Improving Macroeconomic Management: Experiences and Lessons

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The relationship between growth and macroeconomic stability is a well-established phenomenon. Long-term growth requires a higher level of investment and a stable economic environment contributes in promoting saving and investment. Good macroeconomic policies help attract foreign saving. Sound fiscal and monetary policies create a conducive climate for private investment and economic growth. So, the policymakers need to redress the problems of domestic and external financial imbalances by designing and implementing an appropriate mix of policies for achieving higher growth, lower price uncertainty, reduced external imbalances, and other macroeconomic vulnerabilities. So, the important issues facing the policymakers are designing sound exchange rate arrangement, making current account sustainable, and promoting financial and macroeconomic stability. In order to promote sound macroeconomic environment for attaining sustained economic growth, there is a need to pursue more flexible exchange rate regime and make progress toward adopting inflation targeting in addition to improving the financial sector soundness, strength and stability.

INTRODUCTION

As the adverse macroeconomic shocks lead to sharp declines in growth rates, the relation between macroeconomic policy and growth needs to be properly comprehended. Sustainable growth requires policies that do not give rise to price instability, unfinanceable current account deficits or significant economic imbalances. A credible reduction in the fiscal deficit is inevitable to reduce price instability and an appropriate exchange rate is needed to reduce the exchange rate instability. Lack of adjustment may result in price instability, an overvalued exchange rate, and a balance of payments (BOP) crisis which would, in turn, lead

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to low investment and slow growth. High and unstable price uncertainty is likely to reduce growth by creating an unstable economic climate, causing distortions in relative prices, and absorbing resources unproductively. Price uncertainty requires frequent price adjustments which tend to blur the information embodied in relative prices, diverting away the entrepreneurial effort from production and investment decisions. Distortions in key prices such as the real interest rate and the real exchange rate are also likely to hamper growth. Flexibility in adjusting quickly to the fiscal and monetary problems that the macroeconomic shocks cause is crucial if growth is to be sustained.

MACROECONOMIC IMBALANCES

Profligate macroeconomic management results in macroeconomic imbalances and instability. An expansionary fiscal policy is associated with the currency appreciation, adding pressures for a reversal of the reforms. Large fiscal deficits are often at the root of both external and internal macroeconomic imbalances. External imbalances express themselves as current account deficits, capital flight, and rapidly expanding external debts. Internal imbalances take the form of high real interest rates, falling private investment, and rising inflation. Prudent fiscal policy-that is, fiscal deficits consistent with low and stable inflation, a sustainable level of foreign debt, and a favorable climate for foreign investment - is indispensable to foster sound macroeconomic fundamentals. Furthermore, reforms in many other areas like financial liberalization, flexible exchange rate, price deregulation, trade reform, and so on can work only if the fiscal implications are well taken into account.

Expansionary monetary and fiscal policies are the single greatest threat to trade reform. Macroeconomic imbalances would lead to high real interest rates, declining investment rates and negative net resource transfers, volatile exchange rates, growing current account imbalances, stagnated growth rates, sluggish trade, disruptions in financial markets, more slowdown of the economy, and even protectionism. These problems are mainly the legacy of past imprudent policies and structural rigidities. They are also a consequence of the mismatch of the macroeconomic policies. Such an environment would lead to slower growth of both production and trade and the economies would be facing continuing risks and vulnerabilities. As the world experience has underscored, the macroeconomic mismanagement would slow growth substantially and result in significant declines in per capita income. The investments would fall, debts would grow, and developing countries would face negative net resource transfers as debt service obligations exceed the limited amounts of new financing, sometimes the severity of the prolonged economic slump even surpassing the level of the Great Depression in the industrial countries. As a result, poverty and unemployment is bound to rise (World Bank 1988).

MACROECONOMIC STABILITY

Macroeconomic stability is necessary for sustainable growth. As macroeconomic instability leads to the failure of external sector reforms, reforming the external sector regime usually calls for a real devaluation of the currency in response to the effects of reductions in tariffs and non-tariff barriers. Macroeconomic stability also makes reform of the financial sector more likely to succeed, and thus supports the development of capital markets that can foster private investment. For this to work, macroeconomic stability and strong supervision of the financial system require the overall review of issues related to accounting, disclosure, and corporate governance. Expectations of high price uncertainty, exchange rate devaluation, or government borrowing may push real interest rates too high, increasing the fiscal deficit and contributing to further macroeconomic instability. Excessively high interest rates and inadequate supervision of the banking system may cause defaults and instability in credit markets. Rapid interest rate liberalization under conditions of macroeconomic instability and inadequate bank supervision lead to financial crises that severely damage the economies (World Bank 1991). What is, therefore, required are vigilance and a shift from short-term considerations to tackling decisively the underlying economic and financial imbalances in the economy.

Sound management consists of the institutions and policies that would lead to rapid development and poverty reduction. A country with poor policies would be one with high inflation, large fiscal imbalances, and a closed trade regime. As there is plenty of evidence that good macroeconomic management provides a fertile environment for growth, and that large fiscal deficits and high inflation are bad for investment and growth, a stable macroeconomic climate is crucial. As trade liberalization accelerates growth, an outward orientation and a reasonable environment for fostering international transactions are essential. Fiscal, monetary, and trade policy prudence shows that a country is well-managed at the macroeconomic level. Good institutions and economic management are also needed at the microeconomic level. The strength of private property rights and the rule of law and the quality of the civil service coupled with its cleanliness are equally important as they affect long-term growth. The relationship between per capita growth and an economic management index based on the measure of openness, the budget surplus, the inflation rate, and the institutional quality reconfirms that sound management, at both the macroeconomic and institutional levels, is important for growth. This finding suggests that poor countries have been held back not by a financing gap but by an "institutions gap" and a "policy gap". If they can overcome them, they can begin to grow successfully (World Bank 1998).

MONETARY POLICY

The degree of central bank autonomy affects the conduct of monetary policy. Money creation is, in many cases, the residual source of financing. So if the central bank is obliged to finance a big deficit, it may be unable to implement monetary policy targeted at controlling price. When printing more money than the public wants to hold finances a deficit, prices will rise. Price uncertainty may bring a reduction in private wealth insofar as the value of financial assets may be eroded, the so-called inflation tax. High inflation creates uncertainty about the returns on saving and investment, thus creating a disincentive for capital accumulation. Empirical work has shown that high rates of inflation (above single digits) adversely affect growth. Inflation also makes it difficult to maintain a stable but competitive exchange rate, creating wage volatility impeding the country's ability to exploit the benefits of openness. International experience shows that governments around the world find it difficult to achieve and maintain the strong fiscal and monetary discipline required for economic stability. But reforming governments will not inspire the confidence necessary to generate growth unless people believe the new discipline will be sustained. When excessive domestic borrowing finances budget deficits, they can lead to higher interest rates that crowd out the private sector. There are limits to a rapid accumulation of domestic debt as, at some point, the public will be unwilling to hold more debt or will do so only at higher interest rates, thereby further increasing the cost of debt service. Eventually, deficits must be brought down with cuts in expenditure or through higher taxes as otherwise, the inflationary financing of the deficit along with the rise in the cost of funds for investors would be the eventual consequence.

EXCHANGE RATE POLICY

A competitive real exchange rate is necessary to support the expansion of the export sector and to avoid the emergence of BOP difficulties that might lead to calls for import restrictions. Countries that have allowed their real exchange rate to become grossly overvalued have experienced both a slowing in the expansion of the export sector and the rise in the capital flight. Exchange rate overvaluation retards growth and leads to the deterioration of the external sector. Correcting external imbalances generally requires adjusting the exchange rate toward its equilibrium level to redirect resources to the tradable goods sector and to reduce spending. In the short run, most of the nominal devaluation is also a real devaluation. If it is to endure, this real devaluation has to be supported by anti-inflationary policies including, in many cases, directed at lowering fiscal deficits. Evidence shows that a real depreciation is eroded rather quickly when fiscal and monetary policies are lax. A fixed exchange rate has sometimes been used to control inflation, serving as a nominal anchor for domestic policies and demonstrating the policy commitment to low inflation. In this case, exchange rate takes priority, restoring the credibility of the government's commitment to reduce inflation. Exchange rate will not be sustainable unless the macroeconomic fundamentals are right. Commodity booms increase spending, raise the price of non-traded goods relative to that of the traded goods, and shift capital and labor to the expanding sector. The real exchange rate appreciates, squeezing the non-boom tradable sector in a phenomenon known as the "Dutch disease." This shows how large the costs of unsustainable polices could be. The lesson of such episodes is that countries should try to keep their spending consistent with their permanent income. That is why, it is far better, whenever possible, to anticipate rather than react to emerging macroeconomic imbalances; the transition to a sustainable path will then be far less painful. Fiscal adjustment would then be more moderate, making it easier to protect investment in infrastructure, education, and health from cuts.

FISCAL POLICY

A prudent fiscal policy is the foundation of a stable macroeconomy. Taxes and public spending affect resource allocation, and fiscal deficits affect the BOP and, depending on how they are financed, the rate of price rise. Fiscal policy shapes the course of development as it affects aggregate resource use and financing pattern and, together with monetary and exchange rate policies, influences the BOP, the accumulation of foreign debt, and the rates of inflation, interest, and exchange. Public spending, taxes, user charges, and borrowings also affect the behavior of producers and consumers and influence the distribution of wealth and income in the economy. BOP crises and foreign debt problems are often caused and aggravated by imprudent fiscal policy. Their solution almost invariably involves some combination of cutting public spending and raising additional revenue, thus freeing resources for exports and debt service. However, careless fiscal austerity can lead to prolonged recession, and can place a disproportionately heavy burden on the poor. For this reason, the structural aspects of fiscal policy, how spending is allocated and revenue raised, matter as much as the overall macroeconomic balance.

The public sector affects the economy not only through its taxation and spending but also through interventions such as price controls and licensing. Although country experiences vary, the public sector now appears to be as important in developing countries as in the industrial countries. The expanded role of the public sector, however, carries with it risks and opportunities. The risks arise from the ineffective use of public resources and from the overextension of government into areas that are better left to the private markets. The opportunities arise from the government's power, in principle, to allocate resources efficiently when markets fail to do so and from its ability to provide relief to those in poverty. It is the task of public finance to balance the opportunities and risks, and thus improve the quality of government. The most important aspects of public finance within which pragmatic policies should be pursued are the management of public deficits, revenue mobilization, allocation of public spending, and decentralization of public functions.

With increased fiscal expansion or fiscal deficits, current account deficits widen and the ratio of public debt to GDP increases correspondingly. Capital flight worsens the debt problem as domestic savers could respond to unsustainable fiscal deficits by sheltering their assets abroad, the scenario of problem debtors. Those who pursue more sustainable fiscal policies accumulate smaller stocks of public debt in relation to their capacity to service it. This would also prevent the real exchange rate rising excessively. Thus, they steer clear of debt problems. With cautious fiscal management, the commodity-exporting countries could avoid destructive boom and bust cycles. Prudent fiscal policy guards against the risks of excessive foreign debt and overvalued currencies. But sound macroeconomic management is not enough. Many developing countries need to make structural changes if they are to resume satisfactory long-term growth. The ways in which governments raise revenue can substantially affect economic efficiency. Similarly, the quality and composition of public spending strongly influence development.

A prudent fiscal policy can, therefore, be defined as one that maintains the public deficit at a level that is consistent with other macroeconomic objectives: containing inflation, promoting private investment, and maintaining external creditworthiness. A deficit must be funded by the private sector lending the government some of the excess of its saving over its own investment, by foreigners lending part of their savings, by printing money, or by some mixture of the three. Too great a strain on any of these sources of finance can create macroeconomic imbalances. Over-reliance on domestic borrowing may mean high real interest rates and falling private investment. Over-reliance on foreign borrowing can cause appreciating real exchange rates, widening current account deficits, unsustainable external indebtedness, and dwindling foreign exchange reserves. Over-reliance on money creation may prompt higher inflation. Viewed from the alternative perspective of production and expenditure, an increased fiscal deficit is an additional claim on the supply of goods. The only ways to meet this extra claim are by importing additional goods from the rest of the world (that is, increasing the current account deficit), by driving up domestic inflation and interest rates to make the private sector buy fewer goods, or by increasing domestic production (World Bank 1998).

INTERNAL AND EXTERNAL BALANCE

A current account surplus is at one and the same time (a) the excess of the nation's income over its expenditures, (b) the excess of the nation's exports of goods and services over its imports, and (c) the net increment to the nation's foreign asset holdings. Expenditure-changing policies such as fiscal and monetary policies directly affect the levels of economic activity. Expenditure-switching policies such as trade and exchange rate policies change the pattern of economic activity. Finally, financial policies toward the rest of the world concern capital flows, debt management, and the net foreign assets position of a country. In addition, there are the structural policies, the objective of which is to enhance the efficiency of domestic production processes. The objective of both the expenditure-reducing and expenditure-switching policies is to transform a deficit in the current account of the BOP into a surplus. The policies of cutting domestic expenditures may cause the economy to enter into a recession and, consequently, unemployment may increase. Moreover, private investment may be reduced to such an extent that future growth may be jeopardized. In contrast, expenditure-switching policies, which increase the domestic prices of the internationally traded goods, will curtail imports and stimulate exports so that the economy can continue to grow. The problem here, however, is that the price increases of export goods may lead to demand for wage increases. This demand may lead to on inflationary spiral, which may make importing goods again attractive and production of export goods less profitable, so that the effects of the policy will be negated.

The objective of expenditure-switching is not only to increase the nominal prices of the traded goods but also to increase their real prices. A high real exchange rate means that the exchange rate is overvalued: the high value of domestic currency leads to high imports and low exports. However, no automatic mechanism will ensure that exchange rates will not become misaligned. The real exchange rate must, therefore, be considered an important policy guideline (Dornbusch and Helmers 1988). Before the Asian crisis, the fiscal balances of the crisis economies were satisfactory whereas the current account balances were unfavorable, indicating that the sustainability of the current account balance became the crucial element in generating the crisis (Appendix I).

In open and small developing economies, trade and capital flow across the borders in sufficient quantities to influence the domestic economy, particularly prices and the money supply. They are called price takers as their supply of exports nor their demand for imports has a noticeable impact on the world prices of these commodities and services. Tradable goods and services are those the prices of which within the country are determined by supply and demand on world markets. Under the small-economy assumption, these world market prices can not be influenced by any thing that happens within the country. Even if the supply of and demand for tradables changes within an economy, the local price will not change because domestic supply and demand have a negligible influence on the world price. However, the adjustment of the exchange rate does change the domestic price. Because of simplifying all tradables into one composite good, the price of tradables is best thought of as an index, a weighted average of the prices of all tradables, much like a consumer price index. Nontradables are goods and services, such as transportation, construction, retail trade, and household services, that are not easily or conventionally bought or sold outside the country, usually because the costs of transporting them are prohibitive. Prices of nontradables are, therefore, determined by market forces within the economy; any shift in supply or demand will change the price of nontradables. Nontradable prices are thus endogenous as compared to the price of tradables that is exogenous.

