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ASEAN's Sound Fundamentals Bode Well for Sustained Growth

On November 7–8, in Jakarta, a conference cosponsored by Bank Indonesia and the IMF explored Macroeconomic Issues Facing ASEAN Countries. The conference took stock of the achievements of the member countries of the Association of South East Asian Nations (ASEAN) over the past decade, identified key determinants of their success, and looked at how this success could be sustained in today's fast-changing international economic environment.

At the Bank Indonesia-IMF conference (left to right): Jack Boorman, Director of the IMF's Policy Development and Review Department; Mar'ie Muhammad, Indonesia's Finance Minister; Soedradjad Djiwandono, Governor of Bank Indonesia; Michel Camdessus, Managing Director of the IMF; and Kunio Saito, Director of the IMF's Southeast Asia and Pacific Department.

Indonesian Finance Minister Mar'ie Muhammad opened the conference, which brought together finance ministers, central bank governors, and senior officials from across the region, as well as private sector representatives, academics, and representatives of international institutions. IMF Managing Director Michel Camdessus *(Please turn to following page)*

Trade Policy Reform in Transition Countries Linked to Macroeconomic Stabilization

With the dissolution of the U.S.S.R. in late 1991, the Baltic countries, Russia, and the other countries of the former Soviet Union confronted the challenge and opportunity of designing, as part of their economic transformation, a new trade policy regime. An IMF Working Paper, *Recent Trade Policies and an Approach to Further Reform in the Baltics, Russia, and Other Countries of the Former Soviet Union*, by Michael Leidy and Ali Ibrahim, assesses the trade policy performance of these countries from mid-1993 to the end of 1995. It concludes that the response has varied, with some moving quickly to adopt a highly liberal trading system, while others have pursued reform reluctantly and unevenly.

The IMF study reaches three conclusions:

- Macroeconomic stabilization creates a favorable environment for trade reform. In the transition countries, setbacks and delays in the implementation of trade policy reform frequently resulted from inadequate macroeconomic policy and structural weaknesses. *(Please turn to page 384)*

gave the keynote address on the issues and challenges facing the ASEAN countries (see page 379). Other sessions featured addresses by Governor Singson of the Philippines, on current account sustainability, and Governor Djiwandono of Indonesia, on monetary management in an environment of rapid financial liberalization. A roundtable of speakers considered the changing role of the ASEAN countries in the global economy and prospects for sustaining growth over the medium term.

As background for the conference, IMF staff and academics prepared a number of papers, covering such issues as current account and fiscal sustainability, the determinants of ASEAN's high savings rate, exchange rate and monetary management, financial sector development and reform, growth and productivity trends, and trade and investment prospects for ASEAN. (Summaries of these papers are contained in a conference brochure, which is available on the IMF's web site at http://www.imf.org.)

Anoop Singh, Deputy Director of the IMF's Southeast Asia and Pacific Department, summed up some key findings of the two-day meeting; below are excerpts.

Sustained Growth Envisaged

ASEAN's economic success remains alive and well, concluded participants in the Bank Indonesia-IMF conference. The central message was that the region is poised to extend its success into the twenty-first century and that governments still have a major role in driving this process.

Conference participants broadly agreed on the elements underpinning the region's growth. These include the importance member countries attach to sound macroeconomic fundamentals, especially fiscal policies; the region's high rates of domestic saving and investment, which have enhanced the sustainability of external current account deficits; the avoidance of significant misalignments of exchange rates; the ability to adjust policies—in an appropriate and timely fashion—in response to changes in the economic environment; and an emphasis on infrastructure and anti-poverty spending.

Participants' confidence in the ability of the ASEAN countries to sustain rapid growth was rooted in the region's strong macroeconomic fundamentals; in ASEAN's tradition of, and commitment to, efficient allocation of investment; and in the widespread belief that the external environment will continue to be supportive.

Macroeconomic Fundamentals. Conference participants believed that the macroeconomic fundamentals underlying ASEAN's performance would remain strong over the medium term for a number of reasons:

- There is a domestic constituency for maintaining strong fundamentals. Owing to a popular aversion to high inflation throughout the region, policymakers are vigilant about maintaining macroeconomic stability.
- Policymakers remain focused on maintaining low inflation and reducing external current account deficits. While ASEAN countries' external current account deficits were not viewed as unsustainable, participants supported reducing them to minimize risks that might arise from external shocks or changes in investor sentiment.
- Policymakers have launched a number of initiatives to manage macroeconomic policy in a globalized economy. These include adapting monetary policy to the reality of financial liberalization, increasing domestic savings even further in the private and public sectors, and strengthening banking systems throughout the region.
- The strength of the underlying fundamentals—high levels of saving and investment—gives confidence to ASEAN countries that they will be able to adjust their macroeconomic policy as needed, or respond to future shocks, without having to cut consumption or growth too sharply.

Efficiency. Participants generally agreed that ASEAN countries' market-oriented policies have ensured efficient use of the region's high rates of investment. They also concluded that total factor productivity growth in many of the countries has been impressive. Assessing prospects, participants agreed that:

- The ASEAN countries must persevere with, and possibly accelerate, their structural reform efforts, particularly in liberalizing trade and increasing openness. More generally, the dynamism of the region—and the possible expansion of ASEAN to include the transition economies of Indochina—bodes well for future regional trade, investment, and growth.

Indonesia's Finance Minister, Mar'ie Muhammad, delivered the conference's opening address.

• As the ASEAN countries approach levels of productivity comparable to more advanced industrial countries, growth is certain to slow. But for many countries, convergence is expected to take many years, and the region's rate of growth in the intervening period should remain relatively high.

Supportive External Environment. The consensus at the conference was that the global environment would remain favorable over the medium term. As the region's openness to international trade continues to increase and its economic size expands, ASEAN will play a growing role in the world economy.

Role of Government

Adaptability has been a hallmark of the role played by governments in the ASEAN countries and is a part of the region's success. An important theme of the conference was that, although the size of the public sector can—and indeed should—be reduced, the state will retain a crucial role in maintaining an environment conducive to high-quality growth. Conference participants emphasized, in particular:

• Maintaining macroeconomic stability and moving forcefully on structural reforms are key government responsibilities. A critical element in both these tasks will be better regulation and development of the region's financial markets.

• Raising domestic saving—a vital part of future policy adjustment—involves decisions and tradeoffs, partly because it entails raising public saving. This, in turn, raises questions about infrastructure and other essential spending; this process has to be carefully balanced. It matters how public expenditure choices are made; the wrong choices can have longer run detrimental effects on sustainability, even if they appear to help in the short term.

