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In this issue

Council on Foreign Relations address

Camdessus outlines agenda for IMF at start of the twenty-first century

Speaking before the Council on Foreign Relations in New York on February 1, IMF Managing Director Michel Camdessus addressed the role of the IMF at the start of a new century. In his remarks, Camdessus emphasized the institution's ability to adapt to the challenges of a continually evolving global economy—in its response to both the needs of its members and the systemic needs of the global economy. He stressed that the IMF's responsibilities to its members extended beyond crisis prevention—that is, its surveillance function—to include poverty reduction and crisis management. On the global front, Camdessus said, calls for reform of the international financial architecture implied greater economic policy coordination and cooperation among all nations and with international institutions to maintain global stability and reduce the incidence and severity of financial crises.

Following are edited excerpts of Camdessus's remarks. The full text is available on the IMF's website (www.imf.org).

The IMF is a perennially self-reforming institution. Looking to the future, we can anticipate not only a continuation and deepening of the trends toward integration of markets and of massive global private capital flows but also the presence of tough challenges: old ones, like poverty, and new ones, such as the aging of populations in many countries, and the potential for a surge in extremism and violence if we are not able to reverse the trend toward greater inequalities between the poorest countries and the affluent countries.

The IMF that exists today offers its membership five well-demonstrated strengths:

• *universality* and the responsibility it bears to interact cooperatively with its members on their economic policies;

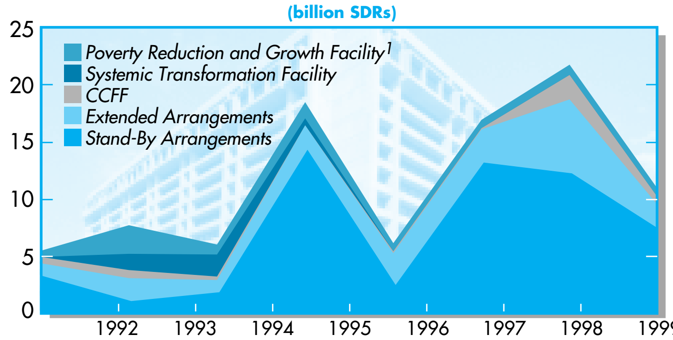
• a clearly defined, tried-and-tested *mandate* as set out in its original purposes, which continue to ring remarkably true today; *(Please turn to the following page)*

Financial activity in 1999

IMF lending declines as recovery takes hold

Member country use of IMF resources decreased in 1999, to SDR 10.8 billion (about $14.7 billion) from SDR 21.5 billion ($29.3 billion) in 1998, as member country economies recovered from the severe crises that had affected many regions in 1998. While lending under all facilities decreased in 1999, several member countries received large disbursements during the year. Brazil received the largest disbursement of any member, under the Supplemental Reserve Facility, for SDR 3.6 billion ($4.9 billion) and also SDR 814.1 million ($1.1 billion) under a Stand-By Arrangement. Mexico received the largest disbursement under a Stand-By Arrangement, SDR 1.04 billion ($1.4 billion). Disbursements under the Extended Fund Facility (EFF) were dominated by drawings totaling SDR 1.0 billion ($1.4 billion) by Indonesia. Nicaragua received the largest disbursement under the Poverty Reduction and Growth Facility (PRGF), for SDR 78.3 million ($106.7 million).

IMF lending
(billion SDRs)

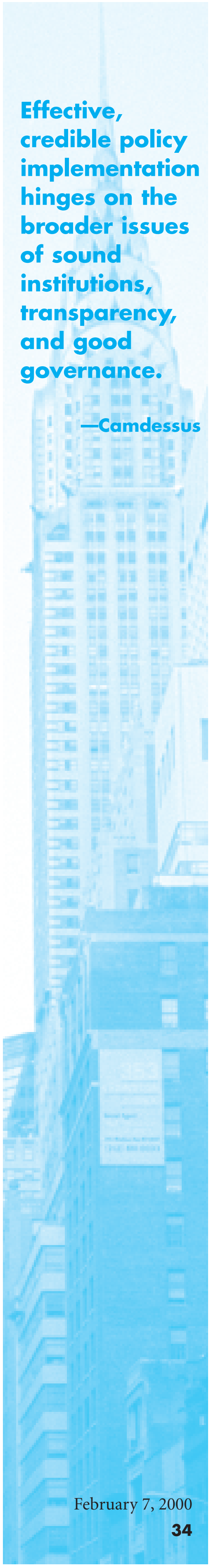


[1]Formerly ESAF—Enhanced Structural Adjustment Facility.

Data: IMF Treasurer's Department

In April, the IMF established Contingent Credit Lines (CCL) for a two-year period to provide short-term financing to help members *(Continued on page 39)*

Camdessus discusses continuing role of IMF



Effective, credible policy implementation hinges on the broader issues of sound institutions, transparency, and good governance.

—Camdessus

(Continued from front page)

• *flexibility*—that is, its capacity to adapt its activities rapidly to the new demands of a continually evolving global economy;

• the fact that it was conceived as "the machinery" for promoting *multilateral cooperation* in addressing international economic issues; and

• a *staff* well known for its professionalism and unique experience in performing its tasks of surveillance, technical assistance, and crisis management.

How can these strengths be most effectively deployed and developed in the midst of today's rapid innovation and evolution, in a world where we must always expect the unexpected? By striving to be responsible to each member whatever its size or condition and, simultaneously, by keeping a global perspective, discharging the IMF's responsibility with respect to the whole international monetary and financial system.

IMF's responsibilities to each member

All countries must always be able to rely on the IMF to be helpful in the pursuit of their objectives of stability and high-quality growth. This points to an active and wide-ranging agenda. Let me concentrate on three areas where our activities are changing.

Crisis prevention. The world needs an institution to help in crisis prevention. But this is the very minimum. The IMF's proper role in normal times is analysis and policy dialogue—surveillance—for all its members, from the United States to the smallest Pacific island nations. The primary focus, of course, will be on the core areas of the IMF's mandate—macroeconomic policy and management. But we have learned that effective, credible policy implementation hinges on the broader issues of sound economic institutions, transparency, and good governance—with all this implies for financial soundness, structural reform, the implementation of standards, and social and labor policies. This is why our surveillance is rapidly changing by

• emphasizing more strongly the international implications of domestic economic policy;

• developing the regional dimensions of surveillance;

• integrating within surveillance technical assessments of vulnerabilities and risks in the financial sectors; and

• disseminating internationally recognized standards and codes.

Poverty reduction. We must try to draw the logical conclusions from the recognition that the plight of the poorest countries—and the poorest people within them—is the "ultimate systemic threat." Despite all the efforts of the past 50 years, gains have been too slow: per capita income in many of the poorest countries has declined, debt has increased, and poverty remains widespread. For these reasons, the international community has recently decided to launch a renewed effort to address simultaneously *poverty and the debt overhang* through the revised Heavily Indebted Poor Countries (HIPC) Initiative, which will provide large-scale debt relief to countries whose pro-growth policies include an explicit and targeted antipoverty strategy, reached by a process involving widespread participation of civil society.

As part of its contribution to the global antipoverty effort, the IMF has replaced its concessional facility with the better-focused Poverty Reduction and Growth Facility. Why should the IMF be involved in this new approach? Because now there is a widespread conviction that there is a mutually reinforcing relationship between macroeconomic stability and structural reform, on one hand, and growth and the reduction of poverty and inequality, on the other.

However, articulating poverty reduction as an explicit objective of IMF-supported programs does not mean that the IMF will be heading off in a major new direction in its operational focus. Rather, we will rely on our partners in the World Bank and the regional development banks to undertake the lending operations that will support the direct antipoverty policies included in the economic programs we support. For the IMF, the aim is to ensure that poverty reduction is an integral and explicit objective when designing policies and to verify that the machinery and support are available to pursue these policies.

Crisis management. This is the IMF's most publicized work, and it must, of course, continue to be essential. But, to respond adequately to the range of country circumstances, the IMF needs a variety of approaches.

• At one end of the spectrum, we find the headline-grabbing situations in which domestic crises have systemic implications in countries suddenly hit by urgent, large-scale liquidity crises. The IMF is now better equipped to extend such support through the Supplemental Reserve Facility, designed to respond rapidly to major crises, and the Contingent Credit Lines, aimed at averting the effects of contagion on countries that are otherwise implementing sound policies.

• At the other end of the spectrum, we find a substantial number of the poorest countries facing the deep-seated crisis of declining incomes and poverty. These cases will need policy advice, technical cooperation, and extensive financial support (albeit small in global terms), typically over a period of years rather than months or weeks.