Therefore, macroeconomic equilibrium is defined as a balance between supply and demand in two markets: nontradable goods (internal balance) and tradable goods (external balance). When the supply of tradables equals demand, there is external balance, and when the supply of nontradables equals demand, there is internal balance. To achieve equilibrium in both the markets, two conditions must be satisfied: expenditure (absorption) must equal income, and the relative price of tradables (the real exchange rate) must be at a level that equates demand and supply in both the markets. If the relative price of tradables in terms of nontradables rises, tradables become more expensive relative to nontradables. If the production of tradables exceeds consumption of tradables, there is an external surplus, which is identical to a surplus in the balance of trade. With the economy in equilibrium, consumption of tradables is equal to production, so the balance of trade is zero. Total of the consumption and investment by both the government and the private sectors is called absorption. When export equals import and income equals absorption, the condition of the equilibrium of the economy is met (Gillis, etc. 1996). This also suggests two remedies for an economy that is out of balance: a government can achieve equilibrium or stabilize the economy by adjusting absorption, the nominal exchange rate, or both. Generally both instruments must be used to achieve internal and external balance. So, the two macroeconomic policy tools of government are: the exchange rate and the level of expenditure.

STABILIZATION VERSUS STRUCTURAL ADJUSTMENT

A distinction could be made between macroeconomic stabilization and structural adjustment. Stabilization policies work mainly on the demand side to reduce inflation and external deficits though they also have supply-side effects. Structural policies are concerned with the supply side as they address the efficiency of resource use, emphasizing reforms in specific sectors like trade, finance, and industry. While structural reforms are unlikely to succeed unless they are preceded or accompanied by stabilization, stabilization is unlikely to be sustainable without structural reforms. Stabilization addresses short-term problems that need to be dealt with urgency like inflation or deflation, loss of foreign exchange reserves, capital flight, and large current account deficits. Structural adjustment addresses obstacles to longer-term growth like distortions in the incentives for production, e.g., overvalued real exchange rates; controls on prices, interest rates, and credit; burdensome tariffs and import restrictions; and excessive taxes and subsidies. Careless structural adjustment can make the problem of stabilization more difficult as the distortions are often a source of revenue to the government. For example, high tariffs provide public revenue as well as protection to domestic industry. Equally, structural reforms are unlikely to command credibility unless stabilization policies are in place. Investors will expect trade liberalization to be short-lived if fiscal deficits imply an eventual external sector crisis.

Fiscal stabilization like cuts in public infrastructure spending to reduce the deficit may cause private investment to fall. Similarly, structural adjustment could be hampered as raising tariffs to increase public revenues may distort relative prices. Stabilization is often associated with a domestic recession characterized by rising unemployment, sharply contracting imports, and falling real wages and living standards. Lower living standards are unavoidable when the previous level has been artificially raised by unsustainable policies. But the recession can be damaging to future growth if it is too deep or too prolonged. The blow to the confidence of domestic investors may inhibit necessary new investment. The slowdown in the economy could also strain the financial system and impair its ability to finance new growth. Excessive cuts in spending risk a downward spiral of continually falling output. These risks make it vital to coordinate the contraction of demand induced by fiscal retrenchment with the implementation of structural adjustment measures to increase output.

Stabilization and structural adjustment face different institutional constraints. Stabilization is often postponed, but its implementation usually follows a crisis situation. In contrast, structural adjustment seldom carries the same sense of urgency as its results are less obvious and more gradual. It often requires the support of a broader circle of policymakers than stabilization, which is typically undertaken at the behest of the central bank and finance ministry. Structural reforms are difficult, too, because they inflict visible damage on a few and bring less obvious benefits to many. These difficulties reinforce the tendency to pursue short-run stabilization to the exclusion of structural adjustment during crises (World Bank 1998).

Responding with the right macroeconomic policy mix after an adverse shock is one of the biggest challenges policymakers face. Driven by political considerations, policymakers may postpone needed adjustment and stabilization measures because they are painful, thereby making the situation far worse. Not all problems arise from unsound macroeconomic policies. In some cases, the policy response errs in the direction of too much adjustment, with fiscal and monetary policy more restrictive than necessary to restore equilibrium in the currency market, the current account, or the capital account (World Bank 2000/01). Overreaction can cause more pain than necessary and, in some circumstances, can be self-defeating.

ECONOMIC CRISES AND IMPACTS

Economy-wide crises entail sharply falling outputs, declining incomes, and rising unemployment. Pervasive in the l990s, crises came in different forms: fiscal crises, BOP crises, terms of trade shocks, currency crises, banking crises, hyper-inflation. The economic crises in Mexico in 1995, in East Asia in 1997, and in Brazil and Russia in 1998 were not the only episodes of economic distress. Most crises were brought on by varying combinations of policy mismanagement and such external factors as terms of trade shocks, volatile capital flows, and contagion in international capital markets. Per capita GDP and per capita private consumption respectively fell by 4.1 percent and 5.6 percent in Argentina (1995), 7.8 percent and 11.1 percent in Mexico (1995), and 14.6 percent and 5.1 percent in Indonesia (1998).

Economic crises hurt both the poor and the non-poor, but they are far more devastating for those already in poverty. Real wages fall and unemployment rises, driving down labor earnings. Non-labor incomes fall as economic activity slows. Macroeconomic crises slow the accumulation of human, financial, and physical capital, weakening the ability of poor people to escape poverty. There is a strong link between macroeconomic downturns and rising income poverty. In most countries in East Asia, poverty rose as a result of the financial crises of the late 1990s. It is estimated that it rose almost by 50 percent in Indonesia and that urban poverty doubled in the Republic of Korea. In both countries, however, poverty fell as the economies recovered. In Russia, the incidence of poverty rose from 21.9 percent to 32.7 percent between 1996 and 1998. In every crisis in Latin America and the Caribbean, the incidence of poverty increased.

Capital account crises in emerging market countries-characterized by a sudden cessation or reversal of capital inflows that forces a large and abrupt current account adjustment together with a large depreciation in the exchange rate-have been associated with severe output contractions. What underlies these steep output declines? From one perspective, they are the counterpart to the massive capital outflows experienced by the countries which, in some cases, amounted to as much as 15-20 percent of GDP. To the extent that these capital outflows could not be met from existing reserves or official support, they required corresponding adjustments of the current account. With only limited scope to increase exports in the short run, this adjustment took place mainly through import compression and a corresponding slump in domestic demand.

The output losses, in turn, reflected a combination of demand-and supply-side factors. On the demand side, the salient event in all these crises was a collapse in private domestic consumption and investment spending. The recoveries, in turn, were driven mainly by a pick-up in private consumption and investment, with export expansion playing only a supportive role. Adverse shocks to aggregate supply also appear to have played a major part in the crises. The large exchange rate depreciations and temporarily high interest rates forced many firms into bankruptcy and disrupted supply and credit channels. These initial supply shocks were accompanied by negative aggregate demand shocks, because the same balance sheet and credit market effects also dampened investment and consumption spending.

Mistakes in macroeconomic management in Latin American economies have been quite rampant as evident from the disproportionate number of debt crisis. High external borrowing, low exports, and volatile fiscal policy characterized these economies' heightened vulnerability. Even though Latin American external debt levels have not been high relative to GDP, they have often still been high relative to exports. The region is subject to a high degree of macroeconomic volatility, stemming not only from terms of trade shocks, but also from volatility due to pro-cyclical fiscal policy. Historically, much of the region has suffered from financial underdevelopment and, partly associated with that, low domestic saving. As a consequence, government borrowing is disproportionately external, and disproportionately denominated in foreign currency. The resulting currency mismatch between government assets and liabilities has all too often left countries in the region quite exposed to the effects of sharp sudden exchange rate depreciation.

Table 1. Real GDP Growth (Percent)

Country	Crisis Year	Real GDP Growth: Previous Year	Crisis Year	Following Year
Argentina	1995	5.8	-2.8	5.5
Brazil	1999	0.2	0.8	4.2
Indonesia	1998	4.5	-13.1	0.8
Korea	1998	5.0	-6.7	10.9
Mexico	1995	4.4	-6.2	5.2
Philippines	1998	5.2	-0.6	3.3
Thailand	1998	-1.4	-10.8	4.2
Turkey	1994	7.7	-4.7	8.1

Source: IMF (April 2002).

These characteristics have a common starting point: problems with tax systems and expenditure controls. A weak internal tax system forces a government to rely more heavily on tariff revenue, reducing the incentive to export. Similarly, revenue shortfalls and expenditure excesses periodically force the governments to resort to monetary financing of deficits. A history of high inflation similarly makes it difficult for governments to borrow at reasonable rates. Finally, a weak tax system and poor spending controls make it difficult to adopt counter-cyclical fiscal policy. As a result, shocks to a country's terms of trade are all too often amplified rather than mitigated by fiscal policy. Though many countries in the region have made substantial progress including better fiscal systems and more flexible exchange rate systems, caution is still the need (IMF April 2002).

Box 1: The Great Depression

Macroeconomic management prudence should also consider the events leading to the great depression of the early-thirties. The US Federal Reserve tightened monetary policy in early 1928, in response to the stock market boom that began in 1926 and the belief that banks should confine their lending strictly to commercial bills and not finance stock market speculation. The contractions in central bank credit and the monetary base, along with a rise in the discount rate, precipitated a downturn in the US economy starting in August 1929 before the stock market crash of October 1929.

A series of banking panics beginning in October 1930 turned an otherwise serious recession into a depression. These panics, which resulted in the suspension of 9,000 banks, more than one-third of the total, exacerbated the economic contraction because they reduced broad money. The US Federal Reserve was insufficiently aggressive in trying to counter the collapse in broad money, for example, via open market purchases. The collapse of broad money reduced output through several channels: (i) lower aggregate demand which, in the face of nominal wage rigidity, decreased real output, (ii) disruption of financial intermediation from the bank failures, and (iii) asset price deflation, whereby declining asset prices reduced the value of collateral for bank loans, inducing weakened banks to engage in a fire-sale.

Output Loss During the Great Depression

Country	Share of World Output, 1931 (Percent)	Economic Activity		Output Loss (Percent)
		Peak	Trough	
United States	42.4	1929	1933	-29.4
United Kingdom	13.1	1930	1931	-0.5
Germany	9.5	1928	1932	-26.3
France	7.9	1932	1935	-10.4
Italy	5.4	1928	1933	-13.7
Japan	5.1	1930	1933	-14.9
Spain	4.2	1929	1931	-6.3
Canada	2.5	1929	1933	-29.7
Netherlands	2.1	1930	1934	-14.2
Switzerland	2.0	1930	1932	-6.5
Sweden	1.6	1930	1933	-12.1
Australia	1.4	1926	1931	-24.9
Denmark	1.1	1930	1932	-4.4
Norway	0.9	1930	1931	-8.0
Finland	0.5	1928	1931	-7.2
Portugal	0.4	1935	1936	-0.7

Source: WEO, April 2002

Crises can occur because of past unsustainable macroeconomic policies or inability to adjust to external shocks like terms of trade shocks, higher international interest rates, and sudden movements in capital flows as a result of contagion. In such circumstances, restrictive fiscal and monetary policies are inevitable and less costly than the alternative of delaying such measures, which could lead to a larger crash. Once adjustment policies are accepted as inevitable, the way governments introduce fiscal austerity can worsen the adverse effects on the living standards of the poor. So, the task of the policymaker is to implement the combination of macroeconomic measures that results in the lowest cost in foregone output and affords the greatest protection to the living standards of the poor. A key element of a poverty-sensitive response is the right composition of revenue-raising measures and fiscal cuts. A poverty-sensitive response should also allow for the expansion of safety nets targeted to poor people during periods of macroeconomic adjustment.

SOUTH-EAST ASIAN EXPERIENCE BEFORE THE CRISIS

In South-East Asia, before the crisis, fundamentally sound development policy was a major ingredient in achieving rapid growth. Macroeconomic management was unusually good and macroeconomic performance usually stable, providing an essential framework for private investment. Policies to increase the integrity of the banking system, and to make it more accessible to non-traditional savers, raised the level of financial savings. The economies were more successful in keeping public deficits within the limits the economy could absorb. As a result, they were better able to restrain inflation and manage both internal and external debt. Low inflation and manageable debt, in turn, facilitated realistic exchange rates and the avoidance of the appreciation that elsewhere undermined export performance. When the macroeconomy did go awry, usually due to external shocks, governments quickly responded by implementing solutions like reducing the fiscal deficit and, when necessary, devaluing the currency. In contrast, many other developing economies were less successful in keeping deficits within bounds and, therefore, experienced more trouble managing inflation, debt and exchange rates. As a result, policymakers in these economies often had less room to maneuver when confronted with a macroeconomic shock. Accordingly, their response was often hesitant and ineffective. The superior macroeconomic management record of the East Asian economies was reflected in less severe imbalances and generally lower variance in key indicators, including real exchange rates, real interest rates, and inflation.

While some governments ran substantial deficits, none financed a deficit in a manner that destabilized the economy. So, the deficit was affordable and not destabilizing, generally larger the faster the rate of growth and the higher the pool of private savings relative to private investment. Although a variety of macroeconomic policy paths were chosen because of their different economic conditions and preferences, all lay within the bounds of prudent stability and, whenever the macroeconomy appeared to be in danger of moving out of control, swift action was taken to restore stability. This was true even when the source of macroeconomic instability was policies intended to promote growth in the real economy. As the economies were remarkably successful in creating and sustaining macroeconomic stability, this became a potent encouragement for private savings, investment, exports and growth, since the private sector could count on relatively stable macroeconomic indicators like prices and interest rates. They successfully managed four macroeconomic fundamentals: budget deficits, inflation, external debt, and exchange rates.

Keeping Budget Deficits Manageable

The economies almost always kept the deficit within the limits that could be financed without macroeconomic destabilization. These limits were higher than in other developing economies because of the beneficial feedback from other good policies. International experience suggests that the macroeconomic consequences of public sector deficits depend on how they are financed. Excessive monetary financing of deficits leads to inflation; heavy government domestic borrowing drives up interest rates and crowds out private borrowing; large external financing of the deficit leads to debt crises. The economies kept each type of financing within bounds, avoiding the corresponding macroeconomic disease. During the 1980s, as a percentage of GDP, Korea's budget deficits (1.9 percent) were below even the OECD average, which explains why Korea was able to keep inflation, external borrowing, and interest rates within bounds. Because of higher growth in Malaysia and Thailand, they could absorb higher levels of budget deficit without a rapid rise in inflation as an economy can borrow more for a given debt to GDP ratio when GDP is rising rapidly. Increased domestic financing of the deficit without resorting to inflationary financing was made possible due to the high financial savings. As the initial level of external debt to GDP was very low, it meant that external financing was available when needed. Because of this, the economies avoided the inflation-inducing bursts of money creation.