• It is important to move toward broad consensus on objectives and the equitable sharing of the benefits of growth—in short, the entire process of sustaining growth. The necessary policy, institutional, and regulatory framework involves crucial judgments about the best way to convince markets and domestic populations of the government's ability to follow consistent policies over long periods. Transparency and openness are important elements of the broader basic ingredient: good governance.

Soedradjad Djiwandono, Governor of Bank Indonesia, noted the importance of monetary management in an environment of financial liberalization.

Sustaining Macroeconomic Performance in ASEAN

In his address to the Bank Indonesia-IMF sponsored conference on macroeconomic issues in the ASEAN countries, IMF Managing Director Michel Camdessus paid tribute to the region's prudent fiscal policies, high domestic saving rates, and emphasis on infrastructure investment. These have produced a stable macroeconomic environment and sustained high-quality growth, which also fosters human development, promotes equity, safeguards the environment, and allows an enhancement of the cultural values of the ASEAN countries. ASEAN's role in the world economy, and in the IMF, is clearly growing, he said. But ASEAN economic success has also brought new challenges. Camdessus outlined what could be done to meet these challenges. Following are edited excerpts of his remarks.

Challenges of Globalization

A major challenge facing the ASEAN countries concerns the globalization of the international financial markets. Asian countries have attracted the largest share of private capital flows to developing countries, but while these inflows have helped boost investment and growth, they also bring new challenges and risks. Two issues demand particular attention:

• *Current account sustainability.* Large net private capital inflows have tended to raise aggregate expenditures, increase inflationary pressures, and widen current account deficits in all major recipient countries. Yet part of these inflows—especially those of a short-term nature—can be suddenly reversed, either because of changes in market sentiment about the recipient country, contagion effects, or changing financial market conditions in other countries. Countries in such situations must thus pay particular attention to the sustainability of their external position.

• *Soundness of domestic financial systems.* Globalization has clearly put new strains on domestic financial systems, especially banks. Large capital inflows often lead to a rapid expansion of domestic credit, which can set the stage for problems in the financial sector, especially if prudential supervision and capital adequacy requirements are insufficient. Globalization has also quickened the pace of financial innovation, and difficulties can arise when the pace of this innovation outstrips countries' regulatory and supervisory capacity.

Financial sector problems cannot be prevented by prudential policy alone; they also require appropriate monetary and fiscal policy action, as well as steps to increase the transparency of institutions' operations and financial condition. It is important to take appropriate action promptly before the situation deteriorates to the point that policymakers are reluctant to tighten policies for fear of intensifying banking sector problems. Otherwise, delays in policy action can lead to a loss of market confidence in domestic economic policy, which can, in turn, trigger capital outflows and put further pressure on weak banks.

Although ASEAN countries have been performing well, they have not been immune to the complications of large capital inflows. In some countries, strong domestic demand has raised external current account deficits and put pressure on private sector credit and domestic prices. These strains have also been felt, in varying degrees, in labor markets—especially for skilled labor—and in real estate markets. More recently, many policymakers have also had to contend with a slowdown in exports.

Camdessus: Further strengthening of public saving will help safeguard macroeconomic stability.

Financial systems have inevitably come under pressure, too. In many countries, increased capital inflows and domestic demand have stimulated excessive lending for consumption and real estate. At the same time, the risks in the region's financial markets have also increased owing to, among other factors, the many new incentives and instruments for domestic enterprises to borrow in foreign currency.

Fortunately, policymakers in the region have been watching these risks closely and have already taken a number of steps to reduce macroeconomic imbalances and the risks of overheating. As a result, growth and inflation rates have begun to moderate in several countries where overheating has been a concern, including Thailand, Malaysia, and Indonesia. At the same time, inflation in the Philippines has fallen significantly below the double-digit threshold reached last year. However—in part because of the slowdown in exports—current account adjustment must remain on the agenda in all of the countries, as must the strengthening of domestic financial sectors.

Sustaining ASEAN's Performance

Against this background, how can risks be best reduced and ASEAN's exemplary performance be sustained? ASEAN's record of policy prudence and adaptability is an excellent starting point. To build on this, I suggest four additional elements:

• *Reduce reliance on foreign saving.* Reducing external vulnerability implies reducing current account deficits and increasing domestic saving rates. So many ASEAN countries already have private saving rates that are among the highest in the world, but many of you have told me there is scope in most countries to do even better. While policies must remain geared to achieve this over the longer term, reducing reliance on foreign saving—at least in the near term—requires strengthening public saving. Such an approach would help address the challenge posed by capital inflows, reduce the burden on monetary policy, and tend to reduce interest rates—all of which would help safeguard macroeconomic stability.

I do not underestimate the magnitude of the task involved, nor the time it takes to design and implement fiscal reforms. There are already pressures to increase spending in critical areas—such as education, health, and infrastructure—but I believe there is room for most countries to adopt an even more ambitious approach to fiscal consolidation.

The task will not be easy, and the appropriate mix of revenue and expenditure measures will vary from country to country, but there is always scope to reduce costly investment incentives and unproductive outlays. Let

me mention military expenditure, because this is a domain where, quite unexpectedly, the ASEAN countries have been recently less successful than others. While worldwide military spending relative to GDP declined between 1991 and 1994, military spending in Asian developing countries (including South Asia) has remained about the same or increased, despite rapid GDP growth in most of these countries. Also, in most countries, there is room to raise revenues through improved tax administration and other measures.

Beyond this, the impressive progress that countries in this region have made in strengthening the financial position of the central government could now be extended to increasing efficiency and reducing imbalances in other parts of the public sector, such as regional governments and public enterprises. It would also be useful to consolidate quasi-fiscal activities and extrabudgetary operations within the central government budget, so that policymakers can formulate fiscal policy on the basis of a more comprehensive—and more transparent—public sector position.

With today's globalized markets, following through with domestic banking reforms deserves the highest priority.

• *Ensure that private capital inflows take the form of long-term investment.* Since the greatest threat of instability is posed by more volatile short-term inflows, macroeconomic and structural policies should be geared to encouraging foreign direct investment and other long-term investment flows. The most important policies in this regard are the same policies that encourage domestic investment—namely, a stable macroeconomic environment and continued structural reform, including further trade liberalization and, with it, the outward orientation of the economy. The adoption of prudential requirements vis-à-vis short-term inflows has also played a useful role. However, in our experience, direct quantitative controls on capital inflows rarely work for any sustained period. They also run counter to the thrust of external liberalization that has been a hallmark of ASEAN's success. Fiscal consolidation can also play a role in discouraging speculative inflows by providing greater scope for short-term flexibility in exchange rate policy. Indonesia, for example, has moved in this direction.