• Between these two extremes are the many countries, each relatively small in global terms, that will continue to demand the IMF's attention and support. Ineligible for concessional support, not yet able to attract sizable private capital flows, and yet at times faced with the challenges of deep structural reform, these countries will continue to need recourse to official sources of support from time to time. These countries should have the assurance of drawing, when necessary, on the IMF's existing facilities.

IMF's systemic responsibilities

A year ago, in virtually every international conference, the central theme was reform of the international financial architecture. A great deal has been achieved in the past year in advancing transparency—the golden rule—together with financial sector stability and internationally recognized standards. But there are also three important areas where the debate is still open.

• First, given the rapidly growing role of private capital flows and the long-term potential for further expansion, a key issue is the *role of the private sector* in financial markets. It seems particularly productive to place the emphasis on how to expand the opportunities for and contribution of the private sector on promoting investors' ability to undertake adequate risk assessment and, generally, on ensuring that the IMF is well adapted to interacting with the private sector.

• A key contribution to creating the conditions for a constructive role for the private sector is the question of promoting the *liberalization of capital movements.* Few would now dispute the potential benefits that can flow from liberal capital movements supported by the appropriate economic policies, institutions, and financial sector stability. However, the wide variety of country situations means that each country needs to prepare its own path to liberalization under carefully tailored conditions.

• The debate on *exchange regimes* still has a long way to run. Certainly some preference is emerging for exchange regimes at one end or the other of the spectrum—firm pegs or currency boards at one extreme and free floats at the other. In practice, today's regimes are not so sharply polarized, and a mixture of regimes will no doubt be with us for some time. In the long run, we are moving toward a world of fewer currencies. But the example of the euro suggests that this process is likely to be measured in decades rather than months or years.

These are some issues currently on the agenda in the search for a more stable global economy. But let us imagine a hypothetical situation in which a meltdown worse than we observed in 1997 and 1998 were to occur. Would the world be in a position to respond? And what would the role of the IMF be?

This brings us to the question of a need for an *international lender of last resort*, and whether the IMF can fulfill that role. The IMF is the closest that the international financial system has to a lender of last resort. It is a function that we have been performing, and adapting, for over 50 years, and it wouldn't hurt to recognize it, to confirm the IMF in this role, and to invite it to continue to offer the international community this vital guarantee, with enough of a judgmental basis to avoid any risk of moral hazard. Admittedly, in a truly systemic crisis, the IMF's resources, substantial though they are, could be completely inadequate. This is not a plea for a massive increase in the IMF's resources. I do not believe such an increase is necessary or desirable. There is a role, however, for being able to create additional liquidity on a temporary basis. The IMF might be authorized to inject international liquidity—and withdraw it when the need had passed—in a manner analogous to that of a central bank, through the creation and selective allocation of SDRs, the IMF's reserve currency.

Finally, let me turn to the perennial question of the international monetary system and of the *governance of the IMF*, as part of the governance of the entire international economy. This is not a reference to some kind of world economic government but instead to the more limited ambition of finding a global response to inescapable global problems. The challenge is to find mechanisms for managing the international economy that do not compromise the sovereignty of national governments, that help the smooth and effective working of markets, that increase opportunities for the poorest, and that ensure international financial stability, but that also offer solutions to problems that now transcend the boundaries of the nation-state. Let me mention two problems: coherence in international economic decision making and political responsibility.

The problem created by a lack of coherence in decision making at the world level is exemplified by the failure, in Seattle, to launch the 2000 round of trade negotiations. Consider the incoherence between, on one hand, the decision by finance ministers—in the framework of the Bretton Woods institutions—to reduce by about one-half the debt of 35 or 40 heavily indebted poor countries and, on the other hand, the failure of these same governments—in the framework of the World Trade Organization (WTO)—to eliminate barriers to the exports of these countries.

Equally urgent is the issue of the "political responsibility" of international institutions. Too often, they are portrayed as unaccountable technocracies. The truth is that the IMF is responsible and accountable to its member governments. Every single loan—including the controversial loans in Asia and to Russia—has had the support of our membership—that is to say, of our member governments.

No, the problem is not that we are not accountable, but that we are not *seen* to be accountable and that some member governments from time to time find it convenient not to express their public support for actions they have supported in the Executive Board.

Camdessus: The IMF is responsible and accountable to its member governments. Every single loan—including the controversial loans in Asia and to Russia—has had the support of our membership.

Part of the problem is that member governments have until recently been reluctant to publish their agreements with the IMF and our Article IV consultation reports on their economies, heightening the perception that we are not accountable. As you know, I have strongly supported much greater transparency for the IMF, and I am extremely happy as I leave the institution to see how much more open we have become. Greater openness will help ensure our legitimacy as well as our effectiveness in improving the quality of policy debate and democratic participation in member countries, and at the same time it will help the international capital markets become more efficient.

But it is also important to ensure that the IMF is seen far more visibly to have the legitimate political support of our shareholders. One reform that I have recently supported would respond to this problem. It would entail transforming the IMF's advisory ministerial committee—until recently called the Interim Committee, renamed in September 1999 the International Monetary and Financial Committee—into a decision-making council for the major strategic orientations of the world economy. Far from leading to an undue politicization of the IMF, this would, in the eyes of the public, place responsibility squarely where it already rests.

Another suggestion would be to alternate the Group of Seven summit with a meeting of the heads of state and government of the countries that have Executive Directors on the Boards of either the IMF or the World Bank. This would provide a fair and legitimate representation of the entire membership of 182 countries. Since it would be attended by the heads of the two organizations, the Secretary General of the United Nations, as well as the heads of the International Labor Organization and the WTO, it would offer a way of establishing a clear and strong link between these institutions and a representative grouping of world leaders with the greatest possible legitimacy.

The reform agenda I have outlined here is not particularly radical, yet it is still proceeding at an uneven pace. May the world leaders who recently expressed their interest in reforming the IMF and the other international financial institutions, may all our 182 members, remember that the period of calm we have bought for the world at a high price may be short lived, and so it must also be a period of intense work toward the reform and strengthening of our institutions. ■

Remember that the period of calm we have bought for the world at a high price may be short lived, and so it must also be a period of intense work toward the reform and strengthening of our institutions.

—Camdessus

Available on the web (www.imf.org)

Press Releases

00/3: IMF Names Horiguchi as Director of Asia and Pacific Department, January 28

Press Briefings

Transcript of a press briefing by Michel Camdessus in advance of the Conference of African Heads of State, January 20

Transcription de la Vidéoconférence de Michel Camdessus avec des journalistes d'Afrique francophone (Bénin, Cameroun, Sénégal), January 21

News Briefs

00/5: IMF Completes Mongolian Review and Approves $8.1 Million Credit Tranche, January 24

00/6: IMF Completes Tajikistan Review and Approves $18 Million Credit Tranche, January 28

00/7: IMF Names Masood Ahmed to Poverty Strategy Post, January 28

00/8: IMF Publishing Global Portfolio Investment Survey, January 31

Public Information Notices (PINs)

00/3: IMF Concludes Article IV Consultation with Jamaica and Staff Report for the 1999 Article IV Consultation, January 27

00/4: IMF Concludes Article IV Consultation with Croatia and Staff Report for the 1999 Article IV Consultation, January 30

Speeches

"Poverty Reduction and Growth: An Agenda for Africa at the Dawn of the Third Millennium"—Michel Camdessus at the Summit Meeting of African Heads of State, Libreville, January 20

"An Agenda for the IMF at the Start of the Twenty-First Century"—Michel Camdessus at the Council on Foreign Relations, New York, February 1 (see page 38)

"The Unfinished Reform Agenda in Asia"—Hubert Neiss at IMF Media Seminar, February 2

Presentation to the International Financial Institution Advisory Committee—Stanley Fischer, February 2

Letters of Intent and Memorandums of Economic and Financial Policies

Albania, January 21

Indonesia, January 27

Tajikistan, February 1

Other

Rate of Remuneration, Rate of Charge, and Burden-Sharing Adjustments, January 19

Redraft of Manual on Monetary and Financial Statistics, available for comment, January 27

Developing a Revised Manual for the PPI, February 2

Notes: PINs are IMF Executive Board assessments of members' economic prospects and policies issued following Article IV consultations—with the consent of the member—with background on the members' economies; and following policy discussions in the Executive Board at the decision of the Board.

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.

