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Contents

Eleventh Review of Quotas

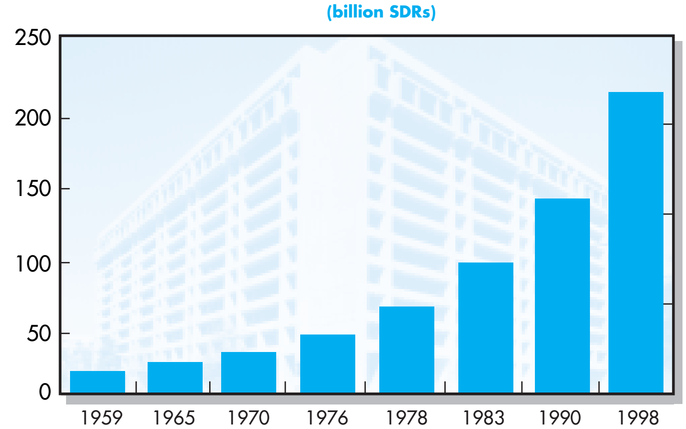
IMF Financial Resources to Rise to $297 Billion As Members Consent to Quota Increase

On January 22, the IMF announced that more than 85 percent of its members had consented to an increase in the IMF's quotas. The text of Press Release No. 99/4, issued on January 22, follows.

On January 22, the IMF determined that members having more than 85 percent of the total of IMF quotas have consented to increases in their quotas under the Eleventh General Review of Quotas. This meets the participation requirement for the quota increase to enter into effect.

For individual quota increases to become effective, each member that has already consented must pay the increase to the IMF within 30 days from January 22. Members that consent later than January 22 must pay the increase within 30 days *(Please turn to the following page)*

Total IMF Quotas
(billion SDRs)



Note: Years are those of adoption of quota resolution by IMF Board of Governors.

Data: IMF Pamphlet No. 45, *Financial Organization and Operations of the IMF*, 1998

Joint Statement

Brazilian Authorities, IMF Staff Agree in Principle On Elements of New Economic Policy Framework

An IMF staff mission team has been in Brasilia since the end of January to review—in consultation with a team of Brazilian authorities led by Finance Minister Pedro Malan—economic policies and developments under the stand-by program that was approved by the IMF Executive Board on December 2, 1998, and to discuss how the program can be adapted to the new floating exchange rate regime (see IMF Survey, *January 25, page 18). Stanley Fischer, IMF First Deputy Managing Director, joined the staff team on February 2. The following is the text of News Brief 99/5, a joint statement of the Ministry of Finance of Brazil and the IMF staff team, issued on February 4, in Brasilia. The text is also available on the IMF's website (www.imf.org).*

Brazilian Finance Minister Pedro Malan (left) and IMF First Managing Director Stanley Fischer meet at the Finance Ministry in Brasilia on February 2.

Discussions have been open and fruitful, and agreement in principle has been reached on important elements of the economic policy framework that the authorities intend to implement in the rest of 1999 and over the medium term. The Brazilian authorities reaffirmed their commitment to work with the international *(Continued on page 41)*

IMF Quota to Increase

(Continued from front page) after the date on which the IMF is notified of their consent. Members have until July 30, 1999, to consent to their individual increases. Under the Eleventh Review, the quotas of the IMF membership as a whole will increase from SDR 145.6 billion (about $204 billion) to SDR 212.0 billion (about $297 billion). [These figures include the Federal Republic of Yugoslavia (Serbia/Montenegro), which is not a member at present but which may succeed to the membership of the former Socialist Federal Republic of Yugoslavia.] The IMF's usable resources are expected to rise by about SDR 45 billion (about $63 billion).

A list of members' current and proposed quotas appears below.

IMF Members' Quotas[1]

	Ninth Review Quotas		Eleventh Review Quotas	
	Amount (million SDRs)	Share (percent)	Amount (million SDRs)	Share (percent)
United States	26,526.8	18.212	37,149.3	17.521
Japan	8,241.5	5.658	13,312.8	6.279
Germany	8,241.5	5.658	13,008.2	6.135
France	7,414.6	5.090	10,738.5	5.065
United Kingdom	7,414.6	5.090	10,738.5	5.065
Italy	4,590.7	3.152	7,055.5	3.328
Saudi Arabia	5,130.6	3.522	6,985.5	3.295
Canada	4,320.3	2.966	6,369.2	3.004
Russia	4,313.1	2.961	5,945.4	2.804
Netherlands	3,444.2	2.365	5,162.4	2.435
China	3,385.2	2.324	4,687.2	2.211
Belgium	3,102.3	2.130	4,605.2	2.172
India	3,055.5	2.098	4,158.2	1.961
Switzerland	2,470.4	1.696	3,458.5	1.631
Australia	2,333.2	1.602	3,236.4	1.526
Spain	1,935.4	1.329	3,048.9	1.438
Brazil	2,170.8	1.490	3,036.1	1.432
Venezuela	1,951.3	1.340	2,659.1	1.255
Mexico	1,753.3	1.204	2,585.8	1.220
Sweden	1,614.0	1.108	2,395.5	1.130
Argentina	1,537.1	1.055	2,117.1	0.999
Indonesia	1,497.6	1.028	2,079.3	0.981
Austria	1,188.3	0.816	1,872.3	0.883
South Africa	1,365.4	0.937	1,868.5	0.882
Nigeria	1,281.6	0.880	1,753.2	0.827
Norway	1,104.6	0.758	1,671.7	0.789
Denmark	1,069.9	0.735	1,642.8	0.775
Korea	799.6	0.549	1,633.6	0.771
Iran, Islamic Rep. of	1,078.5	0.740	1,497.2	0.706
Malaysia	832.7	0.572	1,486.6	0.701
Kuwait	995.2	0.683	1,381.1	0.652
Ukraine	997.3	0.685	1,372.0	0.647
Poland	988.5	0.679	1,369.0	0.646
Finland	861.8	0.592	1,263.8	0.596
Algeria	914.4	0.628	1,254.7	0.592
Iraq	504.0	0.346	1,188.4	0.561
Libya	817.6	0.561	1,123.7	0.530
Thailand	573.9	0.394	1,081.9	0.510
Hungary	754.8	0.518	1,038.4	0.490
Pakistan	758.2	0.521	1,033.7	0.488
Romania	754.1	0.518	1,030.2	0.486
Turkey	642.0	0.441	964.0	0.455
Egypt	678.4	0.466	943.7	0.445
Israel	666.2	0.457	928.2	0.438
New Zealand	650.1	0.446	894.6	0.422
Philippines	633.4	0.435	879.9	0.415
Portugal	557.6	0.383	867.4	0.409
Singapore	357.6	0.246	862.5	0.407
Chile	621.7	0.427	856.1	0.404
Ireland	525.0	0.360	838.4	0.396
Greece	587.6	0.403	823.0	0.388
Czech Republic	589.6	0.405	819.3	0.387
Colombia	561.3	0.385	774.0	0.365
Bulgaria	464.9	0.319	640.2	0.302
Peru	466.1	0.320	638.4	0.301
United Arab Emirates	392.1	0.269	611.7	0.289
Morocco	427.7	0.294	588.2	0.278
Bangladesh	392.5	0.269	533.3	0.252
Congo, Dem. Rep. of	291.0	0.200	533.0	0.251
Zambia	363.5	0.250	489.1	0.231
Sri Lanka	303.6	0.208	413.4	0.195
Belarus	280.4	0.193	386.4	0.182
Ghana	274.0	0.188	369.0	0.174
Kazakhstan	247.5	0.170	365.7	0.173
Croatia	261.6	0.180	365.1	0.172
Slovak Republic	257.4	0.177	357.5	0.169
Zimbabwe	261.3	0.179	353.4	0.167
Trinidad and Tobago	246.8	0.169	335.6	0.158
Vietnam	241.6	0.166	329.1	0.155
Côte d'Ivoire	238.2	0.164	325.2	0.153
Sudan	169.7	0.117	315.1	0.149
Uruguay	225.3	0.155	306.5	0.145
Ecuador	219.2	0.150	302.3	0.143
Syrian Arab Republic	209.9	0.144	293.6	0.139
Tunisia	206.0	0.141	286.5	0.135
Angola	207.3	0.142	286.3	0.135
Luxembourg	135.5	0.093	279.1	0.132
Uzbekistan	199.5	0.137	275.6	0.130
Jamaica	200.9	0.138	273.5	0.129
Kenya	199.4	0.137	271.4	0.128
Qatar	190.5	0.131	263.8	0.124
Myanmar	184.9	0.127	258.4	0.122
Yemen, Republic of	176.5	0.121	243.5	0.115
Slovenia	150.5	0.103	231.7	0.109
Dominican Republic	158.8	0.109	218.9	0.103
Brunei Darussalam	150.0	0.103	215.2	0.102
Guatemala	153.8	0.106	210.2	0.099
Panama	149.6	0.103	206.6	0.097
Lebanon	146.0	0.100	203.0	0.096
Tanzania	146.9	0.101	198.9	0.094
Oman	119.4	0.082	194.0	0.092
Cameroon	135.1	0.093	185.7	0.088
Uganda	133.9	0.092	180.5	0.085
Bolivia	126.2	0.087	171.5	0.081