• *Strengthen domestic banking systems.* Considerable progress has already been made, with the overall thrust being, commendably, to increase capital adequacy requirements, improve transparency and information disclosure, and further develop risk management and robust payments systems. But important additional measures need to be taken. These range from specific actions concerning regulations for adequate loan loss provisioning and avoidance of undue loan concentration to the general need to design comprehensive reform strategies to strengthen internal bank governance and foster market discipline, including firm exit rules for troubled institutions. In our globalized markets, following through with these reforms and dealing with any emerging problems without delay deserve the highest priority.

• *Ensure an appropriate role for the state.* Although fiscal consolidation should be carried out in a way that reduces the size of the public sector, governments still have an essential role to play in maintaining an environment conducive to high-quality growth. Moreover, today's increased competition for private capital inflows—and the need for greater policy vigilance to ensure the sustainability of these inflows—call more than ever for domestic institutions that can formulate and implement effective economic and financial policies, make efficient use of domestic resources, and fulfill government functions in such a way that gives investors confidence to invest. This is indeed an endless task!

There are always additional steps that governments must take if they are to approach excellence in governance. Among such steps would include reducing the regulations and restrictions that foster rent-seeking activities; ensuring that fiscal and central bank accounts and budgetary procedures and controls are transparent; protecting property and contract rights; and guaranteeing the professionalism and independence of the judiciary. Nor should we forget the more traditional items on our agenda: challenges such as reducing trade barriers and deregulating the economy, while maintaining public consensus; strengthening the region's infrastructure, while safeguarding natural resources and the environment; fighting corruption; streamlining the civil service, while guaranteeing its professionalism; and developing a culture of transparency and openness.

Governments also have an important role to play in promoting human development. To sustain high rates of economic growth, ASEAN countries will need to maintain high rates of productivity growth and increase participation rates. Policies that give center stage to human resource development will not only help achieve this but also will enhance equity and, hence, the sustainability of the growth process. The region has already led the developing world in

emphasizing the importance of investing in education and health, which has produced visible payoffs for sustained, high-quality growth. Maintaining the region's edge in skill intensity and, thereby, in the competitiveness of the manufacturing sector, now means putting increasing emphasis on the acquisition of higher skills, through secondary education and vocational training, especially female education and training. It has become a truism that more than ever, economic efficiency, social equity, and progress go hand in hand.

I have considerable confidence that ASEAN countries will take the steps necessary to meet the challenges of the globalized economy and, in so doing, consolidate and enhance the economic success they have achieved to date.

In concluding, Camdessus noted that while the IMF stands ready to assist the ASEAN countries should the need ever arise, these countries are expected to play an ever-increasing role in the world economy. The region's dynamism will, in turn, help sustain global growth. ASEAN's changing role must also be reflected in the IMF, Camdessus added. Several ASEAN countries are already contributing to the financing of the IMF through its operational budget and participating in the new arrangements to borrow, which will double the credit available to the IMF during systemic crises. Most will also be lending support to the establishment of a permanent enhanced structural adjustment facility. Of course, Camdessus added, there is also a significant nonfinancial contribution the region can make. He urged the ASEAN countries to speak out more forcefully about the benefits of economic reforms and the necessary conditions for success.

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Banking Crises: What Do We Know?

In the past 15 years, nearly three-fourths of IMF member countries have experienced significant banking sector problems. And since 1980, banking problems in developing and transition economies have cost the public some $250 billion. The prevalence of banking problems and their extreme costliness have sparked heightened interest in ways to prevent them, according to Morris Goldstein, formerly Deputy Director of the IMF's Research Department and currently Senior Fellow at the Washington-based Institute for International Economics. In addition, the Mexican financial crisis of late 1994–early 1995 focused world attention on the risks posed by banking sector problems. Goldstein's comments were made at a recent seminar for IMF staff, at which he reviewed the current state of knowledge about both banking and currency crises and discussed ongoing research in these areas.

Several definitions have been advanced for what constitutes a banking crisis. An increasingly popular one, according to Goldstein, is when the capital of the banking system is essentially exhausted—with nonperforming loans amounting to at least 15–20 percent of total loans and the public resolution cost equivalent to at least 5 percent of GDP.

The primary causes of banking crises in developing countries, said Goldstein, were the following:

- external and domestic macroeconomic volatility, the main elements of which were sudden adverse changes in terms of trade and wide swings in international interest rates, real exchange rates, and growth and inflation rates;
- lending booms, characterized by rapid increases in bank credit growth and unsound financing during economic expansions;
- rapidly increasing bank liabilities, in the context of large bank mismatches with respect to liquidity, maturity, and currency of denomination;
- inadequate preparation for financial liberalization, which leaves bank supervisors to face new risks before the supervisory and regulatory framework is sufficiently strengthened;
- heavy government involvement in the banking system and loose controls on "connected lending" (loans extended to banks' owners or managers and to their related businesses);
- weaknesses in accounting, disclosure, and legal frameworks, which hinder the operation of market discipline and effective banking supervision;
- distorted incentives, such as pressures for regulatory forbearance created by insufficient political protection of bank supervisors and the absence of suitable financial incentives for bank owners, managers, and depositors to avoid excessive risk; and
- the exchange rate regime: a currency board or fixed exchange rate regime, for example, can constrain the exercise of the lender-of-last-resort function by the central bank.

How early a warning should an indicator provide, Goldstein asked, and which are the best ones? Reporting on work in progress with IIE colleague Carmen Reinhart, he said that an early warning indicator should signal a problem between 1 and 24 months before its onset. Among the indicators that showed promise are real exchange rate appreciation, which lowers the profitability of exports and often precedes losses on unmatched currency positions; falling equity prices, which reduce the net worth of companies and the collateral underlying bank loans; a rise in the money multiplier, resulting from a decline in bank reserve requirements connected with financial liberalization; a rise in the domestic real interest rate; and recession, which leads to loan delinquencies and other problems.

Currency, or balance of payments, crises are generally easier to identify, said Goldstein, by looking at an index of exchange market pressures. Among the warning variables he and Reinhart were studying are real exchange rate appreciation, falling exports, falling stock prices, recession, and a rising ratio of monetary aggregates to international reserves.

Motivating Banking Reform

The serious problems with banking systems in many developing countries underscore the importance of greater macroeconomic stability and sound banking practices. For this reason, Goldstein indicated that he—and others, including IMF staff—were working to develop a set of international banking standards.

Existing guidelines, Goldstein said, were too narrow and related mainly to the circumstances of Group of Ten industrial countries. Any new banking standards, he maintained, should be voluntary, but if the markets know which countries sign on to them, pressure for their widespread adoption would emerge. Goldstein compared the effort to develop banking standards with the IMF's efforts to develop standards for the publication of data (the special data dissemination standard, introduced in September 1996). While adherence to banking standards would not eliminate banking crises, Goldstein concluded, it could mitigate their severity and frequency.

