II

From Crisis to Recovery in the Emerging Market Economies

The emerging market economies have experienced a great deal of financial volatility and macroeconomic instability in the 1990s. For many of them, especially in Asia but to some extent also in Latin America, the first part of the decade was characterized by considerable optimism and buoyant growth. During a period when growth was lackluster in many industrial countries and yields on investments relatively low, increasingly integrated financial markets helped channel financial resources from Japan and Europe, in particular, toward greener pastures in emerging markets. The subsequent financial crises, beginning with Mexico in 1994–95, the Asian crisis of 1997–98, and the crises in Russia, Brazil, and several other Latin American countries in 1998–99 led to reversals of capital flows, portfolio and banking flows in particular, away from emerging markets toward the now most dynamic economy in the world, the United States.

Looking ahead, the global economic environment in which the emerging market economies will be recovering from their recent recessions is likely to undergo substantial changes. Much will depend on the timing and extent of the cyclical slowdown likely to occur in the United States, and on the ability of Japan and Europe to sustain stronger growth of domestic demand and thereby support global activity. During the adjustment process, the emerging market economies will have a substantial impact on each other as trade among them continues to expand and also on the overall performance of the world economy. If they again become the recipients of substantial capital inflows, it is essential that the lessons from earlier excesses and the recent financial turbulence be reflected in stronger policies and institutions, and especially stronger financial systems.

While the worst of the emerging market crisis seems to be over, risks of setbacks cannot be excluded given the vulnerability of systemically important countries and the still widespread need for structural reform. In east Asia, confidence is being rebuilt and output growth has resumed, with relatively strong fundamentals, especially high private sector saving rates, providing support for what could well turn out to be relatively vigorous recoveries. Favorable macroeconomic developments, however, could weaken the impetus to push ahead with structural reforms, which are needed to sustain reasonably strong growth over the medium term. In Brazil, the recession associated with the crises has been less severe than feared, but considerable uncertainties remain about contagion in Latin America and about the speed and strength of the recovery in the region. Some countries in the region have continued to show considerable vulnerability, partly reflecting long-standing fiscal and external imbalances that have been exacerbated during the crises. Among the transition countries, even the more advanced reformers in central and eastern Europe have been affected by the recent crises, the Russian turmoil in particular, but they have shown some resilience. The vulnerabilities of the slow reformers have, by contrast, been openly exposed, underscoring the growing divergences in economic performance among the transition countries.

This chapter focuses on the countries that were at the center of the recent crises in emerging markets—the east Asian countries, Russia, and Brazil—as well as the countries which have been most affected by spillover effects from the crises, those in Latin America and among the transition economies in particular. While this chapter also delves into the experience of some countries which have weathered the recent crises reasonably well—including the interesting case of South Africa (Box 2.1)—other emerging market economies that have also suffered from spillover effects are not covered beyond a brief discussion of significant domestic financial market developments since the spring.

Improving Financial Conditions

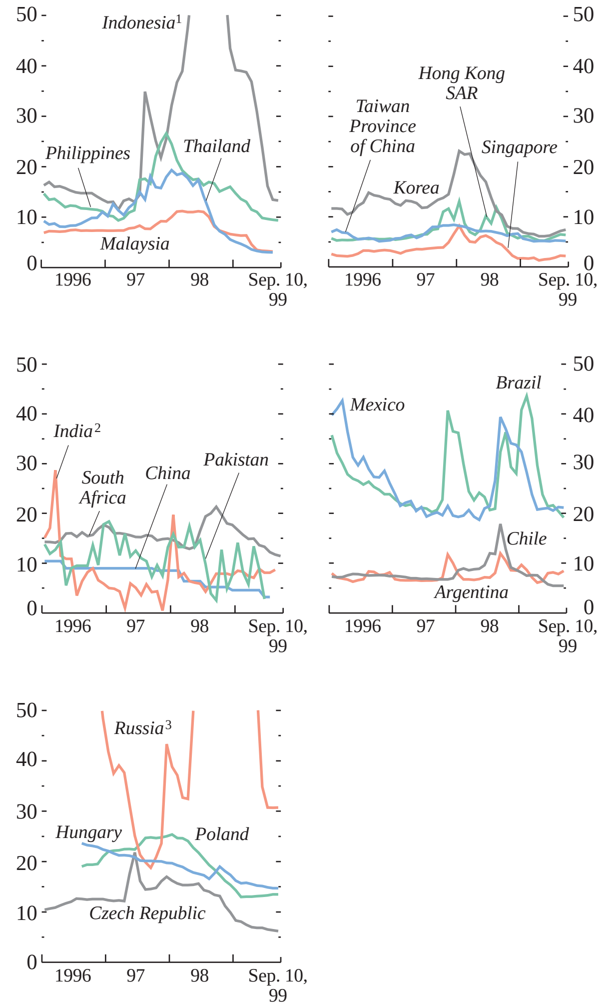
Reflecting the improved economic outlook and recovery in investor confidence, domestic financial markets and asset prices in many emerging market economies continued their rebound through mid-July. In a number of countries, interest rates fell near or below precrisis levels (Figure 2.1). The currencies of Indonesia, Korea, Thailand, and the main central and eastern European countries strengthened, while, with a few exceptions, exchange rates in other countries, including Brazil and Russia, stabilized. Emerging equity markets, in east Asia and Russia in particular, extended the rally seen in the early months of the year, outpacing the gains in the fastest rising industrial country equity markets. The rebound in domestic financial markets and asset prices was, however, not paralleled by a comparable narrowing of yield spreads in international credit markets, which even tended to widen again in early July for countries such as Brazil and Argentina. Since the middle of July, sentiment has turned mixed in the major emerging financial markets on concerns about higher U.S. interest rates and country-specific developments. A number of currencies have come under renewed downward pressure, and equity markets have given up some of their previous gains.