IMFSURVEY

Inflation target bands must be carefully designed to avoid sending confusing signals to markets

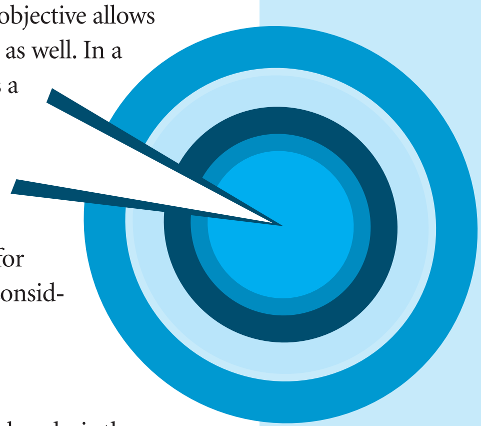
A number of industrial countries, such as the United Kingdom, have sought to achieve and maintain low inflation by adopting a monetary policy framework based on inflation targeting. Under this framework, policymakers announce that they will aim for an explicit quantitative inflation rate. Interest in inflation targeting has now begun to spread to emerging market countries, such as the Philippines and Poland, where inflation is considerably higher than the rate policymakers are aiming for over the longer term.

Margins of tolerance

IMF Policy Discussion Paper 99/8, *Inflation Targeting: What Is the Meaning of the Bottom of the Band?* by Eric V. Clifton of the IMF Institute, explores one aspect of designing an inflation targeting framework for emerging market economies—the significance of the lower limit of a target band when that limit greatly exceeds policymakers' ultimate inflation goal. Given general agreement that a fixed-point target is almost certain to be missed, potentially damaging the credibility of the policy framework, the study starts with the assumption that policymakers will allow room for inflation to fall within a certain range. That is, they will build margins of tolerance for achieving the target into the design. Most countries that have adopted inflation targeting, Clifton says, have included tolerance margins that "allow a central bank to give a sense to markets of how much variability in inflation outcomes should be expected."

It has also been found, the study reports, that trying to hit a too narrowly defined inflation target could cause interest rates to be excessively volatile. If a country sets a narrow band for inflation, more frequent changes in interest rates may be needed to keep inflation inside the band; these could destabilize financial markets even if the inflation target is met.

Once an inflation target is defined, according to Clifton, policymakers must decide what form the margins of tolerance will take: caveats, ceilings, thick points, or bands. These, he says, must then be formalized and announced to the public to ensure transparency. When policymakers set conditions under which missing a point target might be acceptable, they are said to be allowing caveats. Used alone, however, this method provides a tolerance margin only under the specific conditions the policymakers have defined. Under a second method, Clifton explains, the target is set so that inflation must fall below a certain rate, or ceiling, by a given date. This framework allows for a broad margin of tolerance on the lower end without requiring that any conditions be met. Setting the ceiling slightly above the authorities' ultimate inflation objective allows for some margin at the upper end as well. In a third option, the inflation target is a broad central tendency or thick point (for example, 2–3 percent) rather than a specific band. Thus, Clifton notes, if the average rate of inflation falls within the range for the defined period, the regime is considered successful.



Target bands

The most popular method, target bands, is the subject of this study. The top of the band represents a ceiling for inflation. The bottom of the band, Clifton says, is a new feature, which raises the question—to paraphrase the study's title—of what happens when inflation dips below the floor of the band.

There are two basic interpretations of the bottom of the band, Clifton explains. The first is that the bottom is just a guidepost that takes into account the monetary authorities' inability to achieve a specific point—usually the middle—within the target range. For example, he says, if the authorities decide that 5 percent is the optimal rate of inflation to aim for within a given time frame (or horizon) and that tolerance margins of plus or minus 2 percent are necessary, they set the target range at 3–7 percent. According to Clifton, the lower limit serves only to help guide market inflationary expectations toward the middle of the band. Under this interpretation, no corrective action is required if inflation dips below the lower limit, and, Clifton says, market participants should not necessarily begin to expect that monetary policy will be eased.

Under the second interpretation, the bottom of the band is significant—one author has likened breaching the lower limit to touching an electric fence. The band floor, Clifton says, "can communicate information about the authorities' views on the optimal rate of inflation and/or their preferred speed of disinflation." It also indicates to market participants that the authorities may ease monetary policy if the inflation forecast drops below the lower limit at the target horizon.

The point of this paper, Clifton says, is not to argue that one interpretation of the bottom of the band is superior to the other. It argues, rather, that it is crucial, for the sake of transparency and credibility, that policymakers make as clear as possible to market participants which policy they are following or the circumstances under which they will allow inflation to deviate from the target band. The design of lower limits on target bands, Clifton maintains, if not done with care, can confuse markets about how the authorities will react to a fall in inflation.

Case studies

The study briefly reviews the literature on inflation targeting and on the optimal inflation rate and presents case studies of three countries—Canada, Israel, and New Zealand—in which the band floor has been interpreted in one way (as a guidepost) or the other (as an electric fence). The case studies, Clifton explains, are intended to illustrate some of the difficulties of implementing inflation targeting in terms of designing target bands.

Canada. In February 1991, the Bank of Canada made a commitment to price stability and adopted an inflation targeting framework. At the time, inflation registered about 6 percent, compared with the authorities' goal of less than 2 percent. Their strategy, the report states, involved gradually declining target bands, ranging from 2–4 percent for the end of 1992 to 1–3 percent at the end of 1995. In the early years, however, while the authorities were trying to bring inflation down, the target bands were not strongly emphasized, and the inflation targets were described using only the midpoints.

In 1991, the bank announced that if inflation were pushed outside the target band, it would take steps to bring inflation back to the midpoint of the band. However, Clifton infers from comments made by some officials of the Bank of Canada that they were more concerned with exceeding the top of the band than with breaching the bottom of the band. He notes that "it was perhaps natural" that the authorities would not adhere rigidly to the bottom of the inflation band while they were still trying to bring inflation down, given the difficulty of predicting the pace of disinflation. This behavior illustrates, Clifton says, that if the authorities do not provide the markets with precise information about how they are interpreting the bottom of the inflation targeting band, markets cannot be sure what the authorities will do when inflation falls below that lower limit.

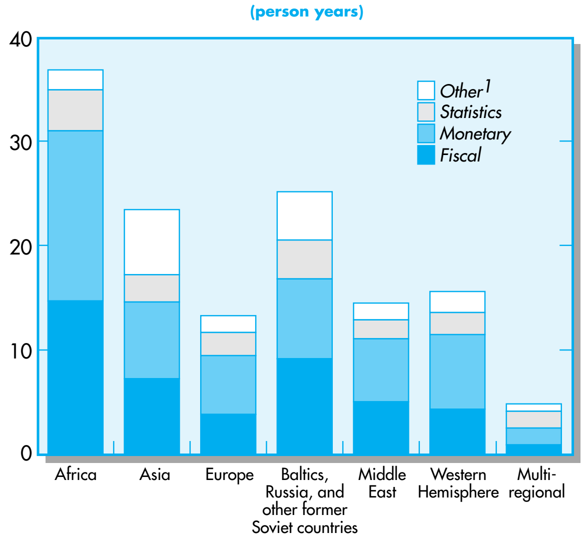
Israel. In the mid-1980s, Israel's monetary policy was formally based on an exchange rate anchor but informally used implicit inflation targets. In December 1991, Israel officially adopted inflation targeting with the aim of maintaining the exchange rate of the sheqel against a basket of currencies within a currency band of plus or minus 5 percent. The band would depreciate over time in line with the projected inflation differential between Israel and its trading partners. According to Clifton, an explicit inflation target was adopted more as a technical requirement for adjusting the exchange rate regime than for its own sake. Accordingly, the inflation targets received little attention until the government took official notice of them in September 1994. The primary objective of the Bank of Israel's monetary policy is price stability, whereas the government has favored stimulating economic activity and reducing unemployment over dampening inflation.

Israel has generally used bands to provide tolerance margins, Clifton says, which the authorities describe as necessary because of the difficulty of hitting a fixed point. However, they have not explained how they would respond if inflation were to drop below the bottom of the band. In other words, Clifton notes, it is not clear if the lower limit of the band is an electric fence or a guidepost.

In 1998, when inflation fell significantly below the existing band, the authorities did not attempt to move it back inside the band and instead took the opportunity to consolidate the disinflation. The Bank of Israel low-

IMF technical assistance remains at high level

IMF technical assistance: May–October 1999
(person years)



Note: IMF technical assistance is conducted under the IMF's own grant resources and through financing arrangements with the United Nations Development Program, the Japanese government, and other donors.
[1]Including legal and computer services.

Data: IMF staff estimates

ered its official lending rates with a view to achieving price stability over time. For a while, however, market participants were unsure whether the bank would ease policy or take advantage of the unexpected decline in inflation to try to achieve the authorities' long-term inflation objectives.