IMF Quotas and Quota Reviews

The IMF is a financial cooperative, and the primary means of financing by the IMF is quotas—a pool of resources that consists of the capital subscriptions paid by each member country. These allow member countries to correct maladjustments without resorting to measures destructive of national or international prosperity.

In an increasingly globalized world, the IMF must have adequate resources to meet the balance of payments needs of its membership. An adequate level of quotas allows the IMF to

• strengthen the pool of resources from which it meets members' needs and reduce resort to supplemental borrowing;

IMF Members' Quotas

	Ninth Review Quotas		Eleventh Review Quotas	
	Amount (million SDRs)	Share (percent)	Amount (million SDRs)	Share (percent)
El Salvador	125.6	0.086	171.3	0.081
Jordan	121.7	0.084	170.5	0.080
Bosnia and Herzegovina	121.2	0.083	169.1	0.080
Costa Rica	119.0	0.082	164.1	0.077
Afghanistan, Islamic State of	120.4	0.083	161.9	0.076
Senegal	118.9	0.082	161.8	0.076
Azerbaijan	117.0	0.080	160.9	0.076
Gabon	110.3	0.076	154.3	0.073
Georgia	111.0	0.076	150.3	0.071
Lithuania	103.5	0.071	144.2	0.068
Cyprus	100.0	0.069	139.6	0.066
Namibia	99.6	0.068	136.5	0.064
Bahrain	82.8	0.057	135.0	0.064
Ethiopia	98.3	0.067	133.7	0.063
Papua New Guinea	95.3	0.065	131.6	0.062
Bahamas, The	94.9	0.065	130.3	0.061
Nicaragua	96.1	0.066	130.0	0.061
Honduras	95.0	0.065	129.5	0.061
Liberia	71.3	0.049	129.2	0.061
Latvia	91.5	0.063	126.8	0.060
Moldova	90.0	0.062	123.2	0.058
Madagascar	90.4	0.062	122.2	0.058
Iceland	85.3	0.059	117.6	0.055
Mozambique	84.0	0.058	113.6	0.054
Guinea	78.7	0.054	107.1	0.051
Sierra Leone	77.2	0.053	103.7	0.049
Malta	67.5	0.046	102.0	0.048
Mauritius	73.3	0.050	101.6	0.048
Paraguay	72.1	0.050	99.9	0.047
Mali	68.9	0.047	93.3	0.044
Suriname	67.6	0.046	92.1	0.043
Armenia	67.5	0.046	92.0	0.043
Guyana	67.2	0.046	90.9	0.043
Kyrgyz Republic	64.5	0.044	88.8	0.042
Cambodia	65.0	0.045	87.5	0.041
Tajikistan	60.0	0.041	87.0	0.041
Congo, Republic of	57.9	0.040	84.6	0.040
Haiti	60.7	0.042	81.9	0.039
Somalia	44.2	0.030	81.7	0.039
Rwanda	59.5	0.041	80.1	0.038
Burundi	57.2	0.039	77.0	0.036
Turkmenistan	48.0	0.033	75.2	0.035
Togo	54.3	0.037	73.4	0.035
Nepal	52.0	0.036	71.3	0.034
Fiji	51.1	0.035	70.3	0.033
Malawi	50.9	0.035	69.4	0.033
Macedonia, FYR	49.6	0.034	68.9	0.033
Barbados	48.9	0.034	67.5	0.032
Niger	48.3	0.033	65.8	0.031
Estonia	46.5	0.032	65.2	0.031
Mauritania	47.5	0.033	64.4	0.030
Botswana	36.6	0.025	63.0	0.030
Benin	45.3	0.031	61.9	0.029
Burkina Faso	44.2	0.030	60.2	0.028
Chad	41.3	0.028	56.0	0.026
Central African Republic	41.2	0.028	55.7	0.026
Lao P. D. R.	39.1	0.027	52.9	0.025
Mongolia	37.1	0.025	51.1	0.024
Swaziland	36.5	0.025	50.7	0.024
Albania	35.3	0.024	48.7	0.023
Lesotho	23.9	0.016	34.9	0.016
Equatorial Guinea	24.3	0.017	32.6	0.015
Gambia, The	22.9	0.016	31.1	0.015
Belize	13.5	0.009	18.8	0.009
San Marino	10.0	0.007	17.0	0.008
Vanuatu	12.5	0.009	17.0	0.008
Djibouti	11.5	0.008	15.9	0.008
Eritrea	11.5	0.008	15.9	0.008
St. Lucia	11.0	0.008	15.3	0.007
Guinea-Bissau	10.5	0.007	14.2	0.007
Antigua and Barbuda	8.5	0.006	13.5	0.006
Grenada	8.5	0.006	11.7	0.006
Samoa	8.5	0.006	11.6	0.005
Solomon Islands	7.5	0.005	10.4	0.005
Cape Verde	7.0	0.005	9.6	0.005
Comoros	6.5	0.004	8.9	0.004
St. Kitts and Nevis	6.5	0.004	8.9	0.004
Seychelles	6.0	0.004	8.8	0.004
St. Vincent and the Grenadines	6.0	0.004	8.3	0.004
Dominica	6.0	0.004	8.2	0.004
Maldives	5.5	0.004	8.2	0.004
São Tomé and Príncipe	5.5	0.004	7.4	0.003
Tonga	5.0	0.003	6.9	0.003
Bhutan	4.5	0.003	6.3	0.003
Kiribati	4.0	0.003	5.6	0.003
Micronesia, Federated States of	3.5	0.002	5.1	0.002
Marshall Islands	2.5	0.002	3.5	0.002
Palau, Republic of	2.3	0.002	3.1	0.001
Memorandum item:				
Fed. Rep. of Yugoslavia (Serbia/Montenegro)	335.4	0.230	467.7	0.221
Total	**145,656.5**	**100.0**	**212,029.0**	**100.0**

[1]Countries ranked by Eleventh Review quota.

• ensure sufficient liquidity to meet members' claims at all times;

• provide balance of payments financing to members undertaking adjustment programs, including those most adversely affected by sudden shifts in international capital flows;

• support members' efforts at establishing currency convertibility and trade liberalization; and

• assist those members making the transition to market-based economies.

Determination of Quotas

On joining the IMF, each member country is assigned a quota, which is expressed in SDRs. A member's quota in the IMF determines, in particular, its capital subscription, its voting power, its access to IMF financing, and its allocation of SDRs.

The initial quotas of the original members of the IMF were determined at the Bretton Woods Conference in 1944, and those of subsequent members are determined by the IMF's Board of Governors, based on principles consistent with those applied to existing members.

The IMF's Articles of Agreement require a general review of quotas at regular intervals of not more than five years to assess their adequacy in terms of both members' needs for conditional liquidity and the ability of the IMF to finance those needs. A general review also allows for adjustments of members' quotas to better reflect changes in their relative positions in the world economy.