With returning confidence and declines in inflation creating room to ease monetary policy without putting pressure on exchange rates, central banks in a number of emerging market economies have cut *policy interest rates* further in recent months. In Asia, official interest rates have been brought down significantly since the beginning of April in Indonesia, Malaysia, the Philippines, and Thailand. In Korea, on the other hand, the central bank in early May announced that its key policy interest rate, which by then had been brought down to 4¾ percent, would be put on hold, in spite of strong upward pressure on the won. China in early June cut deposit and lending rates, in some cases to below comparable U.S. rates, in an effort to stimulate economic growth. A trend toward lower official interest rates was also observed in the Western Hemisphere where, as inflation fears eased, the Central Bank of Brazil has gradually lowered the benchmark SELIC rate from 45 percent in early March to 19½ percent by the end of July, the lowest level since September 1998. In Chile, a cumulative reduction of 200 basis points in the central bank's real overnight reference rate during the second quarter was motivated by the country's deepening recession. In South Africa, the repurchase rate of the Reserve Bank was brought down to around 13.1 percent by the middle of September, some 875 basis points below its October 1998 peak. Among the countries in transition, the Central Bank of Russia lowered its refinancing rate in June to 55 percent from 60 percent, the first such reduction since July 1998, while declines in inflation gave the Czech Republic and Hungary room to lower benchmark official interest rates in successive steps by 150 and 125 basis points, respectively, since the end of March.

In foreign exchange markets, the Indonesian rupiah and the Korean won were subject to significant upward pressure during the second quarter of 1999. The rupiah appreciated by more than 30 percent against the U.S. dollar, reflecting progress with policy implementation, the improved economic outlook, and reduced political uncertainty (Figure 2.2). The appreciation of the won, however, was much more limited as the authorities took steps to absorb the pressure, including through official intervention and measures to raise foreign exchange holdings in the banking sector. Both currencies came under downward pressure in July–August, in particular the rupiah, which depreciated by more than 10 percent in this period, mainly as a result of setbacks in banking sector reform. The ex-

Figure 2.1. Selected Emerging Market Economies: Short-Term Interest Rates
(Percent)

Interest rates in most emerging market countries have come down significantly since the Brazilian crisis.



Sources: Bloomberg Financial Markets, LP; and IMF, *International Financial Statistics.* Three-month interbank rate or, if unavailable, comparable market-determined short-term rate.

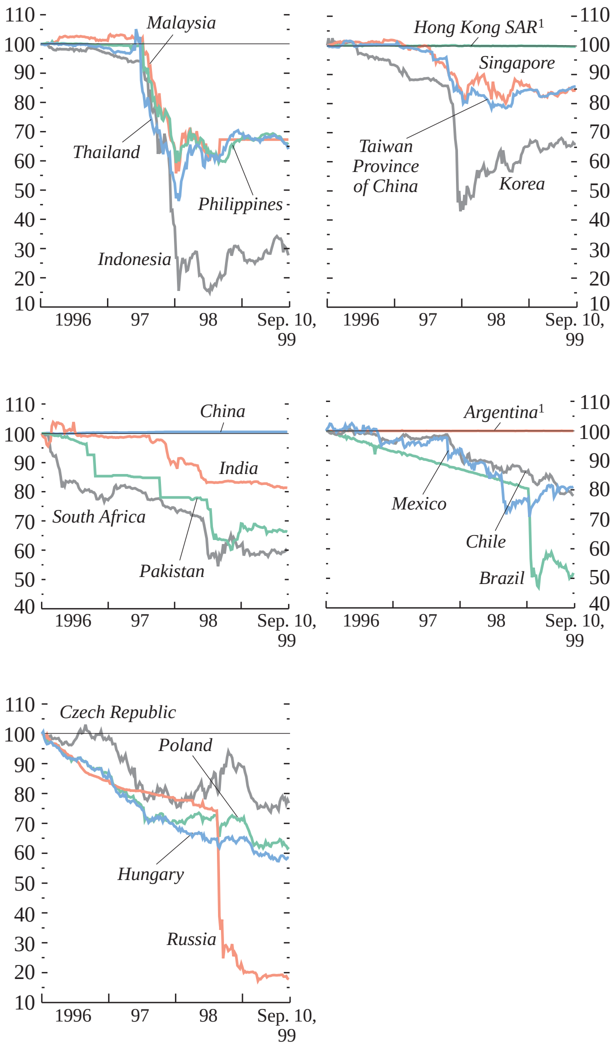
[1]The Indonesian short-term rate in the first half of September 1998 averaged 70.6 percent.