New Zealand. New Zealand's experience with inflation targeting began with the first Policy Targets Agreement in March 1990, when the country set out to reform economic policymaking in response to a number of years of low GPD growth and high inflation. In the initial framework, price stability was defined as 0–2 percent, and, because the starting point of inflation was above 5 percent, a series of intermediate targets were established. Although the Reserve Bank of New Zealand made the overall consumer price index its official target, its operations focused on a measure of underlying inflation that eliminated the effects of some temporary variables (for example, significant changes in public sector charges). In addition, the bank established specific tolerance margins in the form of bands.

The authorities clearly defined the bottom of the band, describing it as an electric fence. In September 1991, inflation as measured by the consumer price index fell to 2.2 percent and was projected to fall to less than 2 percent by the end of the year. Clifton notes that underlying inflation was expected to be about 2 percent in December 1991, which was below the existing target range for that date. Taking the bottom of its December 1991 target band seriously, the central bank eased monetary policy in September. There was no opportunistic attempt to disinflate at a rate faster than the government had specified.

Conclusion

Clifton says that the case studies are not meant to be complete analyses of these countries' experiences with inflation targeting, which, he notes, all three used successfully to reduce inflationary pressures. Rather, they are meant to illustrate the difficulty of designing target bands. He concludes by suggesting that countries deciding to adopt inflation targeting should ask themselves if the construction of the monetary policy framework enhances credibility and transparency. Target bands, he emphasizes, may appear on the surface to be straightforward, but "can send confusing signals to markets about policymakers' intentions if they are not designed carefully." ■

Copies of Policy Discussion Paper 99/8, *Inflation Targeting: What Is the Meaning of the Bottom of the Band?* by Eric V. Clifton, are available for $7.00 each from IMF Publication Services. For ordering information, see page 40.

IMF lending declines as members recover

(Continued from front page) overcome the exceptional balance of payments financing needs that can arise from a sudden and disruptive loss of market confidence caused by international financial contagion. As of the end of 1999, no countries had made use of the CCL.

On September 24, the IMF established a temporary Y2K facility to enable it to extend short-term financing to countries that encountered balance of payments difficulties arising from a loss of confidence or other problems associated with potential or actual Y2K-related failures of computer systems. However, no member had to use resources under this facility, because the anticipated difficulties did not materialize.

In December, the IMF's Executive Board decided that the IMF would make contributions to the strengthened Heavily Indebted Poor Countries (HIPC) Initiative and to the PRGF—formerly the Enhanced Structural Adjustment Facility.

Russia (SDR 471.4 million, $642.6 million) received a large Stand-By credit. Under the EFF, Ukraine received a large disbursement (SDR 466.6 million, $636.1 million). Recipients of large disbursements under the Compensatory and Contingency Financing Facility included Pakistan (SDR 352.7 million, $480.8 million) and Algeria (SDR 223.5 million, $304.7 million). Activity under the PRGF included large disbursements to Honduras (SDR 76 million, $103.6 million) and Yemen (SDR 62 million, $84.5 million).

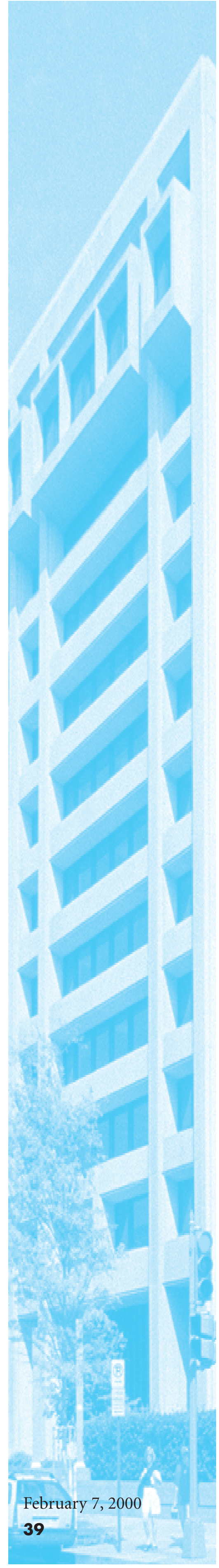
At the end of 1999, 58 member countries were implementing macroeconomic and structural programs supported by financing from the IMF (see *IMF Survey*, January 24, page 30). A total of SDR 57.6 billion ($78.5 billion) in IMF financing was committed as of the end of the year, of which SDR 23.5 billion ($32.0 billion) was undrawn. ■

Members' use of IMF credit
(million SDRs)

	1997	1998	1999
General Resources Account	**16,112.86**	**20,586.19**	**10,010.09**
Stand-By Arrangements	13,255.39	12,098.01	7,480.40
SRF	4,100.00	8,726.31	3,636.09
EFF	2,749.87	6,331.63	1,849.30
SRF	0.00	675.02	0.00
CCFF	107.60	2,156.55	680.40
PRGF	**730.59**	**895.96**	**736.78**
Total	**16,843.45**	**21,482.15**	**10,746.87**

SRF = Supplemental Reserve Facility
EFF = Extended Fund Facility
CCFF = Compensatory and Contingency Financing Facility
PRGF = Poverty Reduction and Growth Facility (formerly Enhanced Structural Adjustment Facility)

Figures may not add to totals shown owing to rounding.

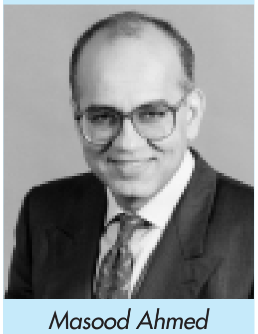


IMF SURVEY

Senior staff appointments

Horiguchi to head Asia Pacific Department; Ahmed to coordinate assistance to poorest

Yusuke Horiguchi



Masood Ahmed

On January 28, the IMF announced that Yusuke Horiguchi had been named Director of the IMF's Asia and Pacific Department and that Masood Ahmed had been appointed a Deputy Director of the IMF's Policy Development and Review Department. The texts of Press Release No. 00/3 and News Brief No. 00/7 are available on the IMF's website (www.imf.org).

The appointment of Yusuke Horiguchi, a Japanese national, is effective February 1, 2000. Currently the Associate Director of the department, Horiguchi succeeds Hubert Neiss, who is retiring from the institution after 33 years of service.

Horiguchi joined the IMF in 1978 and has held various positions in the institution, including Deputy Director of the IMF's European II Department, which covers the Baltics and the former Soviet Union, and the European I Department, which covers the European Union and the transition economies of Eastern Europe. He was appointed Associate Director of the Asia and Pacific Department in December 1998. Horiguchi studied at Keio University and holds a doctorate in economics from Rice University.

Horiguchi's department covers a wide range of countries in the Asia Pacific region, including Japan, China, and India, as well as Indonesia, Korea, Thailand, and the Philippines, which have programs with IMF financial support.

Masood Ahmed, who worked at the World Bank for 21 years, had been the Bank's Vice President for Poverty Reduction and Economic Management since 1997. Ahmed will coordinate the IMF's efforts in supporting its poorest member countries through the Poverty Reduction and Growth Facility (PRGF), a newly created successor to the Enhanced Structural Adjustment Facility. He will also be involved in other aspects of the work of the Policy Development and Review Department.

"Masood's main task will be to work on the PRGF," IMF Managing Director Michel Camdessus said. "He will also be devoting some of his time to IMF interactions with other involved institutions and agencies, particularly in the context of the PRGF." Camdessus noted that Ahmed has been working closely with senior IMF staff to develop a coordinated strategy with the World Bank on debt relief and a concerted poverty reduction effort. "We look forward to his continued input into the process," Camdessus added.

At a press briefing on January 28, IMF External Affairs Director Thomas Dawson said Ahmed was expected to take up his new position in the IMF in late May or early June.

Prior to being named Vice President at the World Bank, Ahmed, a Pakistani national, was Director of its International Economics Department and chief of the department's International Capital Flows and Debt Division. During the 1980s, he helped shape the Bank's response to the global energy crisis, and between 1987 and 1991, he was involved in managing the Bank's lending and advisory activities in the Maghreb countries.