David Cheney
Editor, *IMF Survey*

Trade Reform in Transition Economies Follows Different Paths

(Continued from front page)

• Trade policy reform measures closely tied to the goals of macroeconomic stabilization and structural reform—price liberalization and elimination of the state procurement systems and quantitative export restrictions—have proceeded reasonably well. Less success has been registered in liberalizing import regimes once export barriers were reduced.

• Future IMF trade policy advice should include recommendations on how to establish a framework of transparent rules and procedures for adjudicating trade conflicts.

Status of Trade Policy Reform

The IMF study assesses the performance of three country groups:

Top Performers. Estonia and the Kyrgyz Republic have made the most progress toward establishing a liberal trading system. Both countries liberalized their import regimes and reduced government control over exports. Their success owes mainly to their ability to generate a substantial degree of domestic political support for trade liberalization. The IMF study suggests that the comparatively smaller share of heavy industry—whose representatives are often the leading protectionists throughout the region—in both economies has contributed to a climate favorable to trade liberalization.

These countries' initial approach to trade liberalization differed in important respects, however. While Estonia embarked upon a reform program as early as 1992, the Kyrgyz Republic's trade regime remained largely unaltered until early 1994, at which time liberalization accelerated. Reform in each country sprang from different causes. Estonia's trade reform efforts were made easier by generous access to European markets, the financial discipline imposed by a currency board arrange-

Countries in Transition Reap Major Gains from Trade

The countries in transition to market-oriented economic systems are recovering not only from the initial disruptions of the transition but also from the distortions created by decades of central planning, including the closed system of international trade associated with it. Just as that trade system impeded the growth and development of these economies prior to their transition, so too is the revival of trade critical to these countries' future growth as they become reintegrated into the global economy. These are the main conclusions of an analysis in the October 1996 edition of the IMF's *World Economic Outlook*.

The volume of both imports and exports fell drastically in the transition economies following the breakup of the Soviet Union and the collapse of the planned trading system. The largest declines were in trade flows among the countries of the former Soviet Union, which reflected the necessary undoing of distorted trade patterns imposed by central planning. Trade with the rest of the world declined much more moderately. Trade rebounded in 1995 and 1996 in the countries of Central and Eastern Europe and in a number of countries of the former Soviet Union in the wake of progress with macroeconomic stabilization and structural reform. Particularly strong have been exports to Western Europe and trade among the countries that comprise the Central European Free Trade Association (CEFTA). Growth in the volume of trade in goods and services has broadly been associated positively with the growth performance of the transition countries.

A number of channels through which increased trade contributes to output growth are particularly relevant to the transition countries. The fundamental benefit of free trade is that it allows for the efficient allocation of resources across and within countries. This is in contrast to the often arbitrary specialization imposed by central planning. While output in the transition countries declined with the large-scale restructuring of production that followed the breakdown of central planning, new economic structures and the redirection of trade based on comparative advantage rather than nonmarket considerations should provide long-run benefits in terms of increased efficiency. For these benefits to be reaped, distortions in domestic product and factor markets, which inhibit the necessary adjustments, must be reduced and eliminated; and international competitiveness must be maintained at levels that promote export growth through the containment of costs.

ment, accelerated structural reforms, and a skilled and mobile labor force. In the Kyrgyz Republic, progress toward reform owes more to executive branch leadership. In early 1994, when the momentum toward reform slowed, the Kyrgyz president called for—and won—a national referendum that modified the constitution and restored his ability to act more decisively in support of market-oriented reforms, including trade liberalization. The Kyrgyz central bank also played an important role in advancing this agenda by supporting the introduction of a national currency and ensuring its external convertibility.

Mixed Performers. Trade policy reform within the largest group of countries—Armenia, Azerbaijan, Belarus, Georgia, Kazakstan, Latvia, Lithuania, Moldova, Russia, and Ukraine—has been more modest. Positive developments during 1993–95 featured reductions in the state's direct involvement in foreign trade and elimination of many remaining quantitative export restrictions; export quotas, for example, were phased out during 1995 in Azerbaijan, Kazakstan, Moldova, Russia, and Ukraine. In addition, as prices were liberalized, export taxes were markedly reduced or gradually eliminated in a number of countries.

In other areas, significant barriers to trade liberalization have persisted throughout the region—including export bans and licensing requirements and heavy export taxes and delays in the liberalization and simplification of tariff systems. Agricultural protectionism has also been a major source of concern.

Setbacks and delays in trade reform within the group of mixed performers are largely attributable to deteriorating macroeconomic conditions, structural weaknesses, and both real and potential difficulties in obtaining access to industrial country markets.

Macroeconomic Deterioration. Inadequate macroeconomic discipline—by generating high inflation, excessive exchange rate volatility, frequently deep fiscal imbalances, and high unemployment—has created a political environment hostile to trade liberalization, according to the Working Paper. Governments that chose a gradual approach to trade reform—for example, by maintaining a substantial portion of their state order system and retaining a web of bilateral barter and clearing arrangements—did so in the expectation that such actions would

The extent of trade and exchange liberalization has varied across transition countries, with several of them quickly adopting a highly liberal trading system and moving toward current account convertibility. Others have continued to intervene to a considerable degree in both import and export markets and to retain exchange restrictions. This appears to reflect a number of factors, including both the attempted use of trade restrictions to cushion declines in output and employment, and spillovers of insufficient reforms into other areas such as labor markets. Entrance into such regional trading arrangements as CEFTA and the nascent free trade areas forming within countries of the former Soviet Union can provide a means by which trade is liberalized as long as the common external barriers are not more restrictive than those that previously existed in the individual members. But it is questionable whether the diversion of trade to such trading groups is in the transition countries' long-term interest. The best course of action remains trade and exchange liberalization within a multilateral framework, says the *World Economic Outlook.*

Prospects for the growth of trade in the transition countries also depend on the trade policies adopted by other countries. Virtually all transition countries have requested observer status or have begun the process of accession to the World Trade Organization. Securing market access in the industrial countries is especially important, not least because it increases the potential returns from foreign direct investment. Most industrial countries granted the transition countries most-favored-nation status early in the transformation process, and many transition countries receive preferential market access under the generalized system of preferences. There have also been important bilateral initiatives. The European Union has concluded Association Agreements ("Europe Agreements") with several countries in Central and Eastern Europe, which include provisions for political dialogue, trade in goods and services, and trade-related issues, such as competition law. They also provide for the immediate or phased elimination of trade restrictions on industrial products; tariffs on a large number of industrial products were abolished immediately.