Since 1950—the date of the first quinquennial review—the IMF has held 12 quota reviews, of which 11 were general quota reviews. Eight of them, including the current Eleventh General Review, concluded with an increase in quotas. The remaining four reviews, including the Tenth General Review, concluded that no increase was needed.

Eleventh Review of Quotas

In September 1997, the IMF's Executive Board reached agreement on the size and distribution of an overall increase in quotas under the Eleventh General Review. The agreement on an overall increase of 45 percent reflected changes since the last quota increase in 1990 in the size of the world economy, the scale of potential payments imbalances, and the rapid globalization and liberalization of trade and payments—including the capital account. The Executive Board also considered current and prospective liquidity needs and the adequacy of the IMF's borrowing arrangements.

The agreed distribution of the overall quota increase was predominantly equiproportional while contributing to a correction of the most important anomalies in the quota distribution. Accordingly, 75 percent of the overall increase is distributed to all members in proportion to present quotas; 15 percent in proportion to members' shares in calculated quotas (that is, shares that result from applying the quota formulas to a range of economic factors, using data through 1994); and the remaining 10 percent to members whose shares in calculated quotas exceed their shares in actual quotas, as a means of addressing the most important anomalies in the quota distribution.

The recommendations of the Executive Board were accepted by the Board of Governors in January 1998 (see *IMF Survey*, January 12, 1998, page 7, and February 9, 1998, page 38). On January 29, 1999, the Executive Board agreed to a six-month extension of the period for consents for those members that had not yet been able to complete their internal consent procedures. ■

Camdessus and Labor Leaders Discuss Social Dimensions of Reform

IMF Managing Director Michel Camdessus met with 50 world labor union leaders at the IMF on January 21 for discussions on the social dimensions of a new global financial architecture. The talks addressed concerns about the potential social effects of a new architecture of internationally accepted business standards, strengthened financial systems, integrated financial markets, and increased transparency.

The labor leaders, in a delegation organized by the International Confederation of Free Trade Unions (ICFTU) and led by ICFTU General Secretary Bill Jordan, represented 20 countries and also included observers from the International Labor Organization (ILO). The leaders stressed the importance of the social implications of macroeconomic adjustment including core labor standards, as defined by the recently adopted ILO Declaration on Fundamental Principles and Rights at Work. They hoped to continue regular meetings between the IMF and organized labor and sought an active role for labor in the process of designing the social framework of the new global financial architecture. Camdessus welcomed the opportunity to discuss social and labor issues and agreed it was important to consider the social dimension of the new architecture.

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IMF Urged to Strengthen Its Understanding of Market Thinking and Behavior

With market behavior increasingly influencing the world economy, the IMF is seeking to enhance its understanding of the ways in which market decisions shape global financial flows and affect the policies and performance of national economies. Few have a stronger grasp of what the IMF should know about the markets than former IMF staff members who now head economic analysis units for leading investment banks and hedge funds.

IMF Institute Director Mohsin Khan (second from right) with participants in the IMF Institute seminar on market information and the IMF (from left to right): David Folkerts-Landau, Mahmood Pradhan, and Mohamed El-Erian.

The IMF Institute asked three such former staff members to examine how the IMF's knowledge of the markets could be improved. The panel included Mohamed El-Erian, formerly Deputy Director of the IMF's Middle East Department and currently European Head of Emerging Markets Economic Analysis for Salomon Smith Barney; David Folkerts-Landau, previously Chief of the IMF Research Department's Capital Markets Division and at present Global Head of Emerging Markets Research for Deutsche Bank Securities; and Mahmood Pradhan, formerly Senior Economist in the IMF's Asia and Pacific Department and currently Chief Emerging Markets Economist with Tudor Proprietary Trading hedge fund. In a wide-ranging and frank discussion on January 15, the three panelists recommended that the IMF gather more relevant market data that would give it a better feel for potential problems and likely market responses. They also agreed that more realistic projections for IMF-supported programs would strengthen the institution's credibility with the market and offered market perspectives on the effective regulation of hedge funds and the viability of contingent financing mechanisms.

How the Markets Think

To ensure more timely and consistent reactions from the market, Mohamed El-Erian suggested, the IMF must learn more about how the market works. He sketched a framework of the types of information the market relies on; illustrated how elements other than fundamentals can guide market decisions, particularly in crises; and noted the implications of all this for the IMF's efforts to prevent and deal with crises.

Framework. For the markets, data on country fundamentals are necessary, but far from sufficient, according to El-Erian. Other important factors are information on external market and credit conditions, the relative position of emerging markets, and last, but hardly least, market "technicals" (that is, information available from market trading and from market participants). In the best of times for markets and the IMF, all of these elements simultaneously flash green or red. More commonly, though, the signals are mixed, and then the markets and the IMF must sort through a welter of conflicting data.

In 1998, a weakening external environment led to very bad market technicals that in turn led to large capital flows and bad economic policies and outcomes. That is a difficult process to reverse, El-Erian said. The IMF must realize that, increasingly, the investor base in emerging markets is being shattered, and what might look like irrational contagion to the IMF is, in fact, a very rational portfolio reaction. Given significant casualties among

Available on the Web

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

99/3 Slovenia, January 22
99/4 Pakistan, January 27
99/5 Burundi, January 28
99/6 Paraguay, January 29
99/7 Norway, February 1

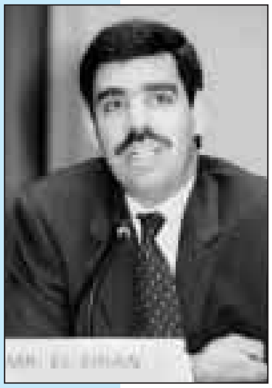
Policy Framework Papers (PFPs) are prepared by the member country in collaboration with the staffs of the IMF and the World Bank. These documents, which are updated annually, describe the authorities' economic objectives and macroeconomic and structural policies for three-year adjustment programs supported by Enhanced Structural Adjustment Facility resources. Recently issued PFPs include

Pakistan, January 26
Azerbaijan, 1999–2000, January 8
1997–2000, January 8

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

emerging market investors—including hedge funds—and enormous volatility, he expected continued investor hesitance about reentering emerging markets. And the longer this state persisted, he added, the more bad technicals would result in bad economic policies.

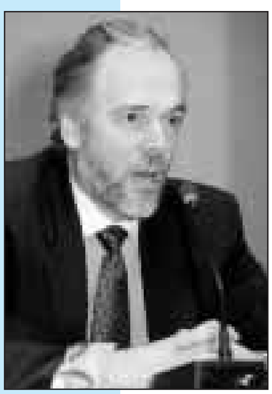
An Illustration. El-Erian cited Russia as a clear instance where bad market technicals had ruled. By July, the country's policy stance was weak, and external factors, principally low energy prices, further undermined Russia's position. What happened when a policy package was injected into this mix? "Because market technicals were wrong," he said, "that policy package had almost no impact on pricing and interest rates. Investors were 'long and wrong' on Russia and looking to get out." The market was positioned to sell, so that the brief uptick the program provided was used solely to unwind positions. "Technicals totally took over the fundamentals," El-Erian observed.



El-Erian: Involve the private sector early, and uniformly, in major policy initiatives.

What This Means for the IMF. Given the disruptions to the investor base, investment in emerging markets is not likely to return soon, El-Erian cautioned. The IMF should factor in the damage done and expect a distinctly bumpy process of capital flows to developing countries. The market will, however, be attracted to economies that have no major exposure to systemic risk, with high reserves, low short-term debt, and good fiscal positions. Even for these economies, however, the news is not entirely good. Their problem will be managing success—that is, dealing appropriately with huge capital inflows.

For the IMF, El-Erian warned, there will be no easy answers. The conditionality and the phasing and backloading of financial support that typify IMF financing are not appropriate, he argued, for countries that have undergone a huge shock; backloading simply accentuates the problem. But the alternatives are not reassuring either, because they raise the specter of moral hazard. What can be done? El-Erian urged the IMF to pay greater attention to five areas:



Folkerts-Landau: The IMF should strengthen the links between its staff and private markets.