He holds a bachelors and masters degree in economics from the London School of Economics. ■

Recent publications

World Economic and Financial Surveys ($36.00; academic rate: $25.00)

World Economic Outlook, October 1999 in French

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

186: *Anticipating Balance of Payments Crises—The Role of Early Warning Systems*, Andrew Berg, Eduardo Borensztein, Gian Maria Milesi-Ferretti, and Catherine Pattillo

188: *Financial Sector Crisis and Restructuring: Lessons from Asia*, Carl-Johan Lindgren, Tomas J.T. Baliño, Charles Enoch, Anne-Marie Gulde, Marc Quintyn, and Leslie Teo

Working Papers ($7.00)

00/5: *Product Variety and Economic Growth—Empirical Evidence for the OECD Countries*, Michael Funke

00/6: *The "Soaring Eagle"—Anatomy of the Polish Take-Off in the 1990s*, Mark De Broeck and Vincent R. Koen

00/7: *The Japanese Banking Crisis of the 1990s: Sources and Lessons*, Akihiro Kanaya and David Woo

00/8: *The Role of Human Capital in Economic Growth—The Case of Spain*, Enric Fernandez and Paolo Mauro

Other

Results of the 1997 Coordinated Portfolio Investment Survey ($27.50)

Publications are available from IMF Publication Services, Box X2000, IMF, Washington, DC 20431 U.S.A. Telephone: (202) 623-7430; fax: (202) 623-7201; e-mail: publications@imf.org.

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

Basis of international comparison

IMF publishes first comprehensive survey of global portfolio investment

The IMF announced on January 31 that it has published the *Results of the 1997 Coordinated Portfolio Investment Survey*. The survey, which was conducted by the IMF, is the first major internationally coordinated statistical initiative designed to gauge portfolio claims on individual countries by the world's principal investing nations.

The survey, which looked at 1997 overseas investments by 29 countries, shows that portfolio holdings of equity and long-term debt securities reached nearly $5.2 trillion at the end of 1997.

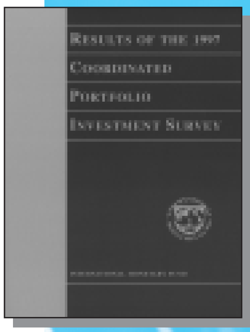
The United States, the United Kingdom, and Japan were the largest investing countries, accounting for almost 68 percent of such holdings, according to the survey. The shares of the Netherlands, Italy, and France were each within 4–6 percent of the total.

Snapshot of portfolio asset holdings

The survey enabled identification of previously uncovered portfolio investment holdings totaling $750 billion. The newly identified assets were largely attributable to investors residing in Europe and North America, and were derived from completely new collections (for example, Canada, Ireland, Italy, and Spain) and an updated benchmark survey in the United States. Bermuda, the only offshore financial center participating in the survey, accounted for $133 billion. The survey also permitted identification of previously unmeasured liabilities of some $500 billion, mostly related to offshore financial centers (about 45 percent of the newly identified liabilities) and emerging market countries (about 36 percent). As a result of these adjustments, outstanding portfolio investment liabilities in both equity and long-term debt securities were estimated to be $9.4 trillion at the end of 1997, and outstanding portfolio investment asset positions were $7.7 trillion.

In principle, however, world portfolio investment assets should equal world portfolio investment liabilities. In practice, a discrepancy remains. Notwithstanding this improved coverage of portfolio investment assets, a difference of $1.7 trillion remained, representing about 18 percent of total liabilities, which is largely attributable to the considerable growth in portfolio investment channeled through offshore financial centers that did not participate in the survey.

By providing a snapshot of where portfolio assets are held and a basis for cross-country comparison, the results of the survey are a step toward providing a foundation for deeper analysis of potential vulnerabilities among nations that rely heavily on portfolio investment flows to sustain economic growth. As the survey is repeated, it should also be possible to assess the impact of changes in portfolio preferences by the major investing countries over time.



The survey contains general tables that show how the participating countries allocated their portfolio investment assets among major partner countries; country tables containing all survey data collected at the national level; and descriptions of the essential features of its implementation in each country.

"The survey represented for the majority of the participating countries the first time that such data were collected in accordance with standardized definitions and methodologies," said Carol Carson, Director of the IMF's Statistics Department, which is spearheading the survey. "This approach enhanced data quality and comparability. Only two-thirds of these countries already compiled an international investment position statement, mostly without any geographic details." To meet the requirements of the survey, major changes and refinements were introduced by most compilers, even those who already collected stock data attributed geographically. Overall, the survey covered portfolio investments made by more than 4,000 banks, 8,000 nonbank financial institutions, and 13,000 nonfinancial enterprises.

An important reason for conducting the survey was to respond to global asymmetries in reported balance of payments data, especially those in portfolio investment flows. These asymmetries were originally identified and analyzed in the IMF's *Report on the Measurement of International Capital Flows* in 1992, which recommended that countries take steps to ensure that there would be improved coverage and better implementation of international standards for balance of payments financial account statistics; statistical activities would be endowed with appropriate resources and legal powers; stock data would be collected on a regular basis; and an effort would be made to undertake a coordinated benchmark survey of international portfolio assets and liabilities broken down by partner country.

Investigating global imbalance

The major goal of the survey was to ensure that all the main investing countries undertook a benchmark portfolio asset survey at the same time; participating countries followed mutually consistent definitions and classifications; all participating countries provided a breakdown of their stock of portfolio investment assets by the country of residency of the nonresident issuer; and best practices in survey design and implementation were drawn on to the maximum extent possible.

These data will be analyzed in a separate forthcoming paper intended to complement the publication of the results of the survey. Publication of the analysis is expected sometime in spring 2000. In particular, the data will be used to investigate global imbalances in portfolio investment assets and liabilities in light of the evidence made available by the survey and some additional sources of information. Data provided by eight countries that collected geographical details on their portfolio investment liabilities will also be compared with the corresponding assets reported by their survey partners.

"The size of the global discrepancy between portfolio investment assets and liabilities remained substantial," said Carson. This could be attributed to the lack of data sources for offshore financial centers and some countries, for which no estimate could be made, and a lack of coverage of holdings of portfolio investment assets by households. "These considerations underscore the need for a more complete participation of major investing countries in future surveys, including offshore financial centers, that would address the remaining sources of underreporting of global portfolio investment assets and provide an indication of the reliability of the global data for portfolio investment liabilities," she said.

Coordinated effort for consistent data

In addition to shedding some light on the size of global discrepancies in portfolio investment positions, the survey also showed that a coordinated effort could be successfully organized across a large number of countries with respect to the scope, coverage, timing, definitions, and concepts used in the compilation of data. The survey also provided an effective and efficient vehicle for establishing and spreading good methodological standards worldwide and facilitated a greater understanding of country practices with respect to survey design and alternative approaches to data collection.

Carson also noted that the survey resulted in a greater awareness of the IMF's *Balance of Payments Manual* and promoted its implementation. "As more countries take steps to compile an annual international investment position, the likely outcome is the improved reporting of stocks and flows of portfolio investment and a reduction in global discrepancies," she said.

A follow-up survey is being planned for end-December 2001, which will include short-term portfolio investment positions. Efforts are also under way to ensure a broader participation by countries and offshore financial centers. ■

The text of News Brief No. 00/8 is available on the IMF's website (www.imf.org). Copies of *Results of the 1997 Coordinated Portfolio Investment Survey* are available for $27.50 from IMF Publication Services. See page 40 for ordering information.

Estonia

Economic integration poses policy challenges to countries seeking EU accession

Estonia, one of the three Baltic transition economies, attaches high priority to rapid accession to the European Union (EU) and participation in the European Economic and Monetary Union (EMU). In pursuit of this goal, the country has taken great strides toward establishing a market-oriented economy. In an IMF Working Paper, René Weber of the IMF's Policy Development and Review Department and Günther Taube of the IMF's European II Department assess the macroeconomic impact and policy challenges for Estonia of EU accession and the potential adoption of the euro. Weber and Taube discussed their findings in an interview with the IMF Survey.

Estonia applied for EU membership in 1995, and two years later, the European Council included it in the first group of countries invited to start membership negotiations. What made Estonia a good candidate for early accession?

TAUBE: Estonia was included in the first group of EU accession candidates together with four other transition countries—the Czech Republic, Hungary, Poland, and Slovenia—because of its strong macroeconomic and structural policies that had led to major progress in disinflation, external stability, and growth. Underpinned by a currency board arrangement—the Estonian kroon is fully convertible and has been tied to the deutsche mark at 8:1 since 1992—Estonia has generally pursued prudent fiscal policies. It has made great strides in liberalizing and deregulating the domestic economy and privatized most state-owned enterprises. Estonia has welcomed foreign investors and liberalized its external trade. By including the smallest and most northern Baltic country in the "first wave" of accession candidates, the European Union recognized Estonia's strong and successful efforts to become a market economy, achieve macroeconomic stability, and make its regulatory environment compatible with that of the European Union.

Joining the common market entails both costs and benefits for EU accession candidates. How will the costs for Estonia of joining the EU common market stack up against the benefits? What is the role of trade in determining this outcome?