More restrictive agreements, however, continue to apply to so-called sensitive goods, principally agricultural products, clothing and textiles, and coal and steel. These are products in which many transition countries may reasonably be expected to be competitive. Restrictions on textiles and steel have been eased somewhat, but market opening in agricultural trade has remained limited. In addition, nontariff barriers can be an important obstacle to trade for these countries, particularly in chemicals and metals, but also in agriculture and textiles. Antidumping actions have specifically been a problem.

help cushion the drop in output. In allowing fiscal imbalances to reach near-crisis levels, trade taxes were frequently resorted to—especially in Armenia, Georgia, Tajikistan, and Russia, where traditional sources of revenue were declining. Protectionist pressures in several of these countries also increased during this period in response to real effective exchange rate appreciation.

Structural Weaknesses. Failure to achieve a critical mass of reform in such areas as price liberalization, labor market and financial system reform, and privatization has also delayed trade liberalization. In Tajikistan and Uzbekistan, for example, the retention of price controls—until mid-1995—provided the government with a rationale for keeping export controls in place.

Market Access. Domestic trade policy reform within this large group of countries may also have been negatively influenced by the treatment accorded their exports in world markets—particularly within the European Union and the United States. While most of the transition countries had already been granted most-favored-nation status by industrial countries, antidumping and countervailing actions—or their threat—continued to pose obstacles for exporters. Antidumping laws are especially pernicious, according to the Working Paper, because they penalize new market entrants at a time of difficult macroeconomic and structural adjustment. The capacity of this group of transition countries to adopt a liberal trading regime at home could thus be undermined by contingent protection practiced by industrial countries.

Slow Performers. In Tajikistan, Turkmenistan, and, to a lesser extent, Uzbekistan, the state has maintained a firm hold on trade through a pervasive system of quotas and licensing requirements and an array of export taxes. In Tajikistan, for example, 54 items representing more than 70 percent of exports were subject to quotas until early 1995, when the number of items was reduced to 6. Many export taxes ranging from 0.2 percent to 500 percent remain in place. The state order system in Uzbekistan applied to about half of the country's cotton and grain production at prices well below those in world markets. Reflecting shortages of foreign exchange, barter and clearing arrangements have also played a negative role in all three countries' trade. Tajikistan's reform efforts were further undermined by regional armed conflict during 1995.

Estonia's main seaport in Tallinn. Trade reforms in Estonia were made easier by generous access to European markets, a currency board arrangement, structural reforms, and a skilled labor force.

Refining the Agenda

For the Baltic countries, Russia, and the other countries of the former Soviet Union, the IMF authors recommend two sets of policy measures:

- *Comprehensive trade reform* consisting of a low and consolidated tariff structure, a formalized system of safeguards that allows temporary protection in the event of serious injury to a domestic industry, and a higher degree of transparency in formulating and adopting new trade measures. Import tariff regimes in these countries could benefit from the experience of a number of developing countries that have employed consolidated tariffs to facilitate movement toward lower uniform rates. To avoid setbacks to tariff reform that might stem from fiscal need, the IMF study recommends that tariff liberalization always be accompanied by a corresponding timetable for implementing compensatory domestic tax or spending measures.

Similarly, the adoption of a formalized system of safeguards authorizing temporary and limited reintroduction of protective barriers when domestic industries are injured by imports could bolster the impetus toward trade liberalization by providing a safety valve to vent and manage protectionist pressures in transition countries. The authors caution that in adopting such a mechanism, governments must resist efforts to appropriate the safeguards process to advance a protectionist agenda. If the safeguards instrument is to be adopted, it is critical that it be crafted with the goal of maintaining forward momentum in the trade liberalization process.

Finally, without a high degree of transparency, insiders in these countries

will continue to frustrate government efforts to liberalize trade policy. A step in the right direction would be laws to require early and frequent press releases detailing all salient developments in the consideration and adoption of new foreign trade measures. A more ambitious approach to expanding the flow of information would include the creation of a permanent office for assessing the domestic economic costs and benefits of existing and proposed trade restrictions.

• *Complementary measures.* As the post-World War II economic performance of the industrial countries demonstrates, a strong macroeconomic environment is a powerful antidote to protectionism. To create a more favorable domestic setting for external adjustment, the IMF study underlines the importance of strong macroeconomic stabilization policies along with efforts to reduce monopoly power, stimulate labor mobility, and achieve far-reaching privatization. Macroeconomic stabilization is particularly important: it not only helps hold down inflation, thus minimizing distortions in relative prices, but it also reduces real exchange rate volatility and helps maintain high levels of domestic employment. Measures to improve economic efficiency directly, such as policies that discourage excessive market concentration, labor market initiatives to enhance mobility, and voucher-based privatizations, will also help reduce the concentration of interests that typically underlie protectionist policies.

Copies of IMF Working Paper 96/71, *Recent Trade Policies and an Approach to Further Reform in the Baltics, Russia, and Other Countries of the Former Soviet Union*, by Michael Leidy and Ali Ibrahim, are available for $7.00 from Publication Services, Box XS600, IMF, Washington, DC 20431 U.S.A. Telephone (202) 623-7430; fax: (202) 623-7201; Internet: publications@imf.org

From the Executive Board

Tanzania: ESAF

The IMF approved a three-year credit for Tanzania under the enhanced structural adjustment facility (ESAF), equivalent to SDR 161.6 million (about $234 million), to support the government's economic reform program for 1996–99. The first annual loan, equivalent to SDR 51.4 million (about $74 million), will be disbursed in two equal semiannual installments, the first of which will be available on November 27, 1996.

After an extended period of macroeconomic instability, Tanzania has made substantial progress with structural reforms in recent years. The external trade and payments system, monetary management, agricultural marketing arrangements, and, more recently, the parastatal sector have been extensively liberalized. Parastatal reform, through the imposition of a hard budget constraint on public enterprises and the privatization of about one-third of the 382 public enterprises, is beginning to generate important improvements in economic efficiency. However, for the three years up to the beginning of 1996, macroeconomic conditions deteriorated, largely because of deficiencies in budgetary management, poor tax administration, weaknesses in expenditure controls, and shortcomings in the management of the financial sector. Against this background, and taking the opportunity afforded by the installation of the new government, an IMF staff-monitored program for January–June 1996 was put in place. The program focused principally on eliminating the main impediments to sound budgetary management and on reforming the financial sector. Performance was broadly satisfactory, although progress with restructuring the financial sector was slower than envisaged.