• *Program design.* Both the markets and the IMF should spend "a lot more time" on program design. The IMF could afford to be bolder on the funding side, but not in its policy mix.

• *Liability management.* The IMF should play a more significant role in advising countries on their borrowing and on managing their debt. The private sector, with its vested interests, is not in a position to do so.

• *More analysis.* There is a surfeit of information, but authoritative interpretation remains a scarce commodity. The IMF should step in when there is a "market failure" in analysis. And it should look beyond fiscal and monetary numbers to key data contained in nondeliverable forward contracts and in market segmentation and swap-market information.

• *Involve the private sector early, and uniformly, in major policy initiatives.* Otherwise, the market perception of risk and the resulting risk premium associated with major changes will overwhelm the benefits.

• *Don't worry about being blamed.* The IMF is going to be blamed; it is part of the market's need for scapegoats. But ultimately, El-Erian counseled, "a lot of what the IMF says determines how the markets actually react."

What the IMF Needs to Know

Key information, observed David Folkerts-Landau, is valuable, expensive, and usually not published. More—and more appropriate—data can enhance the IMF's assessment of systemic risk events. There are roughly three types of market information: short-term trading, longer-term positional, and long-term structural. Short-term trading, or what he termed "noise trading," has little value for capital market surveillance. Long-term structural information is the sort of data the IMF already does a good job of gathering in the course of its consultations with member countries.

Longer-term (that is, two or three quarters ahead) positional trading is crucial to capital market surveillance, however, and it is here that critical information failures have had serious consequences for the global financial system. Folkerts-Landau cited the extraordinary range of estimates, from $15 billion to $150 billion, for the dollar-yen carry trade (borrowing at low interest rates in yen in order to invest in U.S. dollar securities at higher rates) on the eve of the Russian crisis. The upper limit was closer to the truth, with significant implications for hedge fund behavior after the Russia crisis. This information is difficult to obtain, but investment banks and others are now working very hard to develop a more systematic feel for how positions are built up. From the IMF's risk-management perspective, it is vital to develop a much better handle on very large positions as well as some sense of how major participants will react to disturbances.

Structural information is the key to understanding short-term dynamics, Folkerts-Landau explained. The markets' risk management technology instantaneously adjusts positions across asset classes, countries, or instruments in the face of volatility. The markets' need to offset volatility is the key to understanding contagion, and it is something the IMF must understand if it wants to understand how markets will react, how disturbances will spread, and who will be hit next, he said.

Folkerts-Landau advised the IMF to exercise care in using investment bank data. For tax and accounting reasons, profit and loss calculations are often shifted back and forth through in-house accounting systems.

Total return swaps and other derivatives may completely obscure balance of payments data. And, he added, countries do not always provide the true picture to the IMF. A lot of very short term—and for the banks, very profitable—flows and investments circumvent IMF programs. Even reserve numbers can be suspect, because in some cases, such as Russia, the reserves have been collateralized to borrow from U.S. hedge funds. Corrosion of key data in a crisis situation is rampant, he warned. "You have to understand what you are up against. People make a lot of money from this." Folkerts-Landau also urged the IMF to refrain from commenting on market pricing—bond spreads and the like. Second-guessing the market was risky business and unhelpful, he noted, and tended only to undermine the IMF's integrity with the markets.

To improve the quality and timeliness of the IMF's market information, the organization should strengthen the links between its staff and private markets and must try to understand how market participants manage risk and how they react to it, Folkerts-Landau said. Half a dozen trained economists in the IMF's capital markets team could gather key data. If the IMF could not match the banks' resources in this regard, it could tap into them through regular, "nonbureaucratic" contacts.

Hedge Funds

What, asked Mahmood Pradhan, should the IMF know about hedge funds and how they make decisions? One essential element that the IMF has underestimated is that contagion is spread through "the way money is managed." When a leveraged investor, such as a hedge fund, takes losses in one emerging market, it will readily liquidate positions elsewhere. And it will liquidate profitable positions first. Hungary, for example, might ask why its stock market suffered after Russia when Poland's did not. Hungary did have somewhat weaker fundamentals and more connections with Russia, but more crucially, he explained, the country had the most liquid stock market—it was the easiest one in that region to get out of.

A hot topic at the moment, Pradhan said, is regulation of hedge funds. He argued that a regulator's prime concern should be systemic risk and a level playing field. Hedge funds, he explained, have significantly less exposure in emerging markets than, say, investment or commercial banks. And, at present, banks that extend lines of credit have regular access to hedge funds' net asset values and performance in terms of returns. Banks do not have access to net positions, however, and Pradhan argued that if hedge funds were forced to reveal net positions, it would effectively "end the industry." He favored instead raising margin requirements—to reduce leverage and discourage excessive risk taking—through the banks that lend to hedge funds. This could improve the quality of bank regulation and ensure that information on aggregate and net positions on a currency can be relatively easily assembled from investment banks.

Folkerts-Landau argued that the regulators would do better to regulate commercial bank activities, which he believed were chiefly responsible for the large inflows and outflows during the crisis. Regulators would also be wise to separate proprietary (bank) trading from customer-driven trading. "There is something seriously wrong" with institutions that are guaranteed by taxpayers but take enormous amounts of international risk, he said.

Pradhan: Contagion is spread through the way money is managed.

Emerging markets—and the IMF—should be mindful that any country classified as an emerging market will face contagion. When losses occur, hedge funds have instructions to reduce exposure to the entire emerging market asset class, Pradhan said. Given what happened in emerging markets and to the hedge fund industry, he concurred with El-Erian's prognosis: emerging market finance will be very difficult for at least a year or two.

Pradhan emphasized—and El-Erian and Folkerts-Landau underscored the point—that more realistic pro-

ADB, IMF, and World Bank Form Joint Africa Institute

As reported in News Brief 99/4, issued on January 25, the heads of the African Development Bank (ADB), the IMF, and the World Bank announced on January 22 in Abidjan, Côte d'Ivoire, the establishment of a new African training institution, the Joint Africa Institute (JAI). The text of the News Brief follows.

The new institute, which will be located in Abidjan, is being established by the ADB, the IMF, and the World Bank to provide policy-related training to government officials and other participants from African countries. The courses offered by the Joint Africa Institute will focus on macroeconomic management and policies, and on structural, social, and project-related issues, such as governance, poverty alleviation, gender, growth, and the environment. It will also organize seminars on topical development issues and will use the most modern distance-learning facilities as an integral part of its training activity.

The Joint Africa Institute is expected to make an important contribution to meeting the critical learning needs in the region. It will allow the three institutions to mobilize their human and financial resources in a partnership for training that takes full advantage of their synergies and complementarities.

The Joint Africa Institute is expected to commence operations in the second half of 1999.

gram projections were a critical issue for the IMF and its credibility with the markets. Last year, he noted, each letter of intent with Indonesia, Korea, and Thailand saw its growth projections revised downward and its fiscal targets pushed up. On Brazil, all of the panelists agreed the markets simply never believed the IMF's projection of a minus 1 percent growth estimate for 1999. The IMF might look on the projections as targets, but the markets see a consistent and suspect optimism. Pradhan suggested a range of outcomes might be more advisable. Folkerts-Landau said he was "100 percent convinced that the IMF would do much better getting a realistic number out there in terms of market confidence." Pradhan added that market confidence would also be bolstered if IMF programs addressed key market issues, such as corporate debt in Indonesia.

What information could the IMF usefully gather to inform its advice and program design? Know who holds country debt and what types of events might trigger a reversal, Pradhan counseled. Investment banks typically do know what type of investor is doing trades, so that a call to four or five investment banks should yield information on whether these investments are leveraged or not and whether the country would face liquidation trades. "There is no reason," he said, "why this sort of information, in aggregate form, could not be supplied to regulators or to the IMF for surveillance purposes."