Maintaining Moderate to Low Inflation

Low inflation is a corollary of fiscal prudence: East Asian governments never had to rely heavily on the inflation tax because their deficits were within financeable limits. The commitments to low inflation, a fixed exchange rate, self-imposed constraints on fiscal policies and institutional checks, altering public spending and foreign borrowing as needed, etc, generally contributed to fiscal discipline and low inflation. One result of low to moderate inflation rates particularly welcome to business is stable real interest rates. Low inflation and flexible financial policies kept real interest rates within a narrow range. For the comparable economies, the combination of nominal interest rate controls with high and unstable inflation was deadly as large increase in real interest rates created severe uncertainty for investors.

Keeping External Debt under Control

As with fiscal deficits, favorable feedback from other policies enabled these economies to sustain higher external debt to GDP than other economies. High levels of exports meant that foreign exchange was readily available to service the foreign debt. Similarly, high growth implied that returns on borrowed capital were sufficient to pay the interest. Though Korea borrowed heavily to finance private sector investment and build up foreign exchange reserves, with the foreign debt recording the fourth largest (which equaled more than half its GNP) in the world by 1984, yet because of its high export-GNP ratio and rapid overall growth, it never lost creditworthiness. Since 1986, the government pursued an active debt-reduction policy, drawing on burgeoning international reserves generated by exports to make payments ahead of schedule. By 1990, the debt-GNP ratio was down to 14 percent.

Keeping the Exchange Rate in Line

The economies avoided the severe appreciation of their currencies in contrast to other economies. The economies did not cling to a given nominal exchange rate (on inadequate rate of nominal depreciation) in the face of continuing inflation but depreciated when necessary, sometimes quite sharply. Fiscal prudence prevented the excessive demand pressures and the appreciation in the real exchange rates. After a period of pegging and devaluing, their currencies were floated or operated under managed float. Their success at maintaining remarkable stability of real exchange rates contrasts with the severe exchange rate instability in other economies like Argentina which repeatedly attempted to use the exchange rate as a nominal anchor against high inflation but failed as other macroeconomic fundamentals were not kept in line, leading to the collapse of the real exchange rate and sharp real devaluations. In contrast, these economies' pragmatic macroeconomic management enabled them to avoid swings of the real exchange rate, even in the face of major external shocks.

A reputation for macroeconomic stability is quite valuable and it is very costly to lose it. When earnings boom increase public spending, failure to cut back when such revenues fall would result in huge deficits, heavy external borrowing, a full-blown debt crisis, real exchange rate appreciation, and the collapse of investment and growth. So, correcting the mismanagement quickly would avoid turning on a couple of years' delay in adjustment. Low or moderate inflation for long periods provides a favorable environment for growth. High inflation is inevitably unstable and it reduces the efficiency of investment, discourages private investment, and reduces growth. Because real interest rates become negative, depreciations of the exchange rate lag behind inflation and real appreciations take place. As real tax collections lag inflation, the fiscal problem is intensified and public savings reduced by inflation. The real interest rate and the real exchange rate stability are crucial at guiding resource allocation more effectively (World Bank 1993). Hence, microeconomic stability is essential. Similarly, sudden reductions in aggregate demand and in investment compelled by debt crises have been the major causes of the sharp declines in growth rates, which means that fiscal and foreign borrowing prudence is imperative for sustained growth. Although macroeconomic stability and prompt responses to macroeconomic shocks were not the whole story of the success, these factors created a basis from which policies intended to affect the real economy-the supply side-could be launched in an environment of stable real interest and exchange rates, facilitating realistic and, in some cases, even undervalued exchange rates.

LESSONS DRAWN FROM THE ASIAN CRISIS

The South-East Asian economies enjoyed high economic and export growth, macroeconomic stability, and social achievements supported by: strong macroeconomic fundamentals including price and exchange rate stability, fiscal balance, and manageable BOP positions. The export-oriented industrial growth, and liberal and open foreign participation in domestic markets, with the capital account largely open to foreign capital flows, though some sectors remained closed or had limited foreign participation. As capital inflows surged, the governments intervened in the exchange markets to sterilize the inflows with the objective of curbing their adverse macroeconomic and inflationary implications. Despite these efforts, both financial and property markets came under mounting price pressure.

The policymakers and the private sector in the region indulged in higher and riskier investment and reckless offshore short-term borrowings, as they were over-confident of their success. This eventually led to over-exposure of the fragile and under-regulated financial system whose integration deepened with the growing globalization and the regional economic linkages across the trade and banking sectors. Despite the common characteristics (i.e., stable macroeconomic conditions, high growth, large capital inflows, and domestic asset price inflation), the dimensions and causes of crisis at each country level varied. Some argue that the crisis was triggered by the weaknesses of the financial systems owing to the rising imprudent lending and borrowing stemming from weak risk assessment and over-exposure to various sectors and industries with an emphasis on short-term private borrowing. Others attribute the crisis to the contagion effect and the financial panic. The subsequent capital outflows contributed to undermining the Asian currencies that depreciated significantly. This revealed the structural deficiencies of the financial and other sectors in these countries. (http://www.adb.org/Documents/Speeches/1999/ms1999033.asp).

Although high growth was sustained for almost a decade, during most of which fiscal balances were in order, monetary expansion was not excessive and inflation was generally under control, the exaggerated expansion of investment in 'non-tradables' like construction and property boom fuelled by financial sector favoring such short-term investments exacerbated current account deficits. The over-investment of investible funds, especially from abroad, in "non-tradables" only made things worse, especially for the current account. Only a small proportion of commercial bank and other lending went to manufacturing, agriculture, mining and other productive activities. The percentage is likely to be even smaller with foreign borrowing, most of which had been collateralized with assets such as real estate and share prices. Although widespread in East Asia, the property-finance nexus was particularly strong in Thailand, which made it much more vulnerable to the inevitable bursting of the bubble. Insofar as such investments did not contribute to increased production of "tradables", they actually exacerbated the current account deficit, rather than alleviated it, as they were thought to be doing. This, in turn, worsened the problem of "currency mismatch" with borrowings in US dollars invested in activities not generating foreign exchange. Insofar as a high proportion of these foreign borrowings were short term in nature and were deployed to finance medium to long-term projects, an additional 'term mismatch' problem also arose. Though the foreign exchange risk of investments generally increased, there was strong stake in defending the currency peg regardless of its adverse consequences for the economy (Jomo 1998).

The explosion of the crisis can be laid squarely on the financial panic of international and domestic investors suddenly concerned about the fate of their portfolios. But the buildup of structural vulnerabilities-sharp rises in short-term debt that far exceeded international reserves, a financial sector that had poorly intermediated international inflows and found itself saddled with huge mismatches between assets and liabilities, and corporations massively over-leveraged and exposed to changes in interest and exchange rates-provided the dynamite for the explosion. The collapse of the Thai Baht sparked a regional crisis that reflected in the failure of the affected countries to manage globalization. At the macroeconomic level, increased investment did not lead proportionally to increased growth as the East Asian investment became less productive in the 1990s. The loss of confidence that would reverse capital flows and cause a crisis should be avoided by using the inflows productively so that the resulting assets could service the resulting debt. In this respect, maintaining sound macroeconomic policies with consistency between monetary and exchange rate policies even if external or internal conditions changed is equally important. But during the 1990s, and especially after 1993, the crisis countries increasingly did not meet these conditions, thereby raising the risk of a sudden shift in funds. So, the challenge of managing globalization is to capture its benefits without suffering the high costs of sudden capital reversals or trade shocks. This requires that East Asia put in place macroeconomic and structural policies for capital flows that encourage stability (World Bank 2000).

Thus, the crisis emerged as a combination of accumulation of large short-term foreign debt in the private/corporate sector linked to the maintenance of implicit fixed exchange rate pegs that led to rising and unsustainable external pressures. Structural problems of the under-regulated national financial systems that operated without due diligence and regard to credit and market risk assessments and management were the other factors. Deficient corporate and financial sector governance encouraged excess production capacity in property-related sectors and some manufacturing, most such lending based on over-leveraging and mismatch of currency and term structure of liabilities and cash flows. Legal infrastructure problems, including weak insolvency framework for debtors as well as undefined and not implemented bankruptcy regulations and procedures, helped the process. Similarly, disruptive capital outflows created a liquidity crisis.

Box 2: Corporate Balance Sheets and Macroeconomic Policy

The links between the corporate sector and the macroeconomy are two-way. First, macroeconomic developments can affect the health of the corporate sector, especially if corporations are highly leveraged, that is, if they carry large amounts of debt relative to equity and do business in an environment that does not promote sound corporate governance. Changes in world interest rates and country risk premia can sharply alter the cost of borrowing for corporations burdened by foreign debt. Rapid exchange rate depreciation can increase the debt-servicing costs of firms with large foreign debts, destabilize the corporate sector, and even threaten the viability of many firms. A high level of short-term corporate debt denominated in foreign currency increases the vulnerability of the macroeconomy to exchange rate depreciation and sudden capital outflows. The adverse impact of tight monetary policy and high interest rates, which were used to stem rapid exchange rate depreciation on domestic demand and bank lending, was amplified by high corporate debt and could, therefore, worsen the corporate sector's financial situation. Reversionary tendencies at the global level hurt the export sector considerably.

Second, the corporate sector could also affect the macroeconomy. The restructuring of over-leveraged corporations struggling to stay afloat financially can magnify an economic downturn by triggering the rapid disposal of assets at very low prices and prompting large investment contractions. A squeeze on credit to corporations arising from a shortfall of bank capital can force governments to divert their fiscal resources to bank recapitalization. If the corporate sector is tipped into insolvency, lower investment and the prolonged period needed for corporate restructuring can significantly impair growth. Evidence from microeconomic analysis of Asian corporations showed that many were in a very weak financial condition before the crisis. But this information was not condensed and integrated into macroeconomic analysis in a way that would identify potentially serious macroeconomic consequences of, and risks from, such vulnerability.

The experience of South-East Asia shows that operational tools can be used to shed light on the links between corporate sector balance sheets and macroeconomic developments. The refinement of these tools should help policymakers design and introduce policies, both short-term and longer-term, that can reduce the risk of crisis and destabilization. Such policies include better insolvency frameworks, improved corporate governance, better asset-liability and risk management, policies on short-term capital flows, and other preventive policies at the micro and macro levels (IMF September 1999). Applying these tools to accurate and timely data can help policymakers assess corporate sector vulnerability before a crisis emerges and formulate policies to reduce the risks of a serious crisis, as well as resolve problems brought about by excessive corporate leverage.

The proliferation and frequency of currency crisis intensified the debate on the question of appropriate exchange rate policy and its management. Macroeconomic and exchange rate management required to be made sound as the rigid fixed exchange rate and tight monetary policy became incompatible. The pursuance of the fixed or crawling peg exchange rate to promote exports along with tight monetary policy to clamp down inflation served well to promote export and economic growth, foreign exchange reserve accumulation, and technological innovation and other gains. However, maintaining twin objectives of price cum exchange rate stability through fixed pegged rates and tight monetary policy created distortions. Interest rate pressures were generated as the governments maneuvered to curb the expansion in domestic and foreign assets, stemming partly from capital inflows, to maintain money supply within manageable levels. The central bank launched massive sterilization efforts to control the growth in monetary base, but absorbing the cost of these operations became unsustainable. The high interest rates and fixed exchange rates, in the absence of regulations, led private sector to borrow abroad on a short-term basis at relatively low international rates to finance domestic investments, which led to the accumulation of un-hedged foreign currency liabilities. After the crisis, with the exception of Malaysia, all economies switched to floating exchange rates. The crisis reconfirmed the inherent incompatibility of fixed exchange rate and the tight monetary policy and its inherent dangers and costs to the economy.

Traditional norms and practice in foreign reserve management have placed excessive emphasis on determining the adequacy of foreign exchange reserves based on a country's import requirements. However, the swift depletion of reserves used to defend the currencies during speculative attacks in 1997 underscored the need for emerging market economies to maintain larger levels of foreign exchange reserves as a buffer against speculative attacks, or other external shocks. Prudential foreign reserve levels for countries with open capital accounts and substantial capital inflows should be measured on the basis of a broader set of criteria that include, beyond import requirements, the cushion for short-term and volatile foreign currency obligations and debt service capacity indicators.

Theoretically, global capital mobility is advocated on grounds of increased efficiency and welfare by promoting allocation of world savings and specialization to the most productive investment opportunities; foreign resource mobilization for capital deficit economies; pooling of risks, while providing investors opportunities to exploit higher returns across the borders; and capital market integration and technological change. However, unfettered and free global capital mobility carries some risks including exposing fragile economies to the volatility of short-term speculative attacks. On balance, it is well established that benefits of global capital mobility outweigh the costs or risks. To minimize such costs and risks, greater attention needs to be devoted to encourage orderly and proper sequencing of capital account liberalization.

In these economies, the capital accounts were liberalized but without the supportive macroeconomic fundamentals and prudential regulations and safeguards for financial institutions and corporate sector to monitor risk exposures. Generally, there existed no mechanism in place to assess the composition of capital inflows, in particular, the assessment of sustainable and manageable levels of short-term debt; risks associated with sterilization operations needed to neutralize the effects of capital inflows on the monetary base; financial institutions and corporate sector credit exposure of short-term foreign borrowing and its servicing; and risks of misalignment of exchange rate systems with capital flows. As the capital inflows put pressure on exchange rates to appreciate in real terms, export growth would be affected. This experience reconfirmed that pace and sequencing of capital account liberalization is critical. While early liberalization of long-term inflows and other trade flows is key, the short-term capital inflow liberalization needs to be sequenced with sound macroeconomic fundamentals and prudential regulatory safeguards in the financial sector. (http://www.adb.org/Documents/Speeches /1999/ms1999033.asp).

So, a big challenge is to design and establish a framework for international financial markets that will put the enormous potential of private investment capital to use while, at the same time, limiting the inherent risks. Today, private investment capital is indispensable, both in terms of volume and sophistication, for promoting development and growth and for creating jobs. To avoid the devastating impact that financial and currency crises would have on the affected economies and on the people, the need to reform and strengthen the international financial architecture, especially through increased transparency of economic and financial data among the countries, is quite high (http://www.imf.org/external/np/speeches/ 2002/062102.htm). The crisis prevention initiatives to address the vulnerabilities linked to volatile private capital flows, weaknesses in banking and corporate sectors, and contagion revealed by the financial crises are the enhanced surveillance of capital markets and assessments of external vulnerability, implementing standards and codes, pursuing financial sector assessment program, and improving transparency (http://www.imf.org/external/ np/speeches/2002/ 052602.htm).