Medium-Term Strategy and 1996/97 Program

The government's medium-term strategy aims at accelerating the growth of economic activity to achieve higher per capita incomes and reduce poverty. The overall macroeconomic objectives to be achieved by the end of the three-year program period, 1998/99, are a real GDP growth rate of 6 percent; an average rate of inflation of 5 percent; and an external current account deficit, excluding grants, of 13.3 percent of GDP, compared with 20.6 percent in 1994/95, while increasing gross official reserves to the equivalent of three months of imports by end-June 1999.

Within this medium-term strategy, the program for 1996/97, supported by the first annual ESAF loan, aims at accelerating real GDP growth to 5 percent; lowering the average inflation rate to 15 percent; and reducing the external current account deficit, excluding grants, to about 15 percent of GDP, while increasing gross international reserves to the equivalent of almost 10 weeks of imports.

To achieve these objectives, fiscal policy will seek to improve the government's savings performance so as to reduce budgetary dependence on foreign financing. The government's revenue performance

Tanzania: Selected Economic Indicators

	1994/95	1995/96	1996/97[1]	1997/98[1]	1998/99[1]
			(percent change)		
Real GDP	3.8	4.5	5.0	6.0	6.0
Consumer prices (average)	34.0	25.7	15.0	7.5	5.0
			(percent of GDP)		
Overall government budget balance (excluding grants)	−6.9	−4.9	−2.4	−2.0	−1.3
External current account balance (excluding grants)	−20.6	−16.3	−15.1	−14.2	−13.3

[1]Program projections.

Data: Tanzanian authorities and IMF staff estimates

will be strengthened by eliminating important sources of revenue loss; rationalizing the numbers and type of bonded warehouses; intensifying efforts to collect tax arrears; and broadening the tax base into sectors that at present contribute little to government revenue. Also, to sharply curtail tax evasion, import taxes between Zanzibar and mainland Tanzania are to be harmonized by end-December 1996. At the same time, the budgetary process will be strengthened to ensure that adequate funding is available for priority areas, namely health, education, and water supply. Monetary policy will aim at reducing monetary growth, while ensuring that sufficient bank credit is available to the private sector.

Structural Reforms

Building on the progress already made, the privatization program will be expanded by accelerating the disposal of assets managed by the Parastatal Sector Reform Commission. A hard budget constraint for the parastatals will continue to be implemented. Restructuring and privatization of the public utilities will be accorded the highest priority. Refined petroleum imports will be liberalized by January 1997, and petroleum prices completely freed by June 1998.

Addressing Social Issues

Under the program, the government's expenditure priorities are being reordered. Spending on primary and secondary education will be increased, and healthcare spending will focus on cost-effective community efforts and on preventive measures. The government will give high priority to the provision of water and sanitation services to both the rural and urban populations.

The Challenge Ahead

Tanzania's debt burden is expected to decline substantially and reach a manageable level within the next five years. However, the outlook remains highly vulnerable to developments in the terms of trade and other exogenous shocks. In these circumstances, the authorities will need to firmly implement their adjustment policies and to stand ready to adopt additional measures if the need arises. They need to be especially prudent in their debt management strategy, relying on grants and highly concessional loans to finance carefully selected and effectively implemented investment projects.

Tanzania joined the IMF on September 10, 1962. Its quota is SDR 146.9 million (about $213 million). Its outstanding use of IMF credit currently totals SDR 121 million (about $175 million).

Press Release No. 96/55, November 8

IMF Warns of Financial Schemes Misusing Its Name

In view of widespread and continuing inquiries from individuals and companies that have been approached by parties in connection with offers of participation in various financial instruments and schemes promising high returns and making unauthorized use of the name of the IMF, the Treasurer of the IMF warned potential investors to beware of such schemes. He had already issued warnings in the past—in February and May 1994. On November 18, he reiterated that the IMF does not issue or guarantee any obligations called "Prime Bank Notes," "Prime Bank Guarantees," "Bill of Exchange," or "Bill of Equity," or extend any credit lines through commercial banks or other agencies. Moreover, the IMF does not guarantee debentures or other financial instruments issued by a member country or any other entity. It does not sponsor investment programs, "high-yield financial programs," or issue to countries or to outside parties an "IMF Number," "IMF Country Registration Number," or an "IMF Approval Number for Projects."

Other examples of bogus instruments often featured in such schemes that make unauthorized use of the IMF"s name are:

- fictitious stand-by letters of credit—falsely portrayed as risk-free and sanctioned by the IMF;
- securities allegedly backed by the IMF; and
- bonds supposedly issued by the IMF.

The IMF is an intergovernmental organization whose financial transactions and operations are carried out directly with its member countries and only through a fiscal agency designated by each member for this purpose (such as the member's central bank or its ministry of finance). The IMF does not operate through other agents and it does not endorse the activities of any bank, financial institution, or other public or private agency.

Uganda: ESAF

The IMF approved the third annual loan under the enhanced structural adjustment facility (ESAF), in an amount equivalent to SDR 46.9 million (about $68 million), to support Uganda's economic program in 1996/97. The loan is available in two equal installments.

Since 1987, the government of Uganda has been implementing a far-reaching economic recovery program supported by substantial economic assistance from the IMF and other multilateral and bilateral institutions. The current three-year ESAF loan has been in effect since September 1994 and has been successful in producing strong growth and holding inflation at moderate levels.

Over the past five years, real GDP has grown at an average annual rate of 7 percent, and per capita GDP growth has averaged 4 percent a year in real terms. Government revenues have risen by more than 1 percentage point of GDP a year, from 7 percent of GDP in 1991/92 to over 11 percent in 1995/96. At the same time, expenditures have been kept under strict control and have averaged about 19 percent of GDP. As a result, the overall fiscal deficit, excluding grants, fell during the period from 15 percent of GDP to 7 percent. In these five years, the external current account deficit declined from 13 percent of GDP to an estimated 7 percent. The government has also accelerated structural reforms to deregulate the economy and to increase private investors' confidence. Public enterprises have been

privatized, interest rates have been liberalized, and expropriated properties have been returned to former owners.

Medium-Term Strategy and the 1996/97 Program

The government's medium-term strategy seeks to strengthen actions aimed at poverty eradication, particularly by achieving strong economic growth. At the same time, it will maintain macroeconomic stability by pursuing sound fiscal and monetary policies in a liberalized environment. Accordingly, the medium-term objectives of the program are to achieve a regionally balanced and broad-based annual real GDP growth rate of 7 percent (or about 4 percent per capita), to contain inflation at 5 percent a year, to strengthen the balance of payments, and to accumulate gross reserves equivalent to more than five months of imports.