WEBER: First of all, one has to keep in mind that any cost-benefit assessment of EU accession is to a large extent judgmental. In the case of Estonia, the assessment is complicated by the fact that economic integration with Western Europe is already well advanced and set to intensify further in the run-up to full membership. EU accession and eventual participation in EMU are additional steps and part of an ongoing process. In addition, the policy frameworks of the EU and the EMU are "moving targets," meaning that they are undergoing important changes in the next couple of years. Some clues on the welfare impact of EU accession can be taken from the experiences of countries that joined the European Union before the 1990s—for example, the favorable growth performances of Portugal, Spain, and, especially, Ireland. There is thus an expectation that the longer-term economic gains from joining the common market will outweigh the related adjustment costs incurred in the transitory period.

If one looks at the trade side, the additional impact for Estonia is likely to reflect changes in its very low level of protection toward non-EU members and the fact that it has to adopt import restrictions—for example, as part of the Common Agricultural Policy. In our view, any welfare losses from trade diversion should remain limited since Estonia's main trading partners are already part of the European Union's extensive network of trade agreements. Better market access to the European Union for agricultural products and other goods and services is likely to compensate for any welfare losses resulting from import restrictions. Last but not least, there is scope for dynamic integration and welfare gains due to more intensive competition from abroad on the Estonian market.

How will Estonia's financial sector be affected by EU membership? What actions need to be taken in the financial sector?

WEBER: Estonia has relatively easy access to international capital markets, which has increased competitive pressure in the domestic financial sector and contributed to the consolidation of the banking sector. Considering its already favorable climate, Estonia will become even more attractive for investors because it is in the process of fully adopting the European Union's financial sector directives as well as minimum standards for bank regulations and supervision. Foreign borrowing and equity financing should become easier and less costly not just for large but also for medium-sized Estonian enterprises.

A direct impact on economic activity in Estonia can be expected from the amount of transfer payments to and from the European Union. We estimate that net transfer receipts for Estonia could amount to about 2 percent of GDP a year over the medium term. Furthermore, EU membership will influence creditors' perception of sovereign and currency risk, thereby reducing the risk premium on domestic interest rates. Lower capital costs should foster both the supply of and the demand for credit in Estonia, which will spur domestic investment activity and support growth. In the run-up to eventual participation in the EMU, this effect can be expected to become even more pronounced.

René Weber (left) and Günther Taube.

What fiscal policy challenges does EU accession pose and how well equipped is the country to adapt to the requirements of EU membership? What policy changes will be necessary—for instance, in the tax system and in expenditures—and what will be the impact on budgetary performance?

TAUBE: Fiscal policy challenges include the need to further harmonize taxes with the European Union and to strengthen budget formulation and expenditure management. In addition, public administration will need to be rationalized. As regards the tax system, Estonia is in a favorable position vis-à-vis current and prospective EU members because of its relatively transparent, simple, and efficient tax system—for example, a flat income tax rate of 26 percent. So, only a few further adjustments will be necessary to harmonize taxes with those of the European Union.

On the expenditure side, EU accession is likely to cause significant additional pressure, mostly because of the need for increased public sector investment for infrastructure and environmental upgrading. Current expenditures can be expected to rise because of the need to comply with EU standards and establish the necessary legal and institutional preconditions for membership. However, efficiency gains and redeployment of staff should help to limit the increase in such spending.

Photo Credits: Denio Zara, Padraic Hughes, and Pedro Marquez for the IMF, pages 35, 40, 43; Rickey Rogers for Reuters, pages 46 and 47.

Much of the increase in spending can be expected to be financed through a variety of EU funds, including the "Instrument of Structural Policies for Preaccession," PHARE, and agricultural aid that is provided during the preaccession period to facilitate the implementation of the Common Agricultural Policy. Because a substantial part of these funds will become available as grants, the fiscal deficit and public debt will not increase much.

What are the legal and institutional requirements for EMU and how far along is Estonia in meeting these requirements? What are the implications of joining the euro area for the stance of monetary policy, interest rate spreads, and Estonia's continuing attractiveness to capital markets?

WEBER: EU accession candidates have to prepare for eventual participation in EMU, but they are not required to fulfill the "Maastricht" macroeconomic convergence criteria at the time of accession.

Although Estonia has a very good track record of prudent macroeconomic policies, further convergence with the euro area will be needed with respect to inflation and interest rates. To participate in EMU, a country will also need to comply with a range of legal and institutional requirements. These include the full liberalization of capital flows and the existence of an independent central bank with an unequivocal mandate to ensure price stability. Estonia is one of the leaders among the accession candidates in meeting these requirements. The role and functions of its central bank are suitably defined, and as mentioned above, capital movements were liberalized early on in transition, which should facilitate linking the domestic payments system with the network of cross-border settlements systems of the euro area.

Since the Estonian kroon is pegged to the deutsche mark, Estonia's monetary policy stance is already largely determined by euro area monetary policy. A switch to the euro would therefore essentially imply continuity in the monetary policy stance. However, the fact that short-term interest rates will eventually equal those in the rest of the euro area is bound to spur domestic economic activity. From Estonia's perspective, interest rate convergence in the run-up to EMU will happen unilaterally, bringing short-term rates down to the lower level of the euro area. For long-term interest rates, full convergence is neither required nor likely. At any rate, the credibility gained through participation in EMU will further improve Estonia's sovereign ratings and its standing on the financial markets.

Your paper suggests that the positive medium- and long-term growth effects from stronger linkages to the European economy could exacerbate macroeconomic imbalances. What is the nature of these imbalances and why are they likely to arise? Are growth and external balance conflicting objectives?

TAUBE: Our analysis of the budgetary and financial impact suggests that an increase in EU-related public investment expenditures and a decline in the interest rate risk premium will result in fiscal and monetary impulses. These will not only spur domestic activity but also increase the demand for imports and the dependence on foreign financing. As a result, the current account deficit could widen both directly via higher imports of consumption and investment goods related to EU credits and indirectly through the increase in GDP and import demand.

To shed light on the potential trade-off between higher growth and greater external sector imbalances, we ran simulations using the IMF's MULTIMOD macroeconomic model. Assuming a combined impact of higher public investment spending and lower interest rates over time, these simulations show that the current account deficit could indeed widen somewhat in parallel with the increase in real GDP. While these results are strongly dependent on the model assumptions, they nevertheless strengthen the case for addressing macroeconomic stress factors related to the accession process early on.

Clearly, for Estonia, the benefits of EU membership are likely to outweigh the costs. What policy actions do you recommend for minimizing the costs and taking full advantage of the benefits?

WEBER: The limited availability of macroeconomic policy instruments to respond to the challenges from EU accession calls for a determined fiscal and structural policy agenda. In the absence of the exchange rate instrument, the adjustment process will largely operate through the real economy via adjustments in domestic prices, wages, and employment. In our view, the policy instruments available should be geared toward mitigating domestic demand pressures and promoting saving. This will help to improve the consistency of Estonia's external position with a stability-oriented macroeconomic policy framework. In light of the expected additional capital inflows, the efficient use of funds for public investment also seems critical. We would like to stress that Estonia holds considerable sway over its fiscal and structural policies to smooth the accession-related adjustment and take advantage of the potential economic benefits to be had from this process. ■

Copies of IMF Working Paper 99/156, *On the Fast Track to EU Accession: Macroeconomic Effects and Policy Challenges for Estonia*, by René Weber and Günther Taube, are available for $7.00 each from IMF Publication Services. See page 40 for ordering details.

IIF sees net private capital flows to emerging markets rebounding in 2000

With the Asian, Russian, and Brazilian financial crises receding into the past, international lenders and investors appear to be recovering their confidence in emerging markets, according to a report by the Institute of International Finance (IIF) released on January 24. In *Capital Flows to Emerging Market Economies*, the IIF projects that net private capital flows to 29 leading emerging market economies will rise to $190 billion in 2000 from about $150 billion in both 1998 and 1999.

Foreign direct investment (FDI), which constituted the bulk of private capital flows into emerging market economies in 1997–98, rose to $140 billion in 1999 from $120 billion in 1998, and the IIF projects that it will continue to be strong in 2000. Portfolio equity investments into these economies have picked up again after a two-year hiatus and are expected to increase to $34 billion this year from $17 billion in 1999. The IIF expects total FDI and portfolio equity flows this year to match the record volume of $155 billion registered in 1999.

Asia and Latin America

Flows to Asia (China, India, Indonesia, Korea, Malaysia, the Philippines, and Thailand) and Latin America (Argentina, Brazil, Chile, Colombia, Ecuador, Mexico, Peru, Uruguay, and Venezuela) are picking up the fastest, according to the report. Net private flows to Asia are expected to reach $60 billion in 2000 from about $40 billion in 1999 and only $6 billion in 1998. Within Asia, the economies that were hardest hit in 1997–98—and that experienced large negative private flows—should receive modest net private inflows this year. Private flows to China should increase significantly in 2000, while those to Korea are likely to strengthen further.