STRENGTHENING MACROECONOMIC POLICIES

There is no doubt that high priority should be given to consolidating macroeconomic stability and strengthening competitiveness through implementation of sound fiscal, monetary, and exchange rate policies. On fiscal policy, there will be a need to enhance tax efficiency and improve collection through various measures, including reorienting the tax system from foreign trade taxes toward broad-based domestic consumption taxes, curbing tax exemptions, and revamping revenue administration. Strengthening expenditure management systems and strictly limiting the overall government borrowing from the banking system is essential. Concurrently, monetary policy should seek to regulate the growth of the money supply to keep price uncertainty in check. Reliance on indirect monetary instruments and ensuring that interest rates are freely determined by market forces are important as is the increased exchange rate flexibility. Sustaining competitive real exchange rates to facilitate the integration into the global economy, attract investment, and foster export diversification and growth is essential (IMF December 2001).

There is need to create an international financial system in the 21st century that recognizes the new realities of open, not sheltered, economies; international, not national, capital markets; and global, not local, competition. The expansion of trade has now become the centerpiece for a strategy to promote sustained global growth and truly shared prosperity. Advanced countries need to open up their markets and phase out the large business of trade-distorting subsidies and the developing countries need to get rid of barriers among themselves (IMF April 20, 2002). This calls for strong leadership of the advanced industrial countries, by taking action to strengthen the prospects for sustained growth in their own economies and through leading by example in the effort to make globalization work for the benefit of all. There is a need to give as much attention to risks and vulnerabilities arising in the advanced countries as to the problems in emerging markets and developing countries (IMF July 8, 2002).

What are needed at the domestic level are vigilance and a firm policy hand to make the economy robust and more dynamic. This means the main policy forms must shift from short-term considerations to tackling decisively underlying problems. Special attention must be paid to preventing the reemergence of the fiscal and external deficits. This requires firm control over public spending and a long-term strategy to increase national saving. The economy must endeavor to reduce the instability and imbalance associated with the various macroeconomic aggregates through the disposal of non-performing loans (NPL), industrial deregulation, and restructuring of the banking and corporate sectors. Countries with sound fiscal and monetary policies and persistent with structural reforms could weather the storm better than others and have demonstrated that it is possible to decouple from contagion. Good policies always pay off in addition to improving the outlook of the global economy and international financial system (IMF April 29, 2002).

But the persistent vulnerabilities in a number of countries leave no room for complacency. Protracted external borrowing to finance public consumption, without generating sufficient external revenues, breeds disaster. There is a more general point: the expansion of global capital markets needs to be better anchored with stronger trade integration and the growth in debtor countries. The degree of trade openness of developing countries as a group should match their integration into global capital markets. Latin America's external vulnerability is higher than that of other emerging market economies because the former is relatively more integrated into global capital markets while, at the same time, they have not managed to raise the share of their exports in GDP in line with their increased external borrowing. If we understand crisis prevention as tackling the causes of crises, we need to view this imbalance as a fundamental problem. We need more integration of economies to foster growth in the economy, not least to fight poverty. But there is need to manage a better balance between the opening of capital account and the expansion of trade, to reduce the cyclical recurrence of financial crises.

This means that better trade opportunities for all and the expansion of trade must now become the centerpiece for a strategy to promote sustained growth and prosperity. The advanced countries have a main responsibility of opening up their markets and phasing out the trade-distorting subsidies. It is essential to have leadership to face and withstand the special interests of some groups for the benefit of the broad majority of the people in both rich and poor countries. But the leaders in the developing countries should be equally ambitious in getting rid of barriers to trade among themselves. Learning from experience and adapting to changes in the global economy along with focusing on macroeconomic stability and sustainable growth have become most important. To this end, concentrating increasingly on the soundness of financial sector and enhancing transparency and openness in the policy formulation and its practice has become most important. Focusing better on priorities and giving more room to ownership of reforms by the country itself is similarly important. Sound institutions and good governance are crucial for continued growth and financial stability. To resolve homegrown problems, no money in the world can substitute for self-responsibility and political commitment and unity in a society.

A well-functioning market economy is absolutely essential as it draws its strength and dynamism from competition. Good policies always pay off. It has to be accepted that some degree of overshooting and correction will always be part of the process if we want to preserve a system which continuously seeks for better results, based on freedom of choice and self responsibility. And there are limits to the ability to predict and thereby prevent crises. The objective can only be fewer and less severe crises. Concentrating more on vulnerabilities and risks, on seeking improvements in the quality and timeliness of data, and on promoting standards and codes, as "rules of the game", are most essential. Strengthening shock absorbers that make the economy more resilient to adverse external developments is crucial which points to the significance of more flexible exchange rate regimes, prudent fiscal policies, and stronger, deeper and more diversified financial systems.

Taking early action to address emerging problems and imbalances is necessary to reduce risks and vulnerabilities to the economy. Promoting standards and codes, including on corporate governance and accounting principles, along with building positive public-private partnership and dialogue become significant. Implementation of measures for strengthening the self-correcting mechanisms of markets and effective self-regulation and restraint are essential. It is an indispensable principle that debtors and private creditors must bear the responsibility for the risks they take. A clear and predictable economic environment is needed to enable investors to price risks adequately. Debt sustainability is also a major issue in this respect. There is need for better incentives and tools to allow for a timelier, orderly, and less costly restructuring of unsustainable debt.

There is wide agreement on the kind of macroeconomic and financial policies governments need to adopt to reduce vulnerability to policy-induced crises or adverse external shocks. They should avoid profligate fiscal and monetary policies, overvalued exchange rates, and unsustainable current account deficits. Triggered by weak banking systems and weak financial regulation in a world of large and volatile international capital flows, banking crises have been more numerous, especially in the 1990s. For example, the build-up of structural vulnerabilities, viz., (i) sharply rising short-term debt that far exceeded international reserves, (ii) a financial sector that had done a poor job of intermediating capital inflows and found itself saddled with hugely mismatched assets and liabilities, and (iii) corporations that were massively over-leveraged and exposed to interest and exchange rate fluctuations, suddenly created the financial panic among domestic and international investors that unfolded in the 1997 crisis in Thailand. Therefore, to prevent financial crises, governments need to improve the prudential regulation and supervision of financial intermediaries, introduce new standards for data dissemination, and implement corporate bankruptcy reform. These measures are already under way in many developing countries, but there is still a long way to go. Actions at the national level may not be enough to prevent economy-wide crises. Domestic actions will have to be complemented by actions at the international level to contribute to foster global financial stability (World Bank 2000/01).

There is need for policymakers to achieve progress toward reducing economic imbalances, restructuring economic policies especially in developing countries, and reducing the net transfer of financial resources from developing countries. Various steps are needed to enhance growth prospects and reduce the risks of further instability in the financial market and possibly slowdown in economic activity. The first is credible action to reduce large budget deficits, as this is essential to bring about a lasting reduction in the country's current account deficit and to lower real interest rates. To correct growing current account imbalances in the world economy, countries with surplus current accounts need to adopt appropriate macroeconomic and structural policies to maintain the growth of domestic demand. Although judging the appropriate stance of macroeconomic policy will be unavoidably difficult in the climate of economic uncertainty, concerted and credible change would help reduce the rising current account imbalances, lessen the risks of a recession, and stabilize exchange rates, ultimately expediting economic growth. Reducing barriers to trade is also essential in this regard.

The key to faster growth and better export performance is the more efficient use of domestic resources in both the public and private sectors. Macroeconomic stabilization needs to be supported by sectoral policy reform in trade, agriculture, industry, energy, and human resources. This affects the use of public resources directly and influences the use of private resources through improved incentives of taxes, subsidies, and regulation. Countries with relatively sound economic policies would be able to avoid major debt problems. The structural adjustment would, therefore, help raise economic growth by improving the economies' supply response.

Capital inflows from official and commercial sources can help to finance new productive capacity and provide support for policy reform and growth. This has been the rationale for the BOP support provided by the IMF and the World Bank. Favorable prices for developing country exports and unimpeded access to growing markets in industrial countries can sharply strengthen the effectiveness of both domestic policy and external finance. Long-term solvency depends directly on the cost of debt. A simple rule of thumb is that if the real interest rate exceeds the rate of growth of exports, the debt service ratio will tend to rise. Conversely, lower interest rates can significantly reduce the debt service burden over time.

Economic policies in the industrial countries - especially the stance of U.S. fiscal and monetary policy - determine interest rates worldwide. A return to low and stable interest rates would significantly improve the prospect of a gradual release from the debt overhangs. So, excessive fiscal deficits and the resulting financing requirements of the public sector have often been at the root of macroeconomic imbalances. Bringing expenditures more closely in line with revenues to ensure that the resulting deficits are consistent with other macroeconomic policies and objectives is an essential element of improving the quality of government. The goal is to raise additional revenue in the most cost effective way and to cut spending, where necessary, in the least damaging way (World Bank 1988).

AREAS FOR IMPROVEMENT

To promote a strong and sustained world economic recovery, monetary policies should remain broadly supportive of growth while keeping inflation under control. Reforms should be pursued vigorously, with the aim of improving economic flexibility and resilience, contributing to high and sustainable growth, and supporting the orderly reduction of persistent imbalances in the global economy. The recovery in industrial countries based on decisive action to reform the banking and corporate sectors, sustained progress with wide-ranging reforms to enhance the growth potential and focusing on the efforts needed over the medium-term to preserve fiscal balance will contribute to supporting activity in emerging market and developing countries. Many emerging market economies have become more resilient through the adoption of sound economic policies, including more sustainable exchange rate regimes. It will, nevertheless, remain essential to further strengthen fiscal positions and to press ahead with corporate, financial, and institutional reforms to support the emerging recovery and attract foreign direct investment (FDI). For problem emerging economies, it is urgently needed to move ahead with a sustainable economic program that would continue to receive the support of the international financial institutions and provide the basis for the establishment of stability and growth on a sustainable basis.

The commitment of the international community to improve living standards and reduce poverty through sound policies and higher and more effective aid especially for accomplishing the millennium development goals is encouraging. In this regard, strong domestic ownership, sound policies, strengthened institutions, and improved governance are most important. The overall importance of more open trade for a durable economic recovery and for sustained, broad-based growth in the developing countries in particular needs no emphasis. There is need to resist protectionist pressures and to continue to lower trade barriers, enlarge market access for developing countries and phasing out trade distorting subsidies under the WTO framework. Promoting sound economic growth, achieving economic and financial stability and preventing crises should be the focus of the policies. In this respect, strengthened assessments of vulnerabilities, with particular attention to debt sustainability and the private sector's balance sheet exposure, remain critical.

Appropriate and proactive macroeconomic policies support economic recovery. There is an ongoing responsibility to implement sound macroeconomic policies and structural reforms to sustain recovery and support strengthened productivity growth in the economy. Building on improved economic policies, many emerging markets and developing economies are also now showing clear signs of recovery. Better availability and clarity of information furnished to markets have enabled market participants to better assess and differentiate across economies the fundamental causes of market developments.

Helping developing countries strengthen the conditions for growth, poverty reduction, and debt sustainability is important. Ensuring macroeconomic stability, promoting the transparency of public finances, strengthening tax collection, and adopting appropriate policies (including debt management policies) to ensure that debt levels are sustainable becomes urgent. Implementing growth-promoting structural reforms, maintaining open trade regimes, and creating a favorable investment climate to encourage the growth of industries is important. Targeting scarce resources to priority social services, including by ensuring the adequate provision of health and education services, providing more concessional financial support as well as debt restructuring or debt relief where needed, in conjunction with strong reform program so that resources are well used, and increased access to industrial countries' markets and promotion of direct investment become necessary. (IMF April 29, 2002).

Policymakers' records in recent years give reason to believe that the risks of not getting the right policies have reduced over the years as evident from the fact that economic downturns overall have become less marked over the past 15-20 years, thanks partly to better monetary policies and, possibly, to better fiscal policies. Countries that reduced vulnerabilities, for example, by moving to more flexible exchange rates tended to weather the storm better than countries with less flexible markets and a weaker macroeconomic policy framework. As the recovery picks up steam, industrial countries would need to balance the risks of inflation against the fragility of the recovery when conducting their monetary policy. Short-term real interest rates are very low and can not be sustained indefinitely at these levels without generating inflation. One of the recent lessons is that if attention is paid to the economy and the medium-term structural issues are taken care of during the good times, it puts the economy in a much better position to weather downturns.

What the financial crises in Asia and elsewhere have also shown is that economic openness is not enough. Sound and transparent macroeconomic policies, a stable and rational regulatory and incentive framework, robust financial systems accompanied by effective supervision mechanisms, and good governance in the public and private sectors are also required if countries are to take full advantage of globalization so as to prevent the crises that have struck some emerging countries. What the countries need is a reform strategy designed to improve resource allocation and create institutions suitable for accelerated growth. The first pillar of this strategy is maintaining sound macroeconomic policies to contain inflation and avoid a recurrence of BOP difficulties (IMF December 2001).

The crises that shook Mexico in 1994-95 and East Asia in 1997-98 came as a stark reminder that economic fundamentals-sound national macroeconomic and structural policies and a sound and properly regulated financial system-were as critical as ever. The crises that erupted in Russia in 1998, Brazil in l998-99, and Turkey and Argentina in 2001 also underscored the importance of rethinking the international financial architecture to ensure a smoothly functioning and orderly international financial system, maximize the benefits of globalization for all countries, and prevent financial crises or manage them effectively if they do occur.

Reform of the international financial architecture is being undertaken on several fronts. The main elements are:

- Promotion of transparency, accountability, and good governance, which, by fostering broad discussion of economic policies and improving the provision of information to markets, can help countries bolster their economic performance;
- Adoption of international standards and codes, which provide benchmarks against which to assess the performance of individual countries;
- Strengthening of financial systems, which contribute significantly to domestic and international financial intermediation, helping to mobilize savings and channel them efficiently to productive investments;
- Orderly capital account liberalization through careful management and sequencing so that countries are able to benefit from open capital transactions while minimizing the risks of sudden capital movements;
- Implementation of sustainable exchange regimes, which are critical to macroeconomic stability and competitiveness;
- Development of modalities for the involvement of the private sector in forestalling and resolving crises; and
- Reform of the IMF's non-concessional lending facilities to focus more on crisis prevention and to ensure more effective use of IMF resources;

These initiatives for a new international financial architecture are complemented by initiatives focusing on debt relief and poverty reduction for low-income countries. To the extent that the international financial architecture is a force for macroeconomic stability, it also contributes to growth, which is crucial to efforts to fight poverty. To address the problems of poverty and high debt levels more effectively, the IMF in 1996 launched the Heavily Indebted Poor Countries (HIPC) Debt Initiative jointly with the World Bank.