Ultimately, Pradhan argued, market positioning is a critical factor, and knowledge of it must complement the IMF's area of traditional expertise—its knowledge of economic fundamentals. El-Erian agreed, adding that if the IMF were aware of the big positions, understood how money is managed, and tracked key indicators, such as nondeliverable forward contracts, it would know a lot of what it really needed to know about the market. ■

Sheila Meehan
Senior Editor, *IMF Survey*

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Brazil Outlines Policy Framework for 1999

(Continued from front page) community in overcoming their current economic difficulties and restoring economic growth and low inflation.

The priority attached by the Brazilian government to low inflation—a key achievement of the *Plan Real*—was emphasized to the mission by President Fernando Henrique Cardoso in a meeting on February 3. The objective of reducing by the end of the year the annualized monthly rate of inflation to the middle single digits will be pursued through firm monetary and financial policies, strong and sustained fiscal adjustment, and an intensified structural reform effort.

The firm implementation of these policies should promote a lasting recovery of confidence, both domestically and abroad—an indispensable condition for the resumption of sustainable growth of output and employment—toward the end of 1999.

Under the new floating exchange rate regime, monetary policy will have to play a key role in the pursuit of low inflation. The Brazilian authorities intend to put in place a formal inflation targeting framework for monetary policy, drawing on the experience of other countries and the IMF. While the institutional and technical bases needed for the successful operation of an inflation targeting framework are being developed, monetary policy will focus on containing the growth of the monetary and credit aggregates to rates consistent with the inflation objectives. Interest rates will be adjusted flexibly to prevent the emergence of inflationary pressures beyond the foreseeable rise in the price of goods affected by the devaluation of the *real*. The authorities also intend to accelerate and broaden their ongoing efforts to strengthen and modernize the financial system—including the federal and state banks and nonbank financial intermediaries—to ensure its robustness to systemic shocks and to promote the development of private savings over the medium term.

In order to strengthen the ability of the central bank to achieve these objectives, the Brazilian authorities will undertake discussion with congress, with a view to approving proposals for strengthening the central bank`s operational independence through its primary commitment to the preservation of the purchasing power of the national currency; fixed term mandates for its president and the other members of the board of directors; its accountability to congress for achieving specified goals; and specific, time-bound limitations on the professional activities of departing members of the board.

The Brazilian authorities are fully committed to reducing the ratio of the public debt to GDP in 2000 and 2001, with a view to achieving by the end of 2001 a level below the 46.5 percent of GDP projected in the original program. To compensate for the adverse impact of the depreciation of the exchange rate on the public debt, they intend to achieve larger primary surpluses than originally envisaged in the program—in the range of 3–3.5 percent of GDP in 1999. New policy initiatives are being prepared to ensure the achievement of these targets. The authorities also discussed with the IMF staff mission the progress made so far in the implementation of the fiscal adjustment measures for 1999. Most of these measures have already been approved by congress, and the remaining one—the increase in the financial transaction tax—has been passed by the senate and is expected to be approved by the house in March. The authorities also noted that the program target for the primary surplus of the federal government for 1998 has been achieved with some margin.

Discussions also covered the progress to date in a number of structural reform areas, including the tax reform, administrative reform, social security reform, the fiscal responsibility law proposal, social policies, the labor market, and privatization. In a number of these structural reform areas, the Brazilian authorities are benefiting from the financial and technical support of the World Bank and the Inter-American Development Bank, with which the IMF mission is in close contact. The authorities have indicated their firm commitment to carry forward the reform agenda outlined in the Memorandum of Economic Policies [issued November 13, 1998; the full text is available on the IMF's website] and also their intention to intensify and broaden the privatization and divestment effort (including, importantly, in the energy and financial sectors) which they consider essential for the modernization and efficient operation of those key sectors of the economy.

The authorities and the IMF team are confident that the decisive implementation of appropriate economic and structural policies, with the support of the international financial community, will be instrumental in promoting in the course of 1999 a progressive rebuilding of confidence, a substantial improvement of the current account of the balance of payments, a gradual reflow of private capital to Brazil, and a strengthening of the exchange rate.

The Brazilian authorities have reaffirmed their intention to subscribe to the Special Data Dissemination Standard of the IMF, after the necessary technical work has been done, to improve quarterly estimates of GDP and certain state and municipal fiscal data. Building on the progress made so far in liberalizing current account transactions, the authorities expressed their commitment to accept in the near future the obligations of Article VIII of the IMF Articles of Agreement.

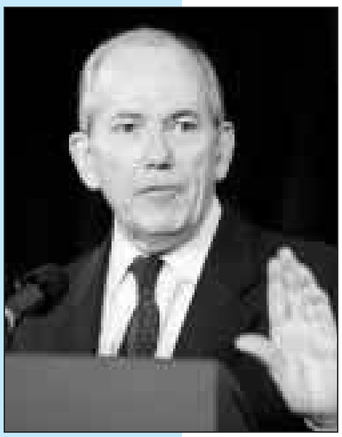
The authorities will continue discussions with the IMF staff team in the days ahead, with a view to proposing to the IMF Management and Executive Board as soon as possible, and in any case before the end of March, the completion of the first review of the program, which would be followed by the release of the next tranche of the arrangement. ■

IMF Conference on Transition

Camdessus Welcomes Discussion on Issues Facing Transition Economies

On February 1–3, the IMF hosted a conference, entitled "A Decade of Transition: Achievements and Challenges," to analyze the experience of transition economies so far and outline the remaining challenges. Following are edited excerpts of the opening address by IMF Managing Director Michel Camdessus. The IMF Survey *will feature full coverage of this conference in its next issue, dated February 22, 1999.*

This gathering includes high-level officials involved in policymaking, academics who have been doing research on transition issues, and staff of international financial institutions who have been working closely on transition countries. This broad spectrum of participants should bring to bear a wide range of perspectives on the accomplishments thus far, as well as on the challenges ahead and the policies needed to address them.



Camdessus: Structural reforms have provided the foundations of private ownership, market pricing, and market discipline.

The Berlin Wall fell in November 1989. The wrenching transformation that followed in countries east of that dividing line has brought liberty and—in many places—also prosperity, as well as economic, social, and political strain to those countries. Recognizing the historic importance and unparalleled difficulty involved in the transition, the IMF became involved very early on with about twenty of those countries to establish their IMF membership. Since then, in collaboration with the World Bank, the IMF has been working closely with the countries in transition in formulating stabilization programs and structural reforms to develop market institutions. The IMF, along with others, has provided a vast array of technical assistance to build up the institutional capacity of the emerging market economies and has supported those efforts through the Systemic Transformation Facility, Stand-By Arrangements, Extended Fund Arrangements, and Enhanced Structural Adjustment Facility-supported programs.

Legacy

Allow me to share with you a few thoughts on the legacy of the past decade. At the outset of transition, little was clear, except that there was no turning back. There was no master plan and scarce relevant experience to guide action. In the economic sphere, a host of proposals quickly filled the vacuum, jostling with the force of events and circumstance to determine what happened. In Central and Eastern Europe, German reunification defined the options for the German Democratic Republic; Poland and countries of the former Yugoslav Republic confronted outright hyperinflation. In these and other countries, a national consensus for change sometimes proved elusive; and, in some cases, hostilities broke out. All the countries had to grapple with the collapse of the trading arrangements under the Council for Mutual Economic Assistance, of key export markets, and of economic activity. The breakup of the Soviet Union in 1991–92 brought further issues into play: planning mechanisms were more deeply entrenched there; hyperinflation was rife; and a raft of new countries and currencies were established.

The essential components of the transition reform agenda, however, rapidly crystallized: fiscal consolidation, monetary and financial reform, price and trade liberalization, and privatization. As a result of courageous decisions by many leaders, progress has been dramatic. Already by the end of 1997, inflation was close to, or in, single digits in many of these countries. Output has been growing in Central and Eastern Europe since 1993, and in many of the Baltics and other countries of the former Soviet Union since 1995. And although much more remains to be done, a number of countries have all but completed the structural reforms that comprise the transition agenda. Indeed, some have already embarked on reforms aimed at accession to the European Union. So, undoubtedly, the foundations of prosperity have been laid. Even to those with no more than a passing acquaintance with the region prior to 1990, the transformation is obvious. Just one short decade later, centrally planned systems already seem like defunct and discredited relics of a distant past.