To meet these objectives, medium-term fiscal policy envisages reducing the overall budget deficit by more than 3 percentage points of GDP. Improvements in tax and customs administration should increase revenues annually by 1 percentage point of GDP, while expenditures are to be maintained broadly constant relative to GDP. The external current account deficit (excluding grants) is expected to decline to 5.7 percent of GDP by 1998/99, from 7.1 percent in 1995/96, through a continued diversification of the export base, buoyant private inflows, and moderation of import growth.

Macroeconomic objectives for 1996/97 are to achieve a real GDP growth rate of 7 percent, contain inflation at 5 percent, limit the external current account deficit to 7.2 percent of GDP, and increase international reserves to an equivalent of 4.7 months of imports from 3.7 months. The achievement of these objectives will require tight fiscal and monetary policies. The overall fiscal deficit (excluding grants and a windfall coffee tax) will be reduced by 1 percent of GDP, to 5.8 percent of GDP. Revenues are programmed to rise by more than 1 percent of GDP to 12.3 percent, while total expenditures are to be maintained at about 18 percent of GDP.

Structural Reforms

Building on the steps taken in the recent past, privatization and restructuring of public enterprises will continue to be pursued under the program to open new opportunities for the private sector and to ensure that services offered by utilities are reliable and priced competitively. The divestiture of public enterprises will be maintained through auctions and by public flotation of companies. This last action aims at facilitating the development of the stock market and the promotion of wider stock ownership. The financial sector reform program is to be continued through the restructuring of weak commercial banks, particularly the rapid privatization of the Uganda Commercial Bank, while strengthening the Bank of Uganda and its supervisory capacity.

Parliament will vote early next year on a new income tax bill that rationalizes tax holidays and provides for the necessary tax incentives for investors. The government is also committed under the program to revise legislation on mineral taxation. The size and organizational structure of the central government are to be reviewed, including the number, functions, and staffing size of ministries in light of decentralization.

Addressing Social and Environmental Issues

The government is committed to strengthening the impact of growth on human development and has initiated a participatory process to develop an action plan for poverty eradication and to provide a comprehensive framework for addressing poverty. The authorities are also aware of the need to promote sustainable development and management of Uganda's rich natural resource base. A national environmental policy recently enacted calls for environmental education, improved information dissemination, community participation, and environmental impact assessments.

The Challenge Ahead

The marked increase in private transfers, including foreign direct investment and sustained support by the international community, is a testimony to external and internal confidence in the Ugandan economy. In light of the vulnerability of the external position and the relatively high debt stock, the authorities will need to maintain their policy of nurturing the diversification of the economy and of exports through continuing the liberal payments and trade system, realistic exchange rates, market-oriented price structures, and structural reforms to strengthen and deepen the financial sector.

Uganda joined the IMF on September 27, 1963, and its quota is SDR 133.9 million (about $195 million). Uganda's outstanding use of IMF financing currently totals SDR 269 million (about $391 million).

Press Release No. 96/56, November 18

Uganda: Selected Economic Indicators

	1994/95	1995/96[1]	1996/97[2]	1997/98[3]	1998/99[3]
			(percent change)		
Real GDP	10.6	8.5	7.0	7.0	7.0
Consumer prices (end-of-period)	3.4	5.3	5.0	5.0	5.0
			(percent of GDP)		
External current account balance (excluding grants)	–8.3	–7.1	–7.2	–6.6	–5.7
Government balance (excluding grants)	–8.9	–6.8	–5.8	–4.7	–3.6
			(months of imports)		
International reserves	3.4	3.7	4.7	5.0	5.5

[1]Provisional.
[2]Estimates.
[3]Projections.

Data: Ugandan authorities and IMF staff estimates

Deficit Reduction, Decentralization Highlight Need to Manage Subnational Government Debt

Rising concern over high public-debt-to-GDP ratios and increasing decentralization of expenditure and revenue-raising responsibilities have heightened the importance of properly managing debt of the subnational governments. A recently published IMF Paper on Policy Analysis and Assessment, *Borrowing by Subnational Governments: Issues and Selected International Experiences*, by Teresa Ter-Minassian, examines four major approaches to managing subnational debt. Ter-Minassian concludes that approaches that rely on transparent standing rules to limit such debt, supported by the dissemination of comprehensive and timely information on the finances of subnational governments to promote market discipline, are likely to prove most effective in an environment of increasing decentralization.

Approaches to Subnational Debt

Subnational debt is a concern, explains Ter-Minassian, whether a country employs a federal or unitary structure of government and whether or not it has accumulated substantial debt at the subnational level. A credible fiscal adjustment effort can be undercut if it fails to address existing subnational debt or the potential for a transfer of fiscal problems to lower levels of government. The experiences of a number of countries suggest that central government controls over subnational government borrowing tend to be looser where fiscal discipline is poor and where fiscal and macroeconomic imbalances remain unaddressed. They may also be looser where financial markets are well developed and can exert effective discipline on the borrowing of subnational governments. A broad survey of country experiences identifies four principal approaches to managing subnational debt.

Market Discipline. Sole reliance on market discipline can be effective, Ter-Minassian notes, but the preconditions for its use are exacting, and few countries satisfy them. Markets must be free and open (without regulations that place government in a privileged borrower position); potential lenders must have sufficient information to assess the borrower's debt level and repayment capacity; there should be no expectation of a bailout in the event of a default; and the institutional infrastructure must respond in a timely fashion to market signals.

In practice, lenders in developing countries typically lack access to timely information on subnational debt levels. Many countries facilitate the placement of government securities at a below-market cost through portfolio requirements on financial intermediaries, and a number of countries have intervened to stave off the default of subnational governments. Also, preoccupation with often short electoral cycles commonly leaves subnational governments unresponsive to early warning signals from financial markets.

Relatively few countries rely solely on market discipline. Canada, which does, has had a mixed record. Canadian provinces have no constitutional or legal limits on borrowing, but their debt and debt-servicing capacity are closely monitored by financial markets, principally through the major debt rating agencies. Despite a clear deterioration in debt ratings and a sizable increase in risk premiums on some provincial bonds, provincial debt has climbed steadily, with provincial governments beginning only recently to design and implement fiscal adjustment. This "recognition lag" may arguably, Ter-Minassian says, necessitate a sharper and more painful retrenchment.

Brazil until recently also shunned legal and administrative controls over state and municipal borrowing, allowing this debt to accumulate rapidly from the end of the 1960s through the 1980s. The federal government assumed and rescheduled most external debt in 1989 and debt to federal banks in 1993. But in some instances, states continued to amass debt to state-owned banks, and others resorted excessively to the issuance of bonds. Subsequently, in the face of high interest rates and the withdrawal of private lenders from state securities, several states faced default. Intervention shifted the default risk to the federal government, but the severity of the problem led Brazil to re-examine its stance on controls. New legal rules and central bank regulations prohibit states from borrowing from their own banks. A constitutional amendment now bans the issuance of state bonds until the end of this decade. And the federal government, through one of its major banks, has extended lines of credit for indebted states that agree to initiate fiscal adjustment programs.