In September 1999, the objectives of the IMF's concessional lending were broadened to include an explicit focus on poverty reduction in the context of a growth-oriented strategy. Reflecting the new objectives and procedures, the IMF established the Poverty Reduction and Growth Facility (PRGF), to be based on the Poverty Reduction Strategy Paper (PRSP), to replace the Enhanced Structural Adjustment Facility (ESAF). Key macroeconomic policies, including targets for growth and inflation, and the thrust of fiscal, monetary, and external policies, as well as structural policies to accelerate growth, are subjects for public consultation. Key social and sectoral programs and structural reforms aimed at poverty reduction and growth are to be identified and prioritized during the participatory PRSP process, and their budgetary impact costed taking into account the need for efficient, well-targeted spending.

The bottom-up approach to costing is to be reflected in the design of the macroeconomic framework, including the level and composition of government expenditures, and the fiscal and external deficits. The authorities need to take into account effects on domestic demand, implementation capacity, and the need to maintain an adequate level of international reserves. They need to ensure that spending programs can be financed in a sustainable, non-inflationary manner. PRGF-supported programs also focus on improvements in governance as a fundamental underpinning for macroeconomic stability, sustainable growth, and poverty reduction. The primary focus is on improving the management of public resources, achieving greater transparency, enhancing active public scrutiny, and promoting increased government accountability in fiscal management (http://www.imf.org/external/np/exr/facts/prgf.htm).

The crises in international financial markets highlighted three areas in which improvement is needed. First, there must be enhanced efforts to identify incipient vulnerabilities in national and international financial systems. Moreover, there should be concerted procedures to understand better the sources of systemic risk and to formulate effective financial, regulatory, and supervisory policies to mitigate them. Second, there should be more effective procedures to ensure that international rules and standards of best practice are developed and implemented, and that gaps in such standards are effectively identified and filled. Third, there should be improved arrangements that apply across all significant financial institutions, and that there are procedures to ensure the continuous flow of information among the authorities responsible for financial stability.

The crises have underscored the importance of assessing domestic vulnerabilities in the light of evolving global conditions, as well as of relaying such assessments to concerned stakeholders to forestall delays in correcting inadequate structures and destabilizing trends. The potential risks posed to the world economy by financial market problems and the threat of chain reactions, or "contagion," in the financial sector can not be undermined. These trends and developments have demonstrated the importance of mitigating systemic risk by better understanding and more effectively alleviating the factors that bear on it. Disabling shocks to the global financial system may arise from a variety of factors and circumstances, including macroeconomic weaknesses, the collapse of major institutions, and weaknesses in the infrastructure that underpins and connects financial systems. The answer lies in transparency, close monitoring, and, if necessary, coherent and appropriate action to forestall accelerating adverse developments. (IMF September 1999)

The South-East Asian countries have achieved progress since the 1997-98 crisis though problems in the corporate and financial sectors still linger. It is worth noting that the signs of economic recovery have since been quite evident, with the real GDP growth turning positive, BOP pressures easing and external current account deficits turning into surpluses, private consumption and exports rebounding, inflation, exchange rates, and prices stabilizing; and the stock market indices reaching or surpassing the pre-crisis levels. The economies made progress on sound macroeconomic framework, which contributed to price stability, a reduction in external vulnerability, and the rebuilding of reserves. The expansionary fiscal policy stance helped cushion the impact of the global slowdown and fiscal consolidation was the necessity to reduce the high level of public debt. The effectiveness and credibility of fiscal policy would be boosted by increased transparency. The table below shows the real GDP of the crisis-hit countries during 1997-2000, before 2001 when the world economy itself witnessed economic slowdown, and since 2002.

Table 2. South-East Asian GDP Growth

	Real GDP Growth Percent							
	1997	1998	1999	2000	2001	2002	2003	2004
Indonesia	4.5	-13.1	0.8	4.9	3.4	3.7	3.5	4.0
Korea	5.0	-6.7	10.9	9.3	3.1	6.3	2.5	4.7
Malaysia	7.3	-7.4	6.1	8.6	0.3	4.1	4.2	5.3
Philippines	5.2	-0.6	3.4	4.4	4.5	4.4	4.0	4.0
Thailand	-1.4	-10.5	4.4	4.6	1.9	5.3	5.0	5.1
Singapore	8.5	-0.9	6.4	9.4	-2.4	2.2	0.5	4.2

Source: IMF (September 2003).

In assessing the appropriate stance of policies, policymakers need to take account of the risks and costs related to the uncertainties of the forecast, within a longer-term policy framework that is consistent with a gradual reduction in the imbalances in the economy over time. Macroeconomic policies in most industrial countries should remain broadly supportive of activity, although in countries where the recovery is most advanced, attention will need to turn toward reversing earlier monetary policy easing. Aggressive action to address deflation is also required. The medium-term policy framework needs to be geared toward supporting sustainable growth and an orderly reduction in the global imbalances. As experience during the downturn has shown, it remains essential to press ahead with efforts to reduce vulnerabilities and maximize the scope for policy flexibility in response to external shocks, especially though fiscal consolidation. To address the structural problems that continue to place a damper on current conditions and the outlook and catalyze the strength and robustness of growth in the period ahead, progress with reforms are needed to strengthen financial and corporate sectors, improve fiscal positions, and boost international and domestic confidence in the emerging economies (IMF April 2002).

World economic recovery is ongoing, with the global output growth in 2003 estimated at 3.2 percent and in 2004 at 4.1 percent (IMF September 2003). While the outlook is positive, policymakers need to remain alert to several possible risks and global imbalances, high corporate and consumer debt, and other non-economic events. Despite that the recovery in the global economy has been underway, there are still uncertainties and risks overcoming which will require a shift in focus from short-term considerations, to tackling decisively the underlying economic and financial imbalances, and implementing sound fiscal and monetary policies and structural reforms. With the pace and robustness of the global recovery still unclear, and inflationary pressures low, monetary policies should remain accommodative for the time being. Fiscal policies need to focus on medium-term consideration. There also must be confidence that the international environment will hold opportunities for countries committed to reform. Trade liberalization is also an important element in crisis avoidance-the experience of Latin America where trade links have lagged behind capital market links illustrates this vividly. Resisting pressures for protectionism is key to strengthening confidence about the future prospects for strong global growth and shared prosperity in the world. Improving further the capacities for crisis prevention and management will also be crucial for sustaining global growth. The role of sound institutions and good governance for sustained growth and financial stability is indispensable. Strengthening surveillance and crisis prevention should always be the first line of defense in dealing with external shocks and vulnerabilities (http://www.imf.org/external/np/speeches/2002/070402.htm).

Participating in the Report on the Observance of Standards and Codes (ROSCs) process and the Financial Sector Assessment Program (FSAP) could help the authorities chart the path ahead and send an unambiguous signal to markets of the commitment to transparency, good governance, and reform. The low inflation, the ongoing recovery, the comfortable reserve level, and the large output gap allow the economies to maintain a bias toward easing. The policymakers need to remain vigilant with regard to the global outlook as well as important medium-and long-term challenges that should be addressed through the acceleration of reforms in the corporate and banking sectors and continued progress in addressing restructuring issues. Corporate and banking sector problems remain an obstacle to sustained economic recovery as there is still overcapacity in many sectors and leverage remains high, requiring stepped-up actions to restructure and reduce corporate debt and efforts to strengthen the financial sector health in order to foster economic growth. Action to remove obstacles for creditors to initiate bankruptcy proceedings and to insist on liquidation in the event of a failed rehabilitation is also necessary (IMF August 29, 2002). Early warning signals are critical to reduce the likelihood of crisis and to take effective and timely steps for crisis response and its management. Sound macroeconomic management is a vital preventive measure, which should focus on avoiding, among others, excessive domestic credit growth, overvaluation of currencies, and large external imbalances with excessive dependence on short-term capital flows relative to foreign exchange reserves. Also, vitally important are developing resilient and robust financial systems; encouraging financial discipline in corporate sector with sustainable debt/equity ratios supported by good corporate governance, credible accounting, auditing and disclosure standards; and adopting viable and credible exchange rate management.

CODE OF GOOD PRACTICES ON TRANSPARENCY

Learning from the experiences where inadequate reporting of macroeconomic and financial data contributed to the build-up of financial imbalances and uncertainty that prompted investor panic, the international fora are encouraging higher disclosure, transparency and development of codes of conduct to guide investors to efficient and productive resource allocation. For improving the macroeconomic management and financial sector soundness, international standards of good practices for economic policies and for the financial infrastructure have been devised (Appendix II). The standards cover macroeconomic policy and data transparency (monetary and financial policy transparency, fiscal policy transparency and data dissemination). The Code of good practices along with the establishment of Special Data Dissemination Standards (SDDS) and General Data Dissemination System (GDDS) are intended to improve information availability and accuracy for risk assessments which will together help present reliable information on member countries on comparable basis (http://www.adb.org/Documents/Speeches/1999/ms1999033.asp). The international standards of good practices also cover institutional and market infrastructure (insolvency, corporate governance, accounting, auditing, payment and settlement, and anti-money laundering/combating the financing of terrorism) and financial regulation and supervision (banking supervision, securities regulations, and insurance supervision). Accordingly, in the context of strengthening the architecture of the international monetary and financial system, the Code of transparency practices for monetary and financial policies identifies desirable transparency practices for central banks in their conduct of monetary policy and for central banks and other financial agencies in their conduct of financial policies. The transparency practices listed in the Code focus on: (a) clarity of roles, responsibilities and objectives of central banks and financial agencies; (b) the processes for formulating and reporting of monetary policy decisions by the central bank and of financial policies by financial agencies; (c) public availability of information on monetary and financial policies; and (d) accountability and assurances of integrity by the central bank and financial agencies. By enabling market participants and the general public to understand and evaluate financial policies, transparency is likely to be conducive to good policy-making

Monetary and financial policies are interrelated and often mutually reinforcing, with the health of the financial system affecting the conduct of monetary policy and vice versa. However, the institutional arrangements for these two types of policies differ considerably. For some, the emphasis is on market efficiency considerations; for others the focus is on market and systemic stability, while for others the principal consideration is client-asset protection, hence, the two sets of practices. Besides, the operation of a country's payment system affects the conduct of monetary policies and the functioning of the financial system, and the design of payment systems has implications for systemic stability. Although a number of countries currently lack sufficient resources and the institutional capacity to implement all of the good transparency practices listed in the Code, these practices are included in the Code in the anticipation that countries would aspire over time to introduce such good practices.

The Code of good practices on fiscal transparency is also believed to make a major contribution to the cause of good governance. It should lead to better-informed public debate about the design and results of fiscal policy, make governments more accountable for the implementation of fiscal policy, and strengthen credibility and public understanding of macroeconomic policies and choices. In a globalized environment, fiscal transparency is of considerable importance for achieving macroeconomic stability and high-quality growth. However, it is only one aspect of good fiscal management, and attention needs to be paid also on increasing the efficiency of government activity and establishing sound public finances. The IMF being well-placed to take the lead in promoting greater fiscal transparency because of its fiscal management expertise and universal membership, the International Monetary and Finance Committee (IMFC) is, therefore, encouraging IMF member countries to implement the Code of good practices on fiscal transparency. The Code is based around the following key objectives: role and responsibilities in government should be clear; information on government activities should be provided to the public; budget preparation, execution, and reporting should be undertaken in an open manner; and fiscal information should attain widely accepted standards of data quality and be subject to independent assurances of integrity. The Code should also facilitate surveillance of economic policies by country authorities, financial markets, and international institutions. Under financial regulation and supervision, the banking supervision guidelines for the assessment of compliance with the core principles have been set out. The Basel Committee's Core Principles for Effective Banking Supervision have been given in Appendix II.4.

EXCHANGE RATE SYSTEM

One of the key lessons drawn from these experiences is that, for the emerging countries in Asia as well as countries elsewhere with heavy involvement in global financial markets, the policy requirements for maintaining a currency peg have become increasingly demanding. The experience also demonstrates that the costs of a forced exit from a fixed exchange rate regime, after a period of resistance against mounting pressures, can be huge. Against this background, floating exchange rate regimes have become the preferred choice for many emerging market economies that, by definition, have substantial involvement in global financial markets. Of course, this is not to say that, for certain economies, a pegged exchange rate regime, buttressed by the requisite supporting policies and institutions, can not be a viable alternative. First, for floating regimes to function effectively, it is important that exchange rates are allowed to actually move—in both directions—in response to market forces. Only such movements can persuade economic agents to recognize, and to manage prudently, the foreign exchange risks that are inescapable for countries open to global financial markets.

Second, this does not imply a policy of benign neglect toward the exchange rate. For emerging market countries, with their high degree of involvement with global trade and finance, movements in exchange rates have important economic consequences, and economic policies, including monetary policy and exchange market intervention, need to take account of these movements. A more flexible exchange rate regime means a need for an alternative nominal anchor. In this regard, many advanced economies and an increasing number of emerging market economies with flexible exchange rates have moved to formal or informal inflation targeting regimes. Making these efforts successful requires work on several fronts, including: developing an institutional framework that allows for greater central bank independence in the conduct of monetary policy; a strengthened analytical and forecasting framework as a basis for making monetary policy judgments; efforts to strengthen the monetary policy transmission mechanism, including through market-determined interest rates and sound financial institutions making loans on a strictly commercial basis; and greater transparency in explaining the central bank's monetary policy objectives and policy actions to enhance the predictability of those actions and build policy credibility.

Successful inflation targeting—and indeed, any form of sound monetary policy on a sustained basis—is not possible in the face of fiscal dominance. More generally, the importance of consistent implementation of sound fiscal policy with medium-term debt sustainability has been proven time and again. Though many of the countries have had a tradition of prudent fiscal management and low public debt, several of them have witnessed a significant deterioration in their fiscal balances and increases in debt levels, partly because of the huge needs related to cleaning up of the banking system. Accordingly, putting fiscal policy on a sustainable medium-term path must be a priority (http://www.imf.org/external/np/speeches/2002/052602.htm).

Exchange rate policy has always been central to the macroeconomic management. Ever since the breakdown of the Breton Woods system, there has been a widespread desire to avoid excessive volatility in the exchange rates of the world's major currencies. In a world of highly integrated global capital markets, there is no realistic alternative to floating exchange rates among the major currencies. So, currency misalignments need to be dealt with by concentrating on the fundamentals by accelerating the pace of key structural reforms.

Looking beyond the major currencies, an important conclusion is that no single exchange rate regime is appropriate for all members in all circumstances. A country that is willing to abandon all monetary policy discretion may be able to adopt a hard peg, such as a currency board arrangement. Because this deprives the country of instruments to deal with external shocks, living safely under a hard peg obliges a country to have not only a disciplined fiscal policy, but also particularly sound financial and corporate sectors and considerable wage and price flexibility. As shown tragically in Argentina, when these conditions do not hold, it can be very difficult for a country to arrange a timely exit strategy.