However, after the reversals in Albania, Bulgaria, and Romania in 1996 and 1997, and the events in Russia in 1998, surely no one still harbors the illusion that progress from here on will be straightforward. These events remind us of important lessons: that the region as a whole is exposed to developments elsewhere in the world; that incomplete transition reform is hazardous; and that interlinkages in the region remain strong.

Future Agenda

We are clearly far from the end of the road. But even where structural reforms have been incomplete, they have at least provided the first foundations of private ownership, market pricing, and market discipline. Now, most of the countries can turn to the much more difficult and time-consuming task of implementing second-generation reforms, even though some of those countries still have a way to go in tackling the first generation of reforms.

I will admit to taking an advance look at some of the conference papers. I was impressed that the one on privatization, while admitting that there have been problems and that it is time to rethink privatization, gives compelling reasons as to why the new thinking should not be *less* privatization, but *better* privatization. More generally, I will hazard a guess that a similar theme—sustained and deeper reforms, rather than reversing the buildup of market institutions—will emerge in your discussions as key to other essential elements of reform: creating a market-friendly environment, developing a sound financial sector, establishing effective government operations, and providing equitable social protection. These issues are surely the right issues to examine in this conference and should provide a basis for exploring the policy strategy—the road map—for the next stages of the transition journey.

Let me highlight one specific task for the future that I believe to be of great importance: enforcing the rule of law and fostering a culture that respects and, indeed, welcomes a framework of law, regulation, and codes of good practice. Within such a framework, governments, enterprises, financial institutions, and individuals should be able to deal with each other at arm's length, in a transparent manner. An important ingredient is that the discipline of the market should be allowed to work. It will thus diminish restraints on the activity of enterprises, old and new, encouraging the initiative of entrepreneurs who are the source of productivity growth, new output, and more value added—in short, the growth of GDP. Ultimately, that is what stabilization, structural reform, and transition are all about.

The discipline of the market should be allowed to work.

— Camdessus

Remaining Questions

In conclusion, I would venture that much has been learned in the past 10 years about what does work in transition, but many questions still remain. I hope that the discussions in this conference will shed light on three issues that seem particularly important to me:

• For those countries that have completed the bulk of the "transition" structural reform agenda and that have achieved moderate inflation, what are the key next steps to stimulate growth and strengthen their resilience to external shocks?

• For the others that still have some distance to go on the reform agenda, what should the priorities be?

• In assisting these two groups of countries, what are the key reform areas on which the Bretton Woods institutions should focus in the period ahead?

Conference on Social Issues

New Approach Should Explore Human Dimensions of Asian Economic Crisis

***F**ollowing are edited extracts of a presentation by Peter S. Heller, Deputy Director of the IMF's Fiscal Affairs Department, to the World Bank Regional Meeting, entitled "Social Issues Arising from the East Asia Crisis and Policy Implications for the Future," held in Bangkok on January 21. The full text is available on the IMF's website (www.imf.org).*

Over the past 18 months, there has been much debate and controversy about the macroeconomic and structural policies that were adopted during the Asia crisis. The IMF staff has just entered this debate, publishing its own in-depth assessment of this policy response, which you can obtain on the IMF's website [see also *IMF Survey*, January 25, page 17]. Concerns about the effect of this crisis on the most vulnerable segments of society certainly influenced the design of the adjustment programs. Thus, with the benefit of hindsight, we in the IMF welcome the opportunity to examine what were the *human dimensions* of the crisis and how they were addressed. How did the poor fare and which groups in society suffered most? Which benefited? What were the implications for health, education, and welfare? What policies were introduced to cushion the effects on the most vulnerable and to limit long-run damage to the human capital and social institutions of these countries? Were these policies successful? We look to this conference to provide answers to these vital questions and to assess what can be done better.

IMF and Social Issues

The human dimensions of macroeconomic adjustment should not be seen as a new preoccupation of the IMF. Indeed, over the past decade, there has been a continuous dialogue between the IMF (and, I might add, the World Bank) and academics, religious leaders, labor unions, NGOs [nongovernmental organizations], and others in civil society as we have sought to understand the social dimensions of adjustment and to take them into account in our work. The IMF has sponsored important conferences examining the linkages between macroeconomic and structural policies, sustainable growth, and equity. Some findings are clear:

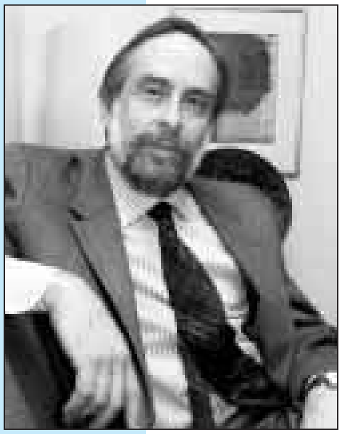
• Restoring quality growth and limiting inflation are the most potent factors in reducing poverty rates and improving equity in a society. Such an economic environment facilitates a lowering of unemployment, higher incomes, avoidance of the inequities caused by high inflation, and the provision of the additional budgetary resources needed to finance social investments and social insurance schemes.

• The equity implications of adjustment measures cannot be ignored. Indeed, pursuing equity can be supportive of high-quality growth.

• Social safety nets are a vital component of adjustment.

• Transparency of the details of IMF-supported adjustment programs and a dialogue with many concerned groups are necessary for both enhancing public support and developing informed programs.

With this perspective in mind, in the recent crisis, the IMF sought to ensure that the macroeconomic policy framework could accommodate social protection measures and emphasized to the authorities that such measures should be part and parcel of IMF-supported programs. It has also led us to reach out actively to labor unions, NGOs, and civil society, and to use our public website to inform the public on the content of these programs.



Heller: The IMF sought to ensure that the macroeconomic policy framework could accommodate social protection measures.

But I should also emphasize that, reflecting the respective mandates of the World Bank and the IMF, the Bank was principally responsible for designing and monitoring the social protection components of the adjustment programs in Asia. This makes sense. Over the years, the World Bank has developed expertise in the fields of poverty reduction, health, education, and rural development. Even when the balance of payments of these countries was strong, the World Bank was working extensively in Asia. Witness the many years and considerable resources spent on Indonesia. Thus, when the crisis struck, the World Bank was well placed to design the details of a strategy to help the poorest groups cope. It is thus fitting that the World Bank has sponsored this conference on the human dimensions of the crisis.

IMF's Response to the Crisis

Let me initially comment on the overall thrust of the IMF's efforts. The Asian crisis was unusual, both in terms of the speed with which it took hold and in the complexity of its origins. We were all struck by the sudden loss of confidence in countries that had only recently experienced such rapid growth, by the resulting capital flight and the dramatic erosion of reserves that occurred so suddenly, and by the depth of the output decline that followed. What was novel about this crisis was that its roots lay not so much in the underlying macroeconomic policies, but in the structural weaknesses in the financial and corporate sectors. The intensity and speed of the shock also placed great pressure on all concerned to elaborate quickly policies of social protection to address the increase in unemployment and inflation.

The most fundamental concern of the IMF, both at the inception of the Asian crisis and since, was to develop a macroeconomic and structural policy package in each country appropriate for quickly restoring macroeconomic stability—containing inflation, fostering expectations of a stable exchange rate, and restoring sustainable growth. This was necessary not only to achieve macroeconomic policy objectives, but also to ensure that the tremendous gains of these countries in reducing poverty were not reversed. Policies were tailored to the specifics of the country but had to remain flexible to take account of the evolving financial situation, changing political circumstances, worsening regional economic situation, and the availability of external financial support, which was not unlimited.

Considerable importance was also attached to ensuring that the macroeconomic framework would allow budgetary room for governments, working with the World Bank and the Asian Development Bank, to finance expenditures for enhanced social safety nets and to protect public spending in health and education. The IMF worked closely with the World Bank and the country authorities to incorporate such social policy interventions in the programs and, perhaps more important, to ensure that they were being effectively implemented.