Cooperative Approach. A cooperative approach eschews legal or centrally dictated limits in favor of a negotiated agreement between the federal and other levels of government. This approach, which actively involves subnational governments in formulating budgetary policies within an overall macroeconomic framework, has found adherents in some European countries—notably in Scandinavia—and, more recently, in Australia. In Australia, the process has been conducted

within a multilateral forum in which all states and the center are represented through the Loan Council. States submit detailed projections of their budgetary operations, and discussions emphasize corrective measures, when needed. The Council also facilitates the collection and dissemination of data on state finances. Other countries, such as Denmark, use bilateral negotiations between individual local governments and the center.

The cooperative approach has clear advantages in improving communication and promoting the exchange of information across levels of government. It also increases the awareness at all government levels of the macroeconomic implications of budgetary choices. But the cooperative approach works best, Ter-Minassian cautions, when a culture of fiscal discipline is already in place.

Rules-Based Approaches. A number of countries rely on constitutional or legal provisions to control subnational government borrowing. Some limit the absolute level of indebtedness; others permit borrowing only for specific purposes (typically investment); others permit borrowing only up to a maximum debt-service ratio; and still others prohibit, or severely limit, borrowing that involves certain types of macroeconomic risk (such as borrowing from the central bank). Many countries use some combination of these constraints.

Rules limiting borrowing to investments are quite common, notes Ter-Minassian, in industrial countries and in most U.S. state constitutions. Some countries, such as Spain, allow regional and local governments to borrow short term for liquidity purposes but require repayment by the end of the fiscal year. Some industrial countries (notably the United States, Spain, and Japan) and a number of developing countries link limits on subnational government indebtedness to projected debt service or other indicators of debt-servicing capacity.

Rules-based approaches have the advantages of transparency and evenhandedness, Ter-Minassian says. They also sidestep the protracted bargaining that can characterize the cooperative approach. But rules, by their very nature, lack flexibility and often inspire inventive circumvention. To be effective, says Ter-Minassian, a rules-based approach must be supported by clear and uniform accounting standards that ideally eliminate off-budget activities, and must also be bolstered by a comprehensive definition of debt, modern government financial management information systems, and privatization efforts that effectively minimize the opportunity to use public enterprises and banks as a source of government financing.

Direct Controls. In a number of countries—principally those with a unitary structure of government—the central government directly controls subnational government borrowing by setting annual limits, reviewing and authorizing individual borrowing operations, or centralizing all government borrowing. In the United Kingdom, until 1988, the central government exercised direct controls over the local governments' capital spending. More recently it has sought to influence the level of spending on capital projects through grants and loans approved for local governments.

In Japan, the central government exerts a strong influence over the entire budget process of local authorities. Borrowing is generally approved solely for investment. In Spain, which affords its regions considerable autonomy, the central government has moved to address rapidly growing regional debt. Spain now requires prior central government approval for all bond placements. In India, extensive central government controls have largely failed to impose discipline on the states. Ter-Minassian notes that borrowing controls are no substitute for properly designed, and sustainable, intergovernmental fiscal relations.

Several considerations argue for direct central government controls on the external borrowing of subnational governments. The intimate link between external debt and monetary and exchange rate policy argues for a strong role for the center in managing a country's external debt. Also, a sovereign borrower is likely to garner better terms than provincial or local governments, while a deteriorating rating in one subnational entity would likely have a damaging impact on other local government borrowing. Ultimately, many foreign lenders require an explicit central government guarantee for subnational borrowing, and the central government is likely to bear responsibility for foreign debt. The center has a very real interest in seeing it handled responsibly.

For domestic borrowing, however, micromanaging may be counterproductive. Ter-Minassian believes that "on balance, effectively and timely monitored aggregate limits on the overall debt of individual jurisdictions, based on market-type criteria like maximum ratios of debt service to revenues, appear preferable to either

Selected IMF Rates

Week Beginning	SDR Interest Rate	Rate of Remuneration	Rate of Charge
November 11	3.88	3.88	4.24
November 18	3.89	3.89	4.26

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 109.4 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.

Data: IMF Treasurer's Department

Ter-Minassian: Market discipline is an effective supplementary means of controlling subnational debt.

centralized borrowing or preapproval of individual borrowing operations."

Conclusions

Market discipline is more likely to be effective as a supplementary rather than a primary means of controlling subnational government debt, Ter-Minassian concludes. In this regard, greater transparency and dissemination of information on subnational government finances are "highly desirable." Also desirable are efforts to reduce government intervention in the financial markets—notably privatization of state and federal banks, and the elimination or substantial reduction of requirements on financial intermediaries to hold government debt or to accord special privileges to government borrowers. Countries that have bailed out insolvent subnational governments in the past face a daunting task in convincing market participants that such bailouts will not occur in the future.

In view of the continuing trend toward decentralized expenditure and revenue-raising responsibilities, administrative controls on domestic borrowing are likely to decline in importance in the future, says Ter-Minassian. A rules-based approach has the advantage of greater transparency and certainty. There is a clear macroeconomic rationale for barring all government borrowing from central banks. Limiting borrowing to investment purposes, however, may pose a variety of problems. It may not be sufficiently restrictive to generate needed government savings or to ensure that investments are tied to adequate economic and social returns.

These concerns seem to argue, says Ter-Minassian, for setting overall debt limits on individual subnational jurisdictions, and for doing so on the basis of criteria that mimic market discipline, such as current and projected debt service in relation to projected revenues. Realistic, even conservative, projections must be used, as well as a comprehensive definition of debt. Greater involvement of subnational governments in formulating and implementing medium-term fiscal adjustment could complement these overall limits. Such involvement is likely to to broaden recognition of the importance of responsible budget policies, and to develop the needed political consensus to carry out fiscal adjustments in a country. Of course, Ter-Minassian concludes, there remains no substitute for effective political and intellectual leadership from the central government.

Copies of IMF Paper on Policy Analysis and Assessment 96/4, *Borrowing by Subnational Governments: Issues and Selected International Experiences*, by Teresa Ter-Minassian, are available for $7.00 from Publication Services, Box XS600, IMF, Washington, DC 20431 U.S.A. Telephone: (202) 623-7430: fax: (202) 623-7201; Internet: publications@imf.org

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The next issue of the *IMF Survey* will appear on December 16.

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