[2]The mid-rate in the overnight call money market.

[3]Three-month interbank transactions were suspended on August 17, 1998, when interest rates reached 127.6 percent, and they resumed on February 26, 1999 with an interest rate of 55.1 percent.

Figure 2.2. Selected Emerging Market Economies: Bilateral U.S. Dollar Exchange Rates
(U.S. dollars per currency unit; January 5, 1996 = 100)

Exchange rates in Indonesia and, to a lesser extent, Korea have appreciated since the middle of 1998. The Brazilian currency recovered in March–April but has gradually depreciated since then.



Sources: Bloomberg Financial Markets, LP; and WEFA, Inc.
[1]Pegged to U.S. dollar.

change rates of the other three former crisis countries in east Asia were broadly unchanged during the second quarter, and, in the cases of the Philippine peso and Thai baht, depreciated moderately thereafter. In Latin America, the Brazilian real strengthened in the second half of April and early May, and then broadly stabilized in the 1.75–1.85 *reais* per U.S. dollar range, roughly 20 percent appreciated from its March nadir. The Mexican peso also stabilized in the second half of June, after weakening in late May and early June as interest rates rose in the United States. The currencies of Colombia and Ecuador came under significant pressure in the same period, reflecting economic and financial sector difficulties. In late June, the Colombian authorities devalued the peso against the U.S. dollar by 9 percent in terms of the central parity of its trading band and widened the trading band from 14 to 20 percent. Latin American currencies generally came under renewed downward pressure in mid-July, in part because of increased concerns about Argentina. Both the Brazilian real and the Colombian peso faced further downward pressure in August, but the real recovered to around 1.85–1.90 per U.S. dollar in the first half of September. Elsewhere in Latin America, in early September Chile suspended the trading bands around the peso, effectively introducing a free-floating exchange rate system. In the Europe and Middle East region, in recent months, the Turkish lira has continued to depreciate in nominal terms broadly in line with inflation. The Czech koruna and Polish zloty strengthened significantly against the euro and somewhat more moderately in effective terms during the second quarter and through mid–July, recovering from the losses incurred earlier in the year. The zloty began to depreciate again in the second half of July, falling temporarily below its central parity in early September as Poland's growth and current account outlook turned less favorable. The Russian ruble stabilized at around 24.5 per U.S. dollar in the middle of May, in part reflecting the effects of foreign exchange restrictions, including a dual exchange rate system, a ban on the use of ruble balances in foreign banks' correspondent accounts for purchasing foreign currency—both eliminated at the end of June—and an export receipt surrender requirement. The ruble weakened again in early September following the central bank's announcement it would let the currency depreciate broadly in line with inflation.

By the middle of September, *emerging equity markets* had on average strengthened by more than 30 percent in U.S. dollar terms since the beginning of the year.[1] Equity markets in east Asia, and also in Russia, have performed particularly strongly (Figure 2.3). Among the former crisis countries in east Asia, stock

[1]Stock market prices in U.S. dollar terms are measured by the corresponding composite, regional, and country IFC Investable Indices.

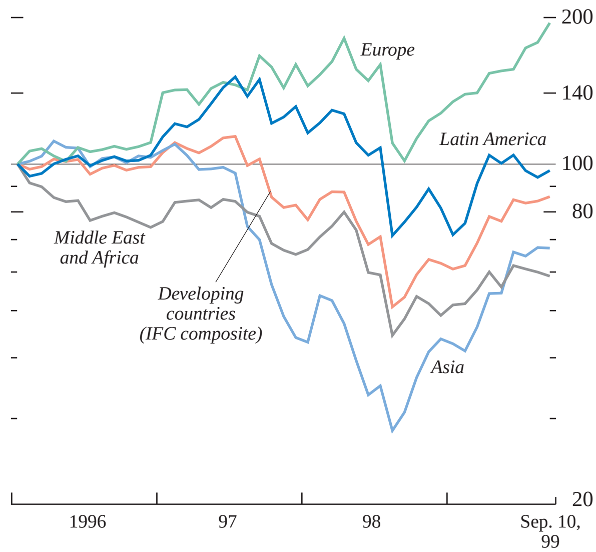
market prices in U.S dollar terms rose in the year through mid-September by around 90 percent in Korea and by around 45 percent in Indonesia. Chinese stocks staged a sharp rally in June, following the reductions in official interest rates and also in part as a result of government measures to stimulate equity investment, and they recorded a 60 percent gain in the year through mid-September. Emerging equity markets in the Western Hemisphere