Private flows to Latin America are expected to rise to about $90 billion this year after falling to about $69 billion in 1999. Net private credit flows to the region should increase to $35 billion from only $8 billion in 1999, with Brazil accounting for the bulk of the rebound. The IIF expects net private flows to Brazil to amount to almost $40 billion this year compared with less than $20 billion in 1999, when the country made substantial net repayments to foreign creditors around the time of its exchange rate crisis. It further projects that net private flows to Argentina will remain substantial at about $14 billion this year and that those to Mexico will stabilize at about $19 billion.

Europe, Africa, and the Middle East

Private flows to emerging market economies in Europe (Bulgaria, Czech Republic, Hungary, Poland, Romania, Russia, Slovakia, and Turkey) are expected to remain stable, at slightly more than $30 billion, in 2000. Equity flows account for about 60 percent of this figure. According to the IIF, net flows to Russia may turn negative this year as the country makes net repayments to some of its creditors. The IIF expects private flows to Africa and the Middle East (Algeria, Egypt, Morocco, South Africa, and Tunisia) to increase moderately this year, largely because of stronger flows to South Africa resulting from improved market sentiment.

Outlook

The IIF cautions that, despite this encouraging prospective rebound, the recovery remains tentative for a number of reasons. First, developments in industrial country financial markets—in particular, possible sharp increases in U.S. interest rates and a substantial stock market correction—could have an adverse effect on financial flows to emerging market economies. Second, a number of emerging market economies are holding elections this year, raising questions about the ability of their authorities to continue to follow prudent macroeconomic policies and persevere with structural reforms in the face of electoral pressures. A third consideration is the concern of private investors and lenders that official sector policies in these countries may harm their interests. The forecasts for 2000 assume that no emerging market economy will experience a severe financial crisis, but the report emphasizes that the possibility of such a shock cannot be ruled out. ■

Financial flows to emerging market economies by region
(billion U.S. dollars)

	1996	1997	1998	1999[1]	2000[2]
Private flows, net	**327.9**	**265.7**	**147.8**	**148.7**	**193.1**
Latin America	97.3	107.7	97.5	68.8	89.6
Europe	50.4	74.5	35.1	31.9	32.5
Africa/Middle East	3.8	15.7	9.4	8.7	11.6
Asia/Pacific	176.3	67.9	5.8	39.3	59.4
Five Asian economies[3]	108.1	–0.2	–36.4	–3.7	7.8
Official flows, net	**7.6**	**38.9**	**52.8**	**11.9**	**9.1**
Latin America	–10.5	–2.6	15.7	5.5	–1.9
Europe	11.2	6.1	8.1	3.0	4.4
Africa/Middle East	1.8	–1.3	–2.2	–1.0	–1.7
Asia/Pacific	5.0	36.7	31.2	4.3	8.3
Five Asian economies[3]	–1.6	29.9	26.9	1.4	6.3

[1]Estimate.
[2]IIF forecast.
[3]Indonesia, Korea, Malaysia, Philippines, and Thailand.

Data: IIF, *Capital Flows to Emerging Market Economies*, 2000

The text of *Capital Flows to Emerging Market Economies* is available on the IIF website (www.iif.com).

Argentina case study

IMF research suggests nature of currency crises may have changed in 1990s

The growing frequency of currency crises in the 1990s has prompted researchers to look at the causes of these crises, but surprisingly little attention has been paid to possible changes in the character of these crises. In *Has the Nature of Crises Changed?* Nada Choueiri and Graciela Kaminsky examine the experience of Argentina, a country that has weathered seven major currency crises over the past quarter century. They conclude that crises in the 1970s and 1980s were chiefly the product of domestic and external monetary and fiscal policies but that spillover from crises elsewhere played an important role in the 1990s.

Crises chronology

Over the past 25 years, Argentina has been affected by virtually every major instance of international financial turmoil and several solely domestic crises. The country's experience makes it a key case study. Using data from the past quarter century and adapting their macroeconomic model to Argentina's two principal exchange rate regimes, Choueiri and Kaminsky examine seven stabilization plans and the crises that unraveled all but the most recent plan. The seven plans were Gelbard (1973– 75), Tablita (1978–81), Alemann (1981–82), Austral (1985–87), Primavera (1988–89), BB (1989–90), and Convertibility (1991–present).

Plagued by chronic inflation through much of its post–World War II economic history, Argentina alternated between a unified fixed exchange rate system, with full convertibility for both current and capital account transactions, and a dual exchange rate, with a fixed-rate system for current account transactions and a floating rate for capital account transactions. The authors' model captures the stylized features of both systems. Under a unified fixed exchange rate regime, the authorities set a predefined goal for domestic credit and abandoned the fixed rate if it hindered discretionary monetary policy. Investors, aware that the two goals might collide, expect the peg to be abandoned once reserves are exhausted.

A variety of shocks could drain reserves. The model formulated by the authors allows for monetary shocks (both money demand and money supply shocks) and external shocks (originating from world interest rate charges and contagion effects). To capture the dual exchange rate regime, the authors introduce a financial market premium (a barometer for policy credibility) that increases with expansionary domestic monetary policy, positive shocks to world interest rates, and contagion across the region, and decreases with lower reserves and positive shocks to money demand.

Nature of crises

Monetary policy shocks were at the heart of many of Argentina's crises, and were particularly strong in the 1970s. The study finds monetary policy shocks responsible for 73 percent of the severity of the Gelbard Plan crisis and 45 percent of the severity of the Tablita Plan crisis and the hyperinflation of the late 1980s.

Typically, adverse monetary policy shocks in Argentina originated in excessive expansions in money supply fueled by either fiscal pressures or financial sector fragilities or some combination of the two. A fiscal deficit was at the center of the monetary expansion under the Gelbard Plan. Domestic credit (in U.S. dollars) more than doubled between September 1973 and February 1975, as the GDP share of the fiscal deficit rose from 5.3 percent in 1972 to 7.8 percent in 1974. Fiscal pressures also contributed to the large monetary policy expansion that precipitated the collapse of the Tablita Plan in 1981, but massive bailouts initiated to deal with a banking sector crisis proved even more destabilizing. Toward the end of the decade, Argentina—cut off from world capital markets—tried to finance another government deficit with huge increases in domestic credit and quickly generated another crisis.

Adverse money demand shocks—largely the product of escalating inflation—also played a key role in many of the crises. As inflation accelerated in the mid-1980s, households and firms began to substitute foreign assets for domestic money. In the vicious circle that ensued, large deficits led to high inflation, dollarization, and more inflation.

A troubled banking sector and a confiscation of deposits in the early 1980s and again in January 1990 also spurred households to hold dollars. Abrupt reversals of efforts to liberalize the banking sector further eroded the public's confidence. Overall, money demand shocks explain 40–60 percent of the severity at the onset of the 1981–82, 1989–90, and 1995 crises. They explain 96 percent of the decline in foreign exchange reserves during the collapse of the Austral Plan.

The Tablita Plan collapsed amid financial uncertainty and several bank runs following the failure of a major bank. Adverse money demand shocks in the early 1980s were also triggered by the prospect of a reintroduction of capital account restrictions and capital tax levies. These fears escalated after the conflict with the United Kingdom erupted in early 1982, and capital flight increased dramatically. The authorities did indeed impose drastic exchange rate controls in April and introduced a dual exchange market in July. Escalating inflation and a scheme in the early 1980s to

Correction

In the printed version of the IMF Survey, dated February 7, 2000, the photo caption inaccurately states that Argentina's Convertibility Plan eliminated the peso and adopted the US dollar. The text of the caption should read: Argentina's Convertibility Plan provides, inter alia, for a currency board arrangement under which the domestic currency, the peso, can be exchanged on a one-to-one basis for the U.S. dollar.

sharply reduce the value of existing bank loans and deposits delivered the final blow. Dollarization accelerated, with an estimated $5 billion in dollar notes circulating by the mid-1980s. The Austral Plan briefly stabilized the financial system, but money demand declined shortly after the program's introduction, as fiscal adjustment faltered and inflation fears reignited.

Accelerated dollarization and financial instability contributed to the collapse of the Primavera and BB Plans in 1989–90, with money demand shocks explaining about a third of the increase in the financial rate premium. In January 1990, a scheme to reduce the value of debt—a conversion of most domestic-currency-denominated bank time deposits into 10-year dollar-denominated bonds known as Bonex—brought about immediate turmoil when these bonds lost 70 percent of their face value. By March 1990, M3—currency and all deposits denominated in domestic currency—had collapsed to 3.1 percent of GDP, and the share of dollar holdings (currency and deposits) in total assets jumped to 80 percent.

After a decade of confiscations and financial repression, Argentines responded rapidly to the first hint of trouble in the financial system. When financial fragilities mounted in 1994 and 1995, households quickly withdrew their deposits. During the first quarter of 1995, commercial banks lost nearly 20 percent of their deposits. Unfortunately, the central bank's efforts raised doubts about the authorities' commitment to the currency board in place since April 1991 and stimulated a sharp move toward dollar-denominated instruments. Overall, Choueiri and Kaminsky note, adverse money demand shocks explain about 47 percent of the unexpected decline in foreign exchange reserves between January 1994 and February 1995.

When Argentina has been active in capital markets, external factors—notably sensitivity to world interest rate changes—have also played a key role in the onset of currency crises. Large increases in U.S. interest rates were responsible for 45 percent of the decline in Argen-tina's foreign exchange reserves between late 1979 and mid-1982. The onset of the 1995 crisis was partly triggered by monetary tightening in the United States; a 3.5 percentage point increase in the U.S. federal funds rate was associated with more than 60 percent of the total decline in the historical forecast error of Argentina's reserves between January 1994 and February 1995.

But in the 1990s, external shocks were not limited to changes in world interest rates. Spillover effects from other Latin American countries multiplied losses triggered by a tighter U.S. monetary policy. Evidence suggests spillover effects stemmed from financial links. In the early 1990s, dedicated emerging market mutual funds invested at least 5, 13, and 8 percent of their portfolio in Argentina, Brazil, and Mexico, respectively. But a loss in one country could prompt a sale of assets in other emerging markets. Predictably, Argentina and Brazil, with the most liquid stock markets, suffered the most during the Tequila crisis. About one-third of the fall in Argentina's reserves from January 1994 to February 1995 can be explained by contagion effects.

Conclusion

Among the findings of their study, Choueiri and Kaminsky say, are the following:

• *Monetary tightening in industrial countries played a role, as earlier studies suggested, in the capital flow reversals of the early 1980s and mid-1990s.* Both the collapse of the Alemann Plan and the speculative attack against the peso in 1994–95 were in large measure precipitated by a contractionary U.S. monetary stance.

• *Inconsistent monetary and exchange rate policies triggered many of the major speculative attacks on the Argentine peso.* Also, the accelerating pace of money creation fueled complete dollarization. Demonetization of the economy intensified after the hyperinflation of the late 1980s–early 1990s, as the ratio of M1 to output (measured by industrial production) collapsed in February 1990 to a fifth of its February 1987 value.

• *Recurrent reversals of liberalization attempts, capital account restrictions, and interest rate and credit controls fueled capital flight and exerted downward pressure on money demand.*

• *Deliberate policies to reduce the real value of internal debt, either private or public, further shook the public's faith in its financial system and accelerated the dollarization process.*

• *The 1990s look somewhat different.* Spillovers from other Latin American countries seem to have been a source of financial distress for Argentina, and explain about 30 percent of the severity of the speculative attack in 1995. This new channel for spillovers is not surprising, given Argentina's integration into world capital markets and the important role played by mutual funds in Latin America.

These results also suggest a wide scope for future research. A deeper understanding of the nature of speculative attacks, Choueiri and Kaminsky say, begs for more precise measures of capital account and interest rate controls to quantify how episodes of liberalization followed by sharp reversals affect money demand. Also, given the fast-changing nature of world capital markets, the nature of financial market channels needs to be better understood so that more effective strategies can be designed to avoid crises and fend off contagion. ■

Copies of IMF Working Paper 99/152, *Has the Nature of Crises Changed? A Quarter Century of Currency Crises in Argentina*, by Nada Choueiri and Graciela Kaminsky, are available for $7.00 each from IMF Publication Services. See page 40 for ordering details.

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UNCTAD study

Foreign direct investment to Asia holds steady, although flows in individual countries vary

An anticipated decline in flows of foreign direct investment (FDI) to Asia in the wake of the 1997–98 financial crisis failed to materialize, according to a United Nations Conference on Trade and Development (UNCTAD) press release issued on January 25. Preliminary UNCTAD estimates for 1999 show, instead, that FDI flows to developing Asia in 1999 actually increased slightly by 1 percent to $91 billion in 1999 over 1998.

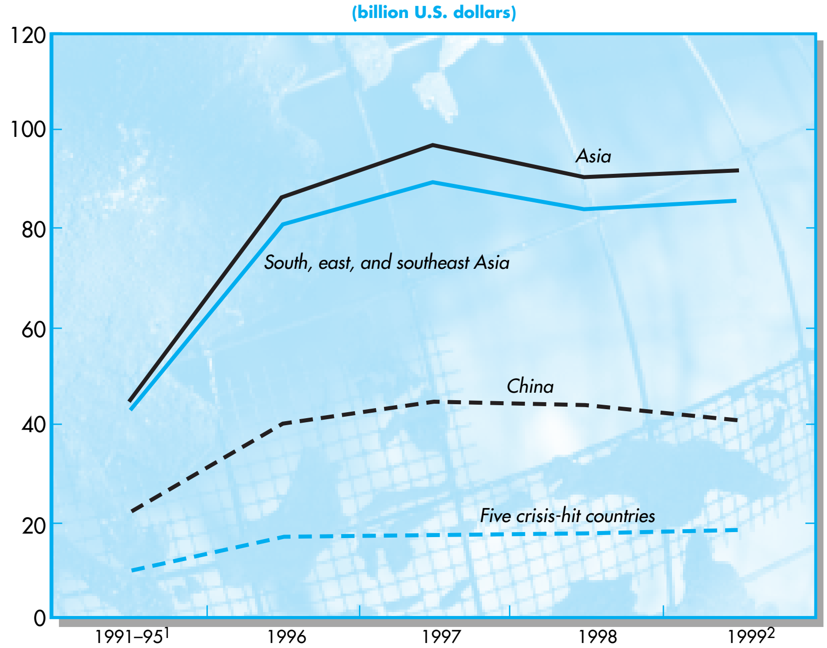
The overall regional increase masks considerable variation in FDI flows to individual countries, however, according to the press release. Flows to China, the principal FDI recipient in developing Asia throughout the 1990s, dropped nearly 8 percent to just over $40 billion in 1999. In contrast, flows to Korea, one of the five countries most heavily affected by the financial crisis, skyrocketed by nearly 55 percent (to $8.5 billion). Singapore followed with a 20 percent increase to $8.7 billion. Among the other four crisis-affected countries, FDI flows fell in Indonesia, the Philippines, and Thailand, while remaining steady in Malaysia. The press release notes that the drop in FDI flows to Thailand—by about 15 percent, to $5.8 billion—was partly due to the flattening of the wave of massive recapitalization in the banking sector, which reached exceptional highs in 1998. Nevertheless, FDI flows into Thailand surpassed the historically high levels the country had achieved in 1997.

Other notable features of FDI flows to Asia in 1999, according to UNCTAD, included:

- Cross-border mergers and acquisitions continued to be a driving force for FDI flows to the five crisis-affected countries.
- Countries whose primary sources of FDI have been other countries in the region continued to suffer from the negative effects of the crisis—for example, Vietnam, the least-developed Asian countries, and, to some extent, China.

Investment prospects for developing Asia remain bright, the press release concludes, bolstered by the quality of the underlying economic determinants for FDI flows, the recovery of the regional economy, the ongoing and widespread liberalization and restructuring efforts, and the possible accession of China to the World Trade Organization in the near future. ■

FDI inflows to developing Asia
(billion U.S. dollars)



[1]Annual average.
[2]Inflows in 1999 are preliminary estimates by UNCTAD.

Data: UNCTAD

Selected IMF rates

Week beginning	SDR interest rate	Rate of remuneration	Rate of charge
January 24	3.92	3.92	4.46
January 31	4.03	4.03	4.58

The SDR interest rate and the rate of remuneration are equal to a weighted average of interest rates on specified short-term domestic obligations in the money markets of the five countries whose currencies constitute the SDR valuation basket (as of May 1, 1999, the U.S. dollar was weighted 41.3 percent; euro (Germany), 19 percent; euro (France), 10.3 percent; Japanese yen, 17 percent; and U.K. pound, 12.4 percent). The rate of remuneration is the rate of return on members' remunerated reserve tranche positions. The rate of charge, a proportion (currently 113.7 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

The text of this press release, as well as further information, is available on UNCTAD's website: www.unctad.org.