Emerging market countries need to be very cautious about adopting pegged or heavily managed exchange rate systems. When a country is open to international capital flows, the reaction to any hint of unsustainable macroeconomic policies can be swift and severe. And a country considering an exchange rate peg needs to be fully aware of the associated costs, including the possibility that extraordinarily high interest rates might be required at times of severe financial market pressure. Especially, its domestic financial institutions and businesses must be well prepared to live with such policy adjustments. Where there is doubt that these requirements will be met, a flexible exchange rate regime is a better choice.

For other developing countries, there is, in principle, a wider range of choice in exchange rate regime, provided these are backed by the appropriate macroeconomic and structural policies. And very few countries, advanced or developing, are indifferent to the behavior of their exchange rates. But on balance, floating exchange rates are seen as the safest solution for a wide range of countries. Unfortunately, this has the disadvantage of leaving the public and markets without a clear anchor, which can make a country vulnerable to accelerating inflation in response to domestic or external shocks.

Several countries with floating exchange rate systems, as a way to anchor inflation expectations, have adopted inflation targeting. Many other countries are actively considering this possibility. After a decade of experience, inflation-targeting regimes are in action through all phases of the business cycle. For countries that are considering the adoption of inflation targeting, the keys to success are transparency and credibility. Once a political decision has been taken to make the inflation target the primary objective of monetary policy, it is crucial for the monetary authorities to keep the public regularly informed about their actions to meet that objective and the basis for the judgments that they make. Perhaps even more than other monetary regimes, inflation targeting obliges the central bank to safeguard its credibility in pursuing the inflation goal. For this reason, inflation targeters are almost invariably countries in which the central bank has a high degree of operational independence. But it is also important to avoid a deflationary bias, which would impose unnecessary costs on society and risk undermining the political basis for the inflation targeting regime and the independence of the central bank.

In preparing for inflation targeting, most countries have adopted an existing, well-known price index as the target, generally the national consumer price index, and they have used a selection of available data series in forecasting inflation and assessing the effects of monetary policy. Moving forward, it will be important to explore whether this is the most appropriate index to target, whether some components of the CPI should be systematically excluded or added to the index, and what new statistics might be needed for related analysis and forecasting.

For countries with inflation targeting regimes, forward-looking indicators such as stock indices, real estate prices, and derivatives yields provide crucial information for assessing the appropriateness of monetary policy. This type of data is also important for promoting stability of domestic and international capital markets. While such information is generally produced by markets or private firms, there might be a role for the public sector-either in collecting these statistics, setting standards or guidelines, or at least encouraging full disclosure of the methodology that was used to assemble the data (http://www.imf.org/external/np/speeches/2002/022802.htm).

EXCHANGE RATE AND CAPITAL ACCOUNT REGIMES

Every major financial crisis since Mexico's in 1994 has in some way involved a fixed or pegged exchange rate regime. Countries without pegged rates, among them Mexico in 1984, South Africa and Israel in 1998, and Turkey in 1998, have certainly suffered from international capital market disturbances, but to nothing like the same degree as those with soft pegs. No wonder then that many have been arguing that the intermediate regimes that lie between hard pegs (currency boards, or membership of a currency union) and floating rates are not generally sustainable in countries open to international capital flows. The fundamental reason for this is the famous "impossible trinity" of Robert Mundell that, among a fixed exchange rate, capital mobility, and a monetary policy dedicated to domestic goals, a country can only have two out of three over a sustained period.

While a floating exchange rate regime reduces the risk of external crises, it is not sufficient to prevent them, for a crisis can also be caused by adverse external debt dynamics or a loss of domestic fiscal control. Second, in a floating rate regime, it should not be implied that policymakers can or should be indifferent to the exchange rate, nor that they should necessarily totally refrain from intervention in the foreign exchange markets. Changes in the nominal exchange rate affect inflation, and changes in the real exchange rate may have a powerful effect on the allocation of resources. So, it is expected that monetary policy in countries with floating exchange rate systems would respond to movements in the exchange rate. Beyond the use of interest rates, some countries intervene directly from time to time in the foreign exchange markets to try to stabilize the exchange rate. So long as they are not perceived as trying to defend a particular rate, this can be useful.

Once a country begins to float, it has to decide on the monetary policy it will follow. Many recent floaters have opted for inflation targeting under which exchange rate movements are automatically taken into account to the extent that they are expected to affect future inflation. This will generally produce a pattern of monetary tightening when the exchange rate depreciates, a response similar, but not necessarily of the same magnitude, to that which would be undertaken if the exchange rate were being targeted directly. One obvious solution to the impossible trinity is to impose capital controls. However, experience suggests that countries will in the course of their development ultimately want to liberalize the capital account and integrate into global capital markets. It is surely no coincidence that the most advanced economies all have open capital accounts, which implies that as countries develop, they will want to get rid of capital controls. Second, it is important to distinguish between outflows and inflows. For controls on outflows to succeed, they need to be quite extensive. As a country develops, controls are likely to become more distorting and less effective. And controls can not prevent a devaluation if domestic policies are fundamentally inconsistent with maintaining the peg. Policymakers have wisely abandoned fixed exchange rates before capital mobility (http://www.imf.org/external/np/speeches/2001/060010.htm).

No single type of exchange rate regime is appropriate for all countries in all circumstances. It is quite striking, however, that financial crises have invariably been linked, directly or indirectly, with fixed exchange rates. Fixed exchange rate regimes, in combination with insufficiently regulated and supervised banking systems, allow the buildup of speculative bubbles. That is why, a flexible exchange rate regime is a better and safer option, particularly for emerging market countries. Such a regime can function as a safety valve in the event of economic policy slippages. A currency board, if accompanied by disciplined economic policies, may be an option in certain circumstances—to ensure price stability. The European experience with economic and monetary integration may hold lessons for other regions of the world on how economic and monetary stability can be secured (http://www.imf.org/external/np/speeches/2001/040201.htm). The crises in Thailand, Indonesia, Korea, Russia, and Brazil were all associated with exchange rates that had been more or less fixed. This is a powerful evidence suggesting that such systems are crisis-prone. Equally striking is the evidence from other countries like Mexico, Turkey, and South Africa that faced strong financial pressures but whose flexible exchange rates allowed them to mange those pressures far better. So, it is likely that in coming years more countries would adopt flexible exchange rate systems.

In the wake of the Asian crisis, many emerging market countries adopted systems of managed floating though a number of countries still maintain fixed exchange rates. Experience has shown that heavily managed or pegged exchange rate regimes can be tested suddenly by exchange markets, and that it can be very costly either to defend them or to exit under disorderly circumstances. While such regimes can succeed, the requirements for a country to maintain a pegged or heavily managed exchange rate are daunting, especially when the country is strongly engaged with international capital markets. Countries opting for such a system must unwaveringly pursue sound macroeconomic policies and also need to be fully aware of the associated costs, including the possibility that extraordinarily high interest rates might be required at times of severe financial market pressure. Moreover, their domestic financial institutions and businesses must be well prepared to live with such policy adjustments. Where there is doubt that these requirements will be met, a flexible exchange rate regime, one in which the rate moves both up and down in response to market forces, sometimes by significant amounts, is a better choice.

A floating rate system is more forgiving of policy errors and, therefore, a somewhat safer solution for most countries, which, however, does not mean that the authorities would be indifferent to the behavior of the exchange rate. At times, it may be appropriate to adjust monetary policy in response to external developments. With a floating rate, there is no need to risk unsustainable drains on the foreign exchange reserves to defend an exchange rate target. Moreover, a country can pursue a more independent monetary policy, while receiving important signals from the exchange markets about the soundness of its policy framework. However, floating requires an alternative anchor for monetary policy and inflation expectations, such as inflation targeting. Countries can still face difficult choices, especially if they are faced with large swings in international capital flows. Still, the absence of an exchange rate target provides an important, extra degree of freedom for domestic policy management and dealing with external shocks.

A country that is willing to abandon all monetary policy discretion may find it feasible to adopt a hard peg--either through a currency board arrangement or the use of another country's currency. Argentina, Bulgaria, Estonia and Lithuania each escaped from a cycle of chronically high inflation through strategies based on the use of currency boards. Hong Kong has maintained a currency board for two decades. This type of commitment can provide greater credibility than managed floating or an adjustable peg. However, like those regimes, living safely under a hard peg obliges a country to have particularly sound financial and corporate sectors and strong support from macroeconomic policies, as well as considerable wage and price flexibility. On balance, hard pegs are appropriate only in limited circumstances--mainly for countries with a history of high inflation, that have the determination to implement very disciplined macroeconomic policies and ambitious structural reforms, but no other credible nominal anchor (http://www.imf.org/external/np/speeches/2001/011301.htm). Inflation targeting as a framework that can improve the design, implementation, and performance of monetary policy requires a considerable degree of central bank independence with no symptoms of fiscal dominance. As a country that chooses a fixed exchange rate system subordinates its monetary policy to the exchange rate objective and is not effectively able to target directly any other nominal variable, such as the rate of inflation, inflation targeting has always been associated with a high degree of exchange rate flexibility. Inflation targeting is also used as a tool to build the credibility of the general framework of macroeconomic policy (IMF March 1998).

NEPAL'S MACROECONOMIC SITUATION

GDP grew by 3.0 percent during 2002/03 compared to the negative rate of 0.6 percent during 2001/02. During 2002/03, the growth rate of narrow money was 5.5 percent and that of broad money 8.1 percent. The growth rate of narrow money was 9.3 percent while broad money grew by 4.4 percent during 2001/02. The rate of inflation during 2002/03 was 4.8 percent. During 2001/02, such rate was 2.9 percent. During 2002/03, exports increased by 4.9 percent as against a decline of 15.6 percent in the previous year. Despite a decline of exports to India following the quantitative restrictions through the trade treaty renewed in 2002, a strong acceleration in garment exports contributed to the growth of overall exports in 2002/03. The import increased by 16.9 percent in 2002/03 against a decline of 7.2 percent in the preceding year. Workers' remittances during 2002/03 amounted to Rs. 54.2 billion. Such remittances had aggregated Rs. 47.5 billion during the previous year. Because of the substantial increment in the workers' remittances, current account of the BOP recorded surplus of Rs. 8.4 billion during 2002/03. Such surplus was Rs. 17.9 billion during 2001/02. BOP surplus was Rs. 5.2 billion and gross foreign exchange reserve level was Rs. 110.4 billion, enough to cover merchandise imports of 10.6 months. BOP had recorded a deficit of Rs. 3.3 billion during 2001/02, the first such deficit after 1995/96 when BOP had recorded a deficit of Rs. 1.1 billion. Gross foreign exchange reserve amounted to Rs. 105.9 billion in mid-July 2003. For 2003/04, GDP projection is at 4.0 percent with the projections of inflation rate at 4.7 percent and BOP surplus at Rs. 6.4 billion. Government revenue/GDP ratio during 2002/03 rose to 12.4 percent from 11.9 percent during 2001/02. Budget deficit/GDP ratio during 2002/03 fell to 4.6 percent compared to the ratio of 5.4 percent during 2000/01. Outstanding foreign debt/ GDP ratio also came down to 48.9 percent during 2002/03 from 52.1 percent during 2001/02.

The monetary policy for 2003/04 is directed at keeping inflation within the control, avoiding the unnecessary depletion of the international reserves, and maintaining exchange rate stability. Along with this, the monetary policy gives priority to achieving and strengthening economic as well as financial sector stability. The growth rate of narrow money is projected at 8.4 percent and that of broad money at 11.1 percent. The bank rate is maintained at 5.5 percent in view of the relatively higher rate of inflation in 2002/03 compared to that in 2001/02. The prevailing system of the commercial banks being required to maintain 7 percent balance of their domestic current and saving deposits and 4.5 percent balance of their domestic fixed deposits with the Nepal Rastra Bank (NRB) as well as 2 percent vault compulsory ratio of total domestic deposit has been changed into a single and uniform compulsory ratio of 6 percent. The 2 percent vault compulsory ratio has been done away with. NRB will make a provision of additional refinancing facility of Rs 1.5 billion for the sick industry loans in the current fiscal year also. The refinancing rate will be lowered from the current 3 percent to 2 percent. To avail this facility, the commercial banks will have to lower the current interest rate of such loans at 6.5 percent to 5.5 percent.

Nepal has implemented the financial sector reform as a part of the overall economic liberalization process. Promoting financial stability and maintaining a secure, healthy and efficient payments system are the important objectives of the new NRB Act, 2002, which has accorded autonomy to the central bank in formulating and implementing the monetary and exchange rate policies for ensuring macroeconomic stability. With the objective of improving the NRB functions by focusing more on the core central banking activities, the ongoing re-engineering and restructuring work of NRB is being expedited on the basis of the report of the re-engineering consultants. In order to ensure a smoother functioning of the overall financial system, the NRB has directed commercial banks and other financial institutions to comply with the various prudential norms. Emphasis has been placed on improving the supervisory process in addition to implementing the international accounting standards in the banks and other financial institutions. As the critical component of the financial sector reform program, foreign management teams in the two largest commercial banks, one fully government-owned and one partly government-owned, have been undertaking the management contract responsibilities.

With a view to reducing the mounting non-performing assets (NPA) of the banking system, the legislative and other necessary work is underway for setting up the Assets Management Company (AMC). The budget for 2003/04 has earmarked Rs. 150 million for the establishment of the AMC. The Debt Recovery Tribunal constituted under the Debt Recovery Act has been in operation. The Debt Recovery Appellate Court has also been constituted. The new credit information and black listing provisions are already in place. The risk-weighted capital adequacy ratio has been fixed at 11 percent, of which 5 percent has to be the core capital for the current fiscal year. For 2004/05, the capital adequacy ratio has been fixed at 12 percent, comprising 6 percent core capital. With an objective of according priority and accelerating the financial sector reform program, HMG/N has expressed its commitment to the enactment of the draft legislations relating to the secured transactions, anti-money laundering, and insolvency. In order to fill the need for an umbrella Act, the banks and financial institutions Ordinance, 2004 has come into force since February 4, 2004. The ceiling of the foreign equity in the joint venture commercial banks, currently 67 percent, could be raised as per the request and requirement of the reputed foreign banks. With the ongoing financial liberalization coupled with Nepal's accession to WTO on September 11, 2003, the competitive environment in the financial sector is destined to intensify. Foreign commercial banks will also be allowed to operate wholesale branches with effect from January 1, 2010.

