing their debt on a sustainable basis; others are defaulting outright. Inspired by the Brady Plan for Latin America, Lago proposed debt reduction based on strong conditionality for some countries of the former Soviet Union. He also suggested debt-for-nuclear-safety swaps and debt-for-environmental-investment swaps.

Gur Ofer and Michael Keren, both from the Hebrew University of Jerusalem, examined empirical data on foreign direct investment (FDI) in the service sectors of transition economies and compared them with those for developing economies. The transition economies, they suggested, have distinctive structural and systemic characteristics. The transition economies have the advantage of existing infrastructure, such as railroads, but must undertake serious reforms—for example in the governance of state services—to attract FDI.

Boris Vujcic and Igor Jemric, of the Croatian National Bank, assessed the relative efficiency of Croatia's banks. Their findings indicated that foreign-owned banks are, on average, the most efficient and that banks that began operations during the transition process are more efficient than those that had operated under socialism. György Szapáry of the



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Miguel Savastano



Yusuke Horiguchi



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Hungarian National Bank looked at the experience of Hungary's banking sector in transition and drew a number of lessons for other transition economies. Bank consolidation should be based, he counseled, on an accurate assessment of bank balance sheets; banks are more efficient in working out bad loans than separate entities; the stock problem of bank recapitalization and the flow problem of new loans need to be addressed adequately; good corporate governance of banks is a necessity; effective supervision requires real autonomy, and the corporate sector must be reformed with the banking sector.



Conference participants gather on the terrace of Hotel Argentina—the venue for the Dubrovnik Economic Conference.

Capital flows

Understandably, capital flows were a dominant topic in this year's discussions. Gunter Baer of the Bank for International Settlements looked at risk and capital flows to the emerging markets and theorized that the lower level of capital flows in recent years and the larger amount of FDI in these flows may leave emerging markets less vulnerable to contagion crises than they were in the past. Existing risks are now much better understood than before. FDI flows do represent a more stable form of capital flows, but this should not be overstated, he said.

James Dean and Kenneth Kassa of Simon Fraser University took an empirical look at capital flows in the euro area. Their findings suggested that reduced Euroland exchange rate volatility has been associated with less volatility in capital flows and with higher net cross-border flows. For potential members of the European Union, Dean and Kassa recommended that adoption of the euro precede EU membership. Unilateral adoption of the euro would, they argued, help stabilize and probably increase capital inflows.

In the aftermath of the Asian financial crisis, Yusuke Horiguchi, Director of the IMF's Asia and Pacific Department, asked whether external borrowing by emerging market countries—which is almost always in foreign currency—should not be restrained. His clear answer was that it should be, particularly in economies where domestic saving is very high, as it is in most Asian countries. Such restraint should be imposed because market failures and policy distortions have skewed incentives toward external debt financing, leading to overborrowing and subsequently

to financial crisis. He proposed a strict prudential rule regarding banks' net open foreign currency position and a tax on non-financial corporations' external borrowing. Horiguchi stressed, however, the importance of dismantling any impediments to FDI and portfolio inflows into stock markets. He also emphasized that those restraints on external borrowing should be phased

out once emerging market countries attain the status of advanced economies through reforms of the financial system and corporate sector.

Jacques de Larosière, former Managing Director of the IMF and President of the EBRD, who is now with BNP Paribas, spoke about the risks and opportunities that globalization poses for emerging markets. Globalization has sharply increased trade and capital flows but has also limited the possibility of having stable exchange rates and an independent monetary policy at the same time. He stressed the link between developing human capital and attracting FDI, citing evidence that sophisticated investments and those with a large research and development component are going to economies with high levels of human capital. All of this, de Larosière said, underscores the need for emerging markets to give priority to investments in education.

Finally, Nobel prize winner Robert Mundell, a founder of and regular participant in the Dubrovnik Economic Conferences, strongly advocated—to no one's surprise—monetary unions and the euro. Despite its present weakness, the euro, he said, has almost immediately become the second most important currency in the world. Mundell also vigorously cautioned against overregulated and overtaxed economies. For economies to succeed, he said, governments need strong markets and a business-friendly environment, and no country can hope to prosper without structural reforms and supply-side incentives. ■

Marko Skřeb
Advisor to the Governor, Bank of Albania

For the full text of the papers presented at the Dubrovnik Economic Conference, please check the conference website (<http://www.hnb.hr/dub-konf/dub-konf.htm>).