Take Thailand as an example. As the recession deepened, the government strengthened its safety net programs in the 1998/99 budget (to over 3 percent of GDP) to include the expansion of a large public works program that would create 500,000 man-months of jobs over the next 2½ years; the extension of the student loan program to maintain student attendance; the provision of free medical treatment and improved rural health care facilities; and the maintenance of a subsidy on transportation in the urban areas. In Indonesia, we supported the provision of subsidized food, petroleum products, and electricity, with an emphasis on targeting these efforts toward the most needy groups and thus cutting unproductive expenditures. In Korea, we advocated an extension in coverage of unemployment insurance programs and an increase in minimum benefits. For *all* of the Asian program countries, once the depth of the recession became clear, we were prepared to support more expansionary fiscal packages as long as these packages addressed important social concerns.

Future Efforts

Time and perspective have also highlighted several areas where we all need to do to better in helping these countries and others cope with the human dimension of such crises.

• First, countries need to strengthen their capacity to monitor, on a timely basis, the situation of the poor.

Witness how the first impressions of the human impact of the crisis have had to be revised. Only several months ago, the World Bank and International Labor Organization were suggesting that in Indonesia, the number of poor would almost double. Now, the evidence suggests that poverty rates in Indonesia may not increase so dramatically. It is the urban poor and middle class that now appear to have been most affected, with rural food producers largely protected, if not benefiting. Without a capacity for monitoring, countries risk devoting scarce budgetary resources to safety net policies that are not targeted efficiently to those most in need.

• Second, policies for economic growth need to be complemented by the development of both a limited framework and enhanced administrative capacity for cost-effective social protection programs. Despite the past rapid economic growth of these Asian countries, their social protection systems were inadequate to cope with the strains of a sharp rise in unemployment. In late 1997, even Korea's relatively developed unemployment insurance scheme covered only large enterprises, exposing many in the labor force to the risks of unemployment. In some countries, there were striking weaknesses in the administrative capacity to design and implement policies targeted at the most vulnerable groups. Developing such a policy framework will require innovative approaches that avoid the types of labor market distortions evident in many OECD [Organization for Economic Cooperation and Development] countries. Equally, administrative capacity is not created overnight, but work must begin soon, together with a resumption of growth.

• Third, the crisis also reminds us of the importance of high-quality growth. When rapid growth is built on asset price bubbles, inefficient and expensive infrastructure projects, and implicit public guarantees of poor investments or financial sector behavior, the foundation for sustained higher income levels is shaky. IMF surveillance and World Bank country assistance strategies must be ever vigilant in warning authorities of these dangers.

• Fourth, we must recognize that one cannot expect an active fiscal policy to have immediate stimulative effects. Although we pressed for a policy of fiscal stimulus in each of these countries, implementing such a policy has not proved easy, particularly in the short run. Good-quality, activist fiscal measures can take time to develop and introduce: witness the delays in the design and implementation of new social protection programs. Also, accurately assessing the true stance of fiscal policies can be difficult, ex ante; increased fiscal deficits can simply reflect the economic downturn and not policy stimulus, especially if the downturn is more severe than expected. Thus, the nature of the fiscal stance needs to be assessed frequently and, if necessary, deficit targets need to be reconsidered in light of the macroeconomic situation.

• Last, the word "crisis" in Chinese characters means the combination of "danger" and "opportunity." This crisis has created opportunities for efficiency-enhancing policy reforms and has heightened the importance of governments' being responsive to the changing demands for public services. For example, in the health sector, budgetary pressures have intensified as households have shifted their demand away from private health providers. If governments can be flexible and open to change, this could facilitate a useful and long overdue restructuring of budgetary expenditure resource allocations toward more efficient and effective policy programs. This has already begun to happen in Thailand and Korea. Witness the shift toward purchases of generic drugs.

These are important lessons as we move forward. I would hope that this conference will offer additional lessons that will enable the World Bank and the IMF to better address the human dimensions of such crises. ■

FINANCE & DEVELOPMENT

PUBLISHED BY THE INTERNATIONAL MONETARY FUND

The March 1999 issue of *Finance & Development*, the English edition of which will be published in late February, will contain several articles focusing on the challenges and opportunities facing the countries of sub-Saharan Africa. Among the articles in this issue are:

Africa: An Agenda for the 21st Century
Alassane D. Ouattara

Adjustment and Growth in Sub-Saharan Africa: The Unfinished Agenda
Evangelos A. Calamitsis

Sub-Saharan Africa: Economic Policy and Outlook for Growth
Ernesto Hernández-Catá

Impact of the Asian Crisis on Sub-Saharan Africa
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The Monetary Policy of the Eurosystem
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Press Releases

Following is an excerpt of a recent IMF press release. The full text is available on the IMF's website (http://www.imf.org) under "news" or on request from the IMF's Public Affairs Division (fax: (202) 623-6278).

Azerbaijan: ESAF, CCFF, and EFF

The IMF has approved loans and credits equivalent to SDR 79.7 million (about $112 million) to support Azerbaijan's 1999 economic and financial program and to compensate for an export shortfall. Of this total, SDR 23.4 million (about $33 million) is available under the Enhanced Structural Adjustment Facility (ESAF), and SDR 56.3 million (about $79 million) is available under the Compensatory and Contingency Financing Facility (CCFF). At the same time, the IMF completed the fourth review under Azerbaijan's existing Extended Fund Facility (EFF) program, releasing an additional tranche of SDR 1.8 million.

Azerbaijan: Summary Macroeconomic Indicators

	1997[1]	1998[2]	1998[2]	1999[3]	2000[4]
			(percent)		
Annual GDP growth	5.8	7.0	8.0	7.0	6.0
Consumer price inflation (December to December)	0.4	4.5	0.5	5.0	3.0
General government cash balance	–1.7	–3.6	–4.3	–3.1	–2.4
External current account balance	–23.7	–30.2	–29.8	–32.5	–38.4

[1]Actual.
[2]Program.
[3]Revised program.
[4]Projection.

Data: Azerbaijan authorities and IMF staff estimates

Medium-Term Strategy and 1999 Program

During 1999–2001, the program envisages average annual GDP growth of about 7 percent and average annual inflation of about 4 percent. While overall growth is expected to be supported by increased oil production, non-oil-sector growth is projected to slow in 1999. The external current account deficit is projected to be 32.5 percent of GDP during 1999, rising to about 38 percent in 2000 and 2001, which will reflect both the lower price of oil exports and a rise in imports. The projected external deficits are expected to be financed mainly through foreign direct investments, with some additional support coming from multilateral and bilateral creditors.

The third year of the ESAF program proposes macroeconomic policy adjustment, including a revised financial program for 1999, and strengthened efforts toward structural adjustment. The projected budget deficit of 3.1 percent of GDP in 1999, while significantly lower than that achieved in 1998, is larger than previously planned. However, this should be manageable given the very low level of government debt and the availability of adequate external financing.

The authorities will continue to pursue a cautious monetary policy during 1999, with a flexible approach to the exchange rate, consistent with financial stability and a competitive non-oil sector.

Structural Reforms

The authorities attach highest priority to reforming the public sector, tackling corruption, and improving the efficiency of the government. The authorities also plan to focus on measures to restructure the banking sector and strengthen the financial system, broaden and strengthen the privatization process, reform public enterprises, and develop a market-based agricultural sector.

Addressing Social Needs

The authorities continue to be committed to reform in the health and education sectors and to better targeting of the social safety net.

Azerbaijan joined the IMF on September 18, 1992, and its quota is SDR 160.9 million (about $225 million). Its outstanding use of IMF financing currently totals SDR 228 million (about $320 million).

Press Release No. 99/5, January 26

Photo Credits: Gregg Newton for Reuters, page 33; Denio Zara, Padraic Hughes, and Pedro Marquez for the IMF, pages 37–39, 42, 44, and 48.