INTERNATIONAL FINANCIAL STANDARDS AND NEPAL

The relevance to Nepal of the international standards of good practices for economic policies and for the financial structure becomes apparent when we look at Nepal's priority policy agenda like consolidating macroeconomic stability, increasing investment, strengthening the financial sector, and reducing the poverty level. Experience worldwide indicates that macroeconomic stability and financial sector soundness are necessary for economic growth and that growth can raise incomes and reduce the incidence of poverty. Nepal has been successful in achieving greater macroeconomic stability though the overall growth rate has slowed down on account of internal and external factors. To make Nepal's economic stability sustainable and to raise the level of economic growth so as to make a lasting dent on poverty, significant reform initiatives need to be put in place. Secondly, in Nepal, gross domestic investment, though around 25 percent of GDP, still falls far short of what is required to accelerate the process of economic development. There is equally an urgent need to improve the efficiency and productivity of such investments. In addition, Nepal accounts for a very small amount of FDI, the kind of investment that could bring Nepal not only the capital but also the technology and know-how she so desperately needs. Nepal has to build and sustain a secure economic environment, without which both domestic and foreign investors will continue to shy away from opportunities available. Thirdly, given the still fragile state of the emerging financial sector, Nepal needs to expedite measures that will enable financial markets to mobilize savings and allocate credit more efficiently and that will make financial products and services available to more of the population.

Nepal can make progress toward achieving these objectives by applying the principles underlying the new international financial architecture. By increasing transparency and accountability and bringing the financial sector up to international standards and codes, Nepal can improve decision-making and develop sounder national economic policies while creating an environment that encourages investment and saving. More generally, by putting broad interests ahead of specific or vested interests, national authorities will be able to address poor governance in its various forms-inefficient management of public resources, reduced accountability, and less responsiveness to the public expectations and needs. As there is increasing evidence that poor governance dampens investment and growth, tackling governance problems will, in turn, help sustain economic development. Measures that promote orderly capital account liberalization and implementation of flexible exchange rate regimes will help bring the benefits of international capital flows to Nepal. And, by promoting a stable financial system, the implementation of the international standards of good practices will immensely serve Nepal's interests.

CONCLUSION

Experience worldwide indicates that macroeconomic stability is necessary for economic growth and that growth can raise incomes and reduce the incidence of poverty. Macroeconomic imbalances and macroeconomic mismanagement result in high real interest rates, declining investment rates, volatile exchange rates, growing current account imbalances, stagnated economic growth, sluggish trade, disruptions in financial markets, and even rising tendencies of protectionism. Failure to counteract the BOP deficits, excessive spending that fuels inflation, and other economic shocks create greater uncertainty and higher risk for private producers and investors, who take evasive actions that reduce future investment, worsen the crisis, and cause development efforts to suffer. Running budget deficits financed through the banking system expand the money supply and feed inflation. Investments would fall, debts would grow, debt service obligations would exceed the available financing resources, and the economies would face continuing risks and vulnerabilities because of the mismatch of the macroeconomic policies as reflected in the overvalued exchange rates, imprudent fiscal policy and instable prices. Consequently, the BOP crises and foreign debt problems arise or get aggravated. At the same time, the growth rate would be significantly reduced. The solution almost invariably involves some combination of cutting public spending and raising additional revenue as well as making the foreign exchange regime more prudent for freeing resources for debt service and exports respectively.

Priority should be given toward consolidating macroeconomic stability and strengthening competitiveness through the pursuance of sound fiscal, monetary, and exchange rate policies. To enhance the growth prospects or reduce the slowdown in economic activity, reducing the risks of instability in the macroeconomy in general and financial markets in particular is inevitable for which various steps are needed. Fiscal policy should be supportive to growth as well as stability. Credible action to reduce the large budget deficits is most urgent to bring about a lasting reduction in the current account deficit, stabilize exchange rates and lower the real interest rates. Concurrently, monetary policy should seek to contain the growth of the money supply to keep inflation in check, with increased reliance on indirect monetary instruments, particularly the open market operations. Increased exchange rate flexibility is essential to correct the fundamental misalignments in the economy. Countries that reduced vulnerabilities, for example, by moving to more flexible exchange rates, tended to weather the storm better than countries with less flexible markets and a weaker macroeconomic policy framework. Sustaining competitive real exchange rates to facilitate the economies' integration into the global economy, attract investment, and foster export diversification and growth is essential.

The expansion of trade becomes the centerpiece for a strategy to promote sustained global growth and truly shared prosperity for which advanced countries need to open up their markets and the developing countries need to get rid of barriers among themselves. What is needed are vigilance and a firm policy hand to make the economies robust and more dynamic, shifting the focus from short-term considerations to tackling decisively the underlying problems. Special attention needs to be given to prevent the fiscal and external imbalances and reduce the instability in the various macroeconomic aggregates. This requires the strengthening of the expenditure management and implementation of a long-term strategy to increase national savings. Tackling decisively the underlying economic and financial imbalances is essential for sustained prosperity. To remove impediments to investment and growth, structural reforms like reducing the level of non-performing loans, improving industrial deregulation, and restructuring the banking and corporate sectors are equally important. Measures aimed at reforming the international financial architecture would be useful in promoting economic and financial stability with growth, both at the national and global levels.

Maintaining financial stability, restoring the momentum of economic growth and reinvigorating the fight against poverty in view of realizing the millennium development goals, including halving the world poverty by 2015, are most basic issues confronting today. Continuing to work together for sustained, broad-based growth, creating opportunities for productive employment, reducing vulnerabilities, further opening up the economies to trade, and providing resources for durable poverty reduction have become important global economic agenda at the present. This will require continued vigilance and a further strengthening of medium-term policy frameworks- both to improve prospects for sustainable growth and stability and to reduce vulnerabilities.

The core principles for effective banking supervision need to be complied for improving the health of the financial system. In the context of Nepal, the basic macroeconomic risks relate to the higher level of the NPA, weak fiscal structure especially the large volume of fiscal deficits including the rising domestic and foreign debt obligations, price volatility, fragile exports and growth uncertainty. The basic risk, however, could generate from the fixed exchange rate mechanism that has been pursued in relation to the determination of the exchange rate vis-à-vis the Indian currency. So, promoting sound macroeconomic fundamentals, strengthening the supervisory process of the financial system, and making exchange rate more flexible comprise the important macroeconomic policy prudence for the medium-term.

APPENDIX I

I.1. Asian Countries: Current Account Balances as a Percentage of GDP, 1989-97

	1989	1990	1991	1992	1993	1994	1995	1996	1997
Hong Kong	11.5	8.5	6.6	5.3	7.0	2.1	-3.4	-1.0	-1.0
Singapore	9.6	8.3	11. 2	11.4	7.3	15.9	17.7	15.0	13.7
South Korea	2.4	-0.9	-3.0	-1.5	0.1	-1.2	-2.0	-4.8	-3.9
Taiwan	7.6	6.9	6.7	3.8	3.0	2.6	1.9	3.8	3.1
China	-1.3	3.9	4.3	1.4	-2.7	1.3	0.2	0.9	1.2
India	-2.3	-2.2	-1.5	-1.5	-1.5	-0.9	-1.7	-1.2	-1.1
Indonesia	-1.2	-2.8	-3.7	-2.2	-1.3	-1.6	-3.4	-3.4	-3.6
Malaysia	0.8	-2.0	-8.9	-3.7	-4.4	-5.9	-8.5	-5.3	-5.9
Philippines	-3.4	-6.1	-2.3	-1.9	-5.5	-4.4	-4.4	-5.9	-4.5
Thailand	-3.5	-8.5	-7.7	-5.7	-5.6	-5.9	-8.0	-8.0	-4.6

Source: Jomo (1998).

I.2. Asian Countries: Fiscal Balances as a Percentage of GDP, 1988-97

	1988-93	1994	1995	1996	1997
Hong Kong	2.3	0.8	-0.3	0.1	1.4
Singapore	6.8	4.0	7.6	6.7	5.1
South Korea	0.5	0.6	0.5	-0.3	-0.5
Taiwan	-1.6	-6.3	-7.4	-8.0	-5.0
China	-2.6	-2.4	-1.3	-1.2	-1.3
India	-7.4	-6.5	-5.8	-5.1	-4.9
Indonesia	-0.6	-0.4	0.8	0.7	0.5
Malaysia	-3.7	-0.2	1.2	-0.7	1.6
Philippines	-3.3	0.7	0.5	0.3	0.4
Thailand	3.3	1.5	3.0	2.2	-0.7

Source: Jomo, K. S. (1998).

APPENDIX II

II. 1. International Standards of Good Practices for Economic Policies and for the Financial Infrastructure

Subject Area	Key Standards	Issuing Body
Macroeconomic Policy and Data Transparency		
Monetary and financial policy transparency	Code of Good Practices on Transparency in Monetary and Financial Policies	IMF
Fiscal policy transparency	Code of Good Practices on Fiscal Transparency	IMF
Data dissemination	Special Data Dissemination Standard (SDDS)/ General Data Dissemination System (GDDS)	IMF
Institutional and Market Infrastructure		
Insolvency	Principles and Guidelines for Effective Insolvency and Creditor Rights Systems	World Bank
Corporate governance	Principles of Corporate Governance	OECD
Accounting	International Accounting Standards (IAS)	International Accounting Standards Board (IASB)
Auditing	International Standards on Auditing (ISA)	International Federation of Accountants (IFAC)
Payment and settlement	Core Principles for Systemically Important Payment Systems	Committee on Payment and Settlement Systems (CPSS)
Anti-Money Laundering/Combating the financing of terrorism	The Financial Action Task Force's Forty Recommendations against Money Laundering and the Eight recommendations on combating terrorism financing.	Financial Action Task Force (FATF)
Financial Regulation and Supervision		
Banking supervision	Core Principles for Effective Banking Supervision	Basel Committee on Banking Supervision (BCBS)
Securities regulation	Objectives and Principles of Securities Regulation	International Organization of Securities Commissions (IOSCO)
Insurance supervision	Insurance Core Principles	International Association of Insurance Supervisors (IAIS)

II. 2 (A). GOOD TRANSPARENCY PRACTICES FOR MONETARY POLICY BY CENTRAL BANKS (Major Points)

1. *Clarity of Roles, Responsibilities and Objectives of Central Banks for Monetary Policy*
   - 1.1 The ultimate objective(s) and institutional framework of monetary policy should be clearly defined in relevant legislation or regulation, including, where appropriate, a central bank law.
   - 1.2 The institutional relationship between monetary and fiscal operations should be clearly defined.
   - 1.3 Agency roles performed by the central bank on behalf of the government should be clearly defined.
2. *Open Process for Formulating and Reporting Monetary Policy Decisions*
   - 2.1 The framework, instruments, and any targets that are used to pursue the objectives of monetary policy should be publicly disclosed and explained.
   - 2.2 Where a permanent monetary policy-making body meets to assess underlying economic developments, monitor progress toward achieving its monetary policy objective(s), and formulate policy for the period ahead, information on the composition, structure, and functions of that body should be publicly disclosed.
   - 2.3 Changes in the setting of monetary policy instruments (other than fine-tuning measures) should be publicly announced and explained in a timely manner.
   - 2.4 The central bank should issue periodic public statements on progress toward achieving its monetary policy objective(s) as well as prospects for achieving them. The arrangements could differ depending on the monetary policy framework, including the exchange rate regime.
   - 2.5 For proposed substantive technical changes to the structure of monetary regulations, there should be a presumption in favor of public consultations, within an appropriate period.
   - 2.6 The regulations on data reporting by financial institutions to the central bank for monetary policy purposes should be publicly disclosed.
3. *Public Availability of Information on Monetary Policy*
   - 3.1 Presentations and releases of central bank data should meet the standards related to coverage, periodicity, timeliness of data and access by the public that are consistent with the International Monetary Fund's data dissemination standards.
   - 3.2 The central bank should publicly disclose its balance sheet on a pre-announced schedule and, after a predetermined interval, publicly disclose selected information on its aggregate market transactions.
   - 3.3 The central bank should establish and maintain public information services.

3.4 Texts of regulations issued by the central bank should be readily available to the public.

4. Accountability and Assurances of Integrity by the Central Bank

4.1 Officials of the central bank should be available to appear before a designated public authority to report on the conduct of monetary policy, explain the policy objective(s) of their institution, describe their performance in achieving their objective(s), and, as appropriate, exchange views on the state of the economy and the financial system.

4.2 The central bank should publicly disclose audited financial statements of its operations on a pre-announced schedule.

4.3 Information on the expenses and revenues in operating the central bank should be publicly disclosed annually.

4.4 Standards for the conduct of personal financial affairs of officials and staff of the central bank and rules to prevent exploitation of conflicts of interest, including any general fiduciary obligation, should be publicly disclosed.

II.2 (B). GOOD TRANSPARENCY PRACTICES FOR FINANCIAL POLICIES BY FINANCIAL AGENCIES

1. Clarity of Roles, Responsibilities and Objectives of Financial Agencies Responsible for Financial Policies.

1.1 The broad objective(s) and institutional framework of financial agencies should be clearly defined, preferably in relevant legislation or regulation.

1.2 The relationship between financial agencies should be publicly disclosed.

1.3 The role of oversight agencies with regard to payment systems should be publicly disclosed.

1.4 Where financial agencies have oversight responsibilities for self-regulatory organizations (e.g., payment systems), the relationship between them should be publicly disclosed.

1.5 Where self-regulatory organizations are authorized to perform part of the regulatory and supervisory process, they should be guided by the same good transparency practices specified for financial agencies.

2. Open Process for Formulating and Reporting of Financial Policies

2.1 The conduct of policies by financial agencies should be transparent, compatible with confidentiality considerations and the need to preserve the effectiveness of actions by regulatory and oversight agencies.

2.2 Significant changes in financial policies should be publicly announced and explained in a timely manner.

2.3 Financial agencies should issue periodic public reports on how their overall policy objectives are being pursued.

2.4 For proposed substantive technical changes to the structure of financial regulations, there should be a presumption in favor of public consultations, within an appropriate period.

3. *Public Availability of Information on Financial Policies*

3.1 Financial agencies should issue a periodic public report on the major developments of the sector(s) of the financial system for which they carry designated responsibility.

3.2 Financial agencies should seek to ensure that, consistent with confidentiality requirements, there is public reporting of aggregate data related to their jurisdictional responsibilities on a timely and regular basis.

3.3 Where applicable, financial agencies should publicly disclose their balance sheets on a pre-announced schedule and, after a predetermined interval, publicly disclose information on aggregate market transactions.

3.4 Financial agencies should establish and maintain public information services.

3.5 Texts of regulations and any other generally applicable directives and guidelines issued by financial agencies should be readily available to the public.

3.6 Where there are deposit insurance guarantees, policy-holder guarantees, and any other client asset protection schemes, information on the nature and form of such protections, on the operating procedures, on how the guarantee is financed, and on the performance of the arrangement, should be publicly disclosed.

3.7 Where financial agencies oversee consumer protection arrangements (such as dispute settlement processes), information on such arrangements should be publicly disclosed.

4. *Accountability and Assurances of Integrity by Financial Agencies*

4.1 Officials of financial agencies should be available to appear before a designated public authority to report on the conduct of financial policies, explain the policy objective(s) of their institution, describe their performance in pursuing their objective(s), and, as appropriate, exchange views on the state of the financial system.

4.2 Where applicable, financial agencies should publicly disclose audited financial statements of their operations on a pre-announced schedule.

4.3 Where applicable, information on the operating expenses and revenues of financial agencies should be publicly disclosed annually.

4.4 Standards for the conduct of personal financial affairs of officials and staff of financial agencies and rules to prevent exploitation of conflicts of interest, including any general fiduciary obligation, should be publicly disclosed.

Source: http://www.imf.org/external/np/mae/mft/code/index.htm

II. 3. Code of Good Practices on Fiscal Transparency (Major Points)

1. *Clarity of Roles and Responsibilities*
   1.1 The government sector should be distinguished from the rest of the public sector and from the rest of the economy, and policy and management roles within the public sector should be clear and publicly disclosed.
   1.2 There should be a clear legal and administrative framework for fiscal management.
2. *Public Availability of Information*
   2.1 The public should be provided with full information on the past, current, and projected fiscal activity of government.
   2.2 A commitment should be made to the timely publication of fiscal information.
3. *Open Budget Preparation, Execution, and Reporting*
   3.1 The budget documentation should specify fiscal policy objectives, the macroeconomic framework, the policy basis for the budget, and identifiable major fiscal risks.
   3.2 Budget information should be presented in a way that facilitates policy analysis and promotes accountability.
   3.3 Procedures for the execution and monitoring of approved expenditure and for collecting revenue should be clearly specified.
   3.4 There should be regular fiscal reporting to the legislature and the public.
4. *Assurances of Integrity*
   4.1 Fiscal data should meet accepted data quality standards.
   4.2 Fiscal information should be subjected to independent scrutiny.

Source: http://www.imf.org/external/np/fad/trans/code.htm

II. 4. CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION

1. *Preconditions for Effective Banking Supervision*
   1.1. An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banking organizations. Each such agency should possess operational independence and adequate resources. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorization of banking organizations and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.

2. *Licensing and Structure*

2.1 The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined, and the use of the word "bank" in names should be controlled as far as possible.

2.2 The licensing authority must have the right to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the banking organization's ownership structure, directors and senior management, its operating plan and internal controls, and its projected financial condition, including its capital base; where the proposed owner or parent organization is a foreign bank, the prior consent of its home country supervisor should be obtained.

2.3. Banking supervisors must have the authority to review and reject any proposals to transfer significant ownership or controlling interests in existing banks to other parties.

2.4. Banking supervisors must have the authority to establish criteria for reviewing major acquisitions or investments by a bank and ensuring that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.

3. *Prudential Regulations and Requirements*

3.1. Banking supervisors must set prudent and appropriate minimum capital adequacy requirements for all banks. Such requirements should reflect the risks that the banks undertake, and must define the components of capital, bearing in mind their ability to absorb losses. At least for internationally active banks, these requirements must not be less than those established in the Basle Capital Accord and its amendments.

3.2. An essential part of any supervisory system is the evaluation of a bank's policies, practices and procedures related to the granting of loans and making of investments and the ongoing management of the loan and investment portfolios.

3.3. Banking supervisors must be satisfied that banks establish and adhere to adequate policies, practices and procedures for evaluating the quality of assets and the adequacy of loan loss provisions and loan loss reserves.

3.4. Banking supervisors must be satisfied that banks have management information systems that enable management to identify concentrations within the portfolio and supervisors must set prudential limits to restrict bank exposures to single borrowers or groups of related borrowers.

3.5 In order to prevent abuses arising from connected lending, banking supervisors must have in place requirements that banks lend to related companies and individuals on an arm's-length basis, that such extensions of credit are effectively monitored, and that other appropriate steps are taken to control or mitigate the risks.

3.6 Banking supervisors must be satisfied that banks have adequate policies and procedures for identifying, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining appropriate reserves against such risks.

3.7 Banking supervisors must be satisfied that banks have in place systems that accurately measure, monitor and adequately control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.

3.8 Banking supervisors must be satisfied that banks have in place a comprehensive risk management process (including appropriate board and senior management oversight) to identify, measure, monitor and control all other material risks and, where appropriate, to hold capital against these risks.

3.9 Banking supervisors must determine that banks have in place internal controls that are adequate for the nature and scale of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding its assets; and appropriate independent internal or external audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.

3.10 Banking supervisors must determine that banks have adequate policies, practices and procedures in place, including strict "know-your-customer" rules, that promote high ethical and professional standards in the financial sector and prevent the bank being used, intentionally or unintentionally, by criminal elements.

4. *Methods of Ongoing Banking Supervision*

4.1 An effective banking supervisory system should consist of some form of both on-site and off-site supervision.

4.2 Banking supervisors must have regular contact with bank management and thorough understanding of the institution's operations.

4.3 Banking supervisors must have a means of collecting, reviewing and analyzing prudential reports and statistical returns from banks on a solo and consolidated basis.

4.4 Banking supervisors must have a means of independent validation of supervisory information either through on-site examinations or use of external auditors.

4.5 An essential element of banking supervision is the ability of the supervisors to supervise the banking group on a consolidated basis.

5. *Information Requirements*

5.1 Banking supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with consistent accounting policies and practices that enable the supervisor to obtain a true and fair view of the financial condition of the bank and the profitability of its business, and that the bank publishes on a regular basis financial statements that fairly reflect its condition.

6. *Formal Powers of Supervisors*
   6.1 Banking supervisors must have at their disposal adequate supervisory measures to bring about timely corrective action when banks fail to meet prudential requirements (such as minimum capital adequacy ratios), when there are regulatory violations, or where depositors are threatened in any other way. In extreme circumstances, this should include the ability to revoke the banking license or recommend its revocation.
7. *Cross-border Banking*
   7.1 Banking supervisors must practice global consolidated supervision over their internationally-active banking organizations, adequately monitoring and applying appropriate prudential norms to all aspects of the business conducted by these banking organizations worldwide, primarily at their foreign branches, joint ventures and subsidiaries.
   7.2 A key component of consolidated supervision is establishing contact and information exchange with the various other supervisors involved, primarily host country supervisory authorities.
   7.3 Banking supervisors must require the local operations of foreign banks to be conducted to the same high standards as are required of domestic institutions and must have powers to share information needed by the home country supervisors of those banks for the purpose of carrying out consolidated supervision.

Source: http://imf.org/external/standards/agency.htm

APPENDIX III

III.1. Nepal: Macroeconomic Indicators in Amount (Rs. Billion)

		2000/01	2001/02	2002/03	2003/04
1	Money Supply				
	1.1 Narrow Money	70.6	77.2	83.7	88.9
	1.2 Broad Money	214.5	224.0	245.9	269.3
2	Credit to Private Sector	126.8	133.3	151.0	170.6
3	Time Deposits	143.9	146.8	162.2	180.4
4	Exports	55.7	46.9	49.2	56.0
5	Imports	115.7	107.4	125.9	147.0
6	Trade Deficit	60.0	60.4	76.6	91.0
7	Travel Receipts	11.7	8.7	11.7	13.5
8	Remittances	47.2	47.5	54.2	68.0
9	Regular Expenditure*	42.8	48.6	56.2	60.6
10	Development Expenditure*	37.1	31.5	28.0	41.8
11	Revenue*	48.9	50.4	55.3	62.2
12	Foreign Grants*	6.8	6.7	8.4	15.5
13	Budget Deficit*	24.2	22.9	21.0	24.7
14	Foreign Loans*	12.0	7.7	9.0	12.8
15	Domestic Loans including overdraft*	12.1	15.2	12.0	11.8
16	Total Consumption**	349.3	371.5	402.2	-
	16.1 Private	309.1	329.2	355.5	-
	16.2 Public	40.2	42.3	46.7	-
17	Gross Domestic Savings**	61.5	50.7	51.5	-
18	Total Investment**	98.8	108.2	122.2	-
	18.1 Gross Fixed Capital Formation	78.0	81.6	87.0	-
	Private	46.8	49.6	55.7	-
	Public	31.3	32.0	31.3	-
	18.2 Change in Stock	20.8	26.6	35.2	-
19	Gross National Saving**	77.7	69.1	74.3	-
20	Total Outstanding Loans	260.4	293.7	306.6	-
	20.1 Domestic	60.0	73.6	84.6	-
	20.2 Foreign	200.4	220.1	222.0	-
21	BOP Surplus (+) / Deficit (-)	5.2	-3.4	5.2	6.4
22	Foreign Exchange Reserve	105.2	105.9	110.4	112.0
	2.1 Convertible	80.2	80.3	99.2	100.0
	2.2 Non- Convertible	25.0	25.6	11.2	12.0
23	GDP at Producers' Prices	410.8	422.2	453.7	495.4
24	Nepse Index				
	(Base, Feb. 12, 1994=100)	348.4	227.5	204.9	

* *Budget Figures.*
** *At nominal prices*

III.2. Nepal: Macroeconomic Indicators (Annual Percent Change)

		2000/01	2001/02	2002/03	2003/04[P]
1	Nominal GDP Growth				
	1.1 Producer's Prices	8.2	2.8	7.4	8.9
	1.2 Factor Cost	7.3	3.0	7.0	8.9
2	Real GDP Growth				
	2.1 Producer's Prices	5.5	-0.6	3.0	4.0
	2.2 Factor Cost	4.6	-0.4	2.6	4.0
	Agriculture	5.5	2.2	2.4	3.0
	Non-Agriculture	4.3	-1.9	2.8	4.7
3	Total Consumption*	8.5	6.4	8.3	
	3.1 Private	7.3	6.5	8.0	
	3.2 Public	18.2	5.4	10.2	
4	Gross Domestic Savings*	6.9	-17.6	1.6	
5	Total Investment*	7.1	9.5	12.9	
	5.1 Gross Fixed Capital Formation	6.4	4.6	6.6	
	Private	-0.3	6.0	12.4	
	Public	18.3	2.5	-2.5	
	5.2 Change in Stock	9.7	28.1	32.3	
6	Gross National Saving*	9.9	-11.1	7.5	
7	Money Supply				
	7.1 Narrow Money	15.7	9.3	5.5	8.4
	7.2 Broad Money	15.2	4.4	8.1	11.1
8	Credit to Private Sector	20.5	5.2	11.8	13.0
9	Time Deposits	15.0	2.1	9.5	12.4
10	Exports	11.7	-15.6	4.9	27.3
11	Imports	6.6	-7.2	16.9	15.3
12	Trade Deficit	2.3	0.7	26.2	7.5
13	Travel Receipts	-3.0	-26.1	31.1	6.8
14	Regular Expenditure	23.9	13.6	16.4	7.1
15	Development Expenditure	16.7	-15.1	-11.0	49.4
16	Revenue	14.0	3.2	11.7	12.6
17	Foreign Grants	18.2	-1.0	25.2	85.3
18	Budget Deficit	36.9	-5.2	-8.7	17.7
19	Foreign Loans	2.0	-36.1	16.3	43.2
20	Domestic Loans including overdraft	20.7	25.5	-21.3	-1.3
21	Inflation	2.4	2.9	4.8	4.7
	21.1 Food and Beverages	-2.3	3.7	4.4	3.5
	21.2 Non-Food and Services	8.1	2.1	5.0	5.8

* *At nominal prices.*

III.3. Nepal: Macroeconomic Indicators as Percentages of GDP

		2000/01	2001/02	2002/03	2003/04P
1	Money Supply				
	1.1 Narrow Money	17.2	18.3	18.5	18.0
	1.2 Broad Money	52.2	53.0	54.2	54.4
2	Credit to Private Sector	30.9	31.6	33.3	34.4
3	Time Deposits	35.0	34.8	35.7	36.4
4	Exports	13.5	11.1	10.9	11.3
5	Imports	28.2	25.4	27.7	29.7
6	Trade Deficit	14.6	14.3	16.9	18.4
7	Travel Receipts	2.9	2.0	2.6	2.7
8	Remittances	11.5	11.3	11.9	13.7
9	Regular Expenditure*	10.4	11.5	12.5	12.2
10	Development Expenditure*	9.0	7.5	6.2	8.4
11	Revenue*	11.9	11.9	12.4	12.6
12	Foreign Grants*	1.6	1.6	1.8	3.1
13	Budget Deficit*	5.9	5.4	4.6	5.0
14	Foreign Loans*	2.9	1.8	2.0	2.6
15	Domestic Loans including overdraft*	3.0	3.6	2.6	2.4
16	Total Consumption**	85.0	88.0	88.6	-
	16.1 Private	75.2	78.0	78.4	-
	16.2 Public	9.8	10.0	10.3	-
17	Gross Domestic Savings**	15.0	12.0	11.4	-
18	Total Investment**	24.1	25.6	26.9	-
	18.1 Gross Fixed Capital Formation	19.0	19.3	19.2	-
	Private	11.4	11.7	12.3	-
	Public	7.6	7.6	6.9	-
	18.2 Change in Stock	5.1	6.3	7.8	-
19	Gross National Saving**	18.9	16.4	16.4	-
20	Total Outstanding Loans	63.4	69.6	67.6	-
	20.1 Domestic	14.6	17.4	18.7	-
	20.2 Foreign	48.8	52.1	48.9	-
21	BOP Surplus (+) / Deficit (-)	1.3	(0.8)	1.1	1.3
22	Foreign Exchange Reserve	25.6	25.1	24.3	22.6
	22.1 Convertible	19.5	19.0	21.9	20.2
	22.2 Non- Convertible	6.1	6.1	2.5	2.4
23	GDP at Producers' Prices	100.0	100.0	100.0	100.0

P Projections

Source: Calculations based on various issues of Economic Survey and NRB Publications

ACRONYMS USED

AMC	Assets Management Company
BOJ	Bank of Japan
BOP	Balance of Payments
CPI	Consumer Price Index
ESAF	Enhanced Structural Adjustment Facility
F&D	Finance & Development
FDI	Foreign Direct Investment
FSAP	Financial Sector Assessment Program
GDP	Gross Domestic Product
GDDS	General Data Dissemination System
GNP	Gross National Product
HIPC	Highly Indebted Poor Countries Debt Initiative
HMG/N	His Majesty's Government of Nepal
IMF	International Monetary Fund
IMFC	International Monetary and Finance Committee
NPA	Non-Performing Assets
NPL	Non-Performing Loans
NRB	Nepal Rastra Bank
PIN	Public Information Notice
PRGF	Poverty Reduction and Growth Facility
PRSP	Poverty Reduction Strategy Paper
ROSCs	Report on the Observance of Standards and Codes
SDDS	Special Data Dissemination System
US	United States of America
WDR	World Development Report
WEO	World Economic Outlook
WTO	World Trade Organization

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