Selected IMF Rates

Week Beginning	SDR Interest Rate	Rate of Remuneration	Rate of Charge
January 25	3.44	3.44	3.68
February 1	3.50	3.50	3.75

The SDR interest rate and the rate of remuneration are equal to a weighted average of interest rates on specified short-term domestic obligations in the money markets of the five countries whose currencies constitute the SDR valuation basket (the U.S. dollar, weighted 39 percent; deutsche mark, 21 percent; Japanese yen, 18 percent; French franc, 11 percent; and U.K. pound, 11 percent). The rate of remuneration is the rate of return on members' remunerated reserve tranche positions. The rate of charge, a proportion (currently 107 percent) of the SDR interest rate, is the cost of using the IMF's financial resources. All three rates are computed each Friday for the following week. The basic rates of remuneration and charge are further adjusted to reflect burden-sharing arrangements. For the latest rates, call (202) 623-7171 or check the IMF website (www.imf.org/external/np/tre/sdr/sdr.htm).

Data: IMF Treasurer's Department

Study by Vito Tanzi

Distribution of Human Capital Is Key Element In Tackling Problems of Income Inequality

Traditionally, economists have paid scant attention to the social and cultural roots of inequality. But the pervasive role of social norms and attitudes in closed and traditional societies, or the growing role of human capital formation in determining wealth in more open and developed economies, is a key element in the dynamic of development and the roots of inequality. In a recent IMF Working Paper, *Fundamental Determinants of Inequality and the Role of Government*, Vito Tanzi, Director of the IMF's Fiscal Affairs Department, examines the economic and policy implications of the progressive replacement of real assets (such as land) with human capital (such as education) in the development process. Once human capital becomes a key determinant in the creation of incomes and wealth in developed economies, access to human capital and the government's role in ensuring that access become vital issues, he argues, in tackling income inequality.

Social Norms and Inequality

Social norms influence income distribution in both traditional and more developed societies, and changes in these norms can alter the sources and dynamic of wealth accumulation. Tanzi cites, as examples, the impact of rental and labor contracts, marriage conventions, inheritance rules, and "positional rents."

Rental Contracts. Significant in countries where the ownership of assets is highly concentrated, traditional rental contracts, such as those dictating the division of output between landlord and tenant, play an important role in the use of land and other assets.

Labor Contracts. In several societies, notably in Asia, employers may assume a paternalistic attitude toward employees. During recessions, profits may fluctuate sharply, but unemployment rates do not. These economies commonly feature lower income inequality than those with less paternalistic labor arrangements.

Marriage Conventions. Customs influencing the size of dowries, the choice of spouse, the cost of marriages, the age of marriage, and the gifts associated with marriage all have significant implications for income and wealth distribution. When the rich and the poor marry only within their own social stratum, income distribution tends to remain static. Modernization, mobility, and globalization can break down the status quo, with major implications for the formation of wealth and for income inequality.

Inheritance Rules. In traditional societies, where real wealth is the principal determinant of income, rules governing the transfer of wealth between generations are critically important. Inheritance rules, for example, might dictate the conveyance of property to the first-born son. In societies where human capital is crucial in determining wealth, the holding (and transfer) of real capital declines in importance. (Wealth, however, may be a crucial ingredient in obtaining human capital.)

Positional Rents. Social capital—that is, family name, prestige, contacts, and, in some societies, claims to certain positions or occupations—is a key element in determining the distribution of income and privilege in many these societies. (Such positional rents may also dictate the basis for promotions and determine to whom priority will be given.)

In the absence of major upheavals, such as war or severe economic dislocation, social norms tend to be stable over time in traditional societies. The deep and pervasive economic changes wrought by development and globalization, however, have the power to induce profound changes in social norms, which, in turn, have implications for the economy. Modernization, for example, can induce greater labor mobility, influence the choice of marriage partner, and ultimately reduce the influence of positional rents.

In traditional societies, income inequality is essentially determined by the distribution of real wealth and by positional rents (with real wealth also a key contributor to positional rents). To address income inequality issues in these societies, governments must alter the distribution of real capital (land reform, for example) or influence positional rents (through social and structural reforms). By contrast, in more open and developed societies, where human capital plays a significant role in wealth accumulation and where globalization has a continuing and potent impact, government can address income inequality and other inequities through its role in generating and distributing human capital.

Government's Traditional Role

What government can, and cannot, accomplish—and the means it uses—is conditioned by the level of a country's economic and institutional development, according to Tanzi. Ironically, where government is most needed—that is, in developing economies where the markets are most underdeveloped and flawed—it is least likely to have the tools needed to carry out this corrective function efficiently. Developing countries often lack the capacity to collect sufficient revenue, and the tools they do wield tend to produce distortions. By contrast, advanced industrial countries, with their efficient markets, tend to have much larger governments and are less likely to have to address market failures—primarily because they are better able to collect taxes.

Even countries highly concerned about inequality, Tanzi stresses, must first promote macroeconomic sta-

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bility and efficiency. Stability is the foundation of economic growth, and growth is the basis for jobs and public resources. Efficiency complements this, ensuring that limited resources are put to best use. Beyond stability, growth, and efficiency, government has two major tools at its disposal: taxation and spending.

Taxation. Because of the importance of real wealth in poorer countries, governments often seek to tax land and property to achieve redistributive ends. For political and administrative reasons, however, this form of taxation has rarely been effective. Progressive income tax schemes have been seized upon as an alternative, but high marginal rates have encouraged evasion, and a multitude of loopholes and poor administration have undercut both their progressivity and efficiency. Experience suggests that effective taxation can make a major contribution to the reduction of income inequality if it provides revenue for essential expenditures and avoids taxing similar incomes at very different effective tax rates. Taxation, Tanzi advises, should be broad based, offer limited exemptions and special treatments, and use rates low enough to satisfy the need for revenue and avoid inequities within the tax system.

Spending. But collecting revenues is only part of the equation. Adequate revenues, once collected, must be used efficiently and effectively. "Public spending, justified in the name of equity, has at times contributed little to equity and much to macroeconomic instability," Tanzi observes. He cites two problems that often characterize public spending and reduce its contribution to equity:

• *Hijacking of expenditure programs by special interest groups.* Political pressures often push spending away from its desired targets and toward either the general public or less needy, but more politically influential, groups. Education spending, for example, may start with a focus on primary education but increasingly find itself targeting secondary and tertiary education, where the spending is more likely to benefit higher-income groups. Likewise, health spending may be diverted from primary care to hospitals in urban centers. The level of social spending is thus not an accurate reflection of its impact. If redressing inequity is the goal, it matters who the real beneficiaries are.

• *Hijacking of expenditure programs by their providers.* Certain public services, notably in education and health, are labor intensive; much of the spending actually goes to the providers of the services in the form of wages and salaries. If that labor force is underproductive or overpaid, that investment may generate limited returns for its intended beneficiaries. Ensuring the cost-effectiveness of social investment may necessitate deep and complex administrative and legal reforms.

Ultimately, it is what citizens receive—not what governments spend—that determines the impact on inequality. But without social spending, Tanzi adds, there is little hope that the government will affect income distribution in a positive way.

Tanzi: Beyond stability, growth, and efficiency, government has two major tools at its disposal: taxation and spending.

Role of Government

Both human capital and the share of wages and salaries in national income grow with economic development—with important implications for public policy in both poor and developed countries. In poor countries, the distribution of real assets determines not only incomes but access to scarce resources. Real assets provide collateral for credit, and social capital provides valuable connections that facilitate gathering critical information and obtaining access to credit, foreign exchange, and positional rents. In traditional societies, clubs and associations share a common characteristic—real wealth.

At higher levels of development, information is more readily available and important networks tend to revolve around human capital rather than the possession of real assets. Income from employment, not family name and holdings, provides collateral. And the establishment of a market—with its arm's length relationships and rules of law—reduces both the importance of personal connections and the value of social capital.

Ultimately, Tanzi concludes, the distribution of human capital is the most important factor determining the distribution of income in developed economies. There are pitfalls, but governments can improve the quantity and quality of human capital and ensure that all citizens, especially individuals at the lower end of the income distribution, have full access to the means to develop human capital. ■

Copies of IMF Working Paper 98/178, *Fundamental Determinants of Inequality and the Role of Government*, by Vito Tanzi, are available for $7.00 each from IMF Publication Services. See page 40 for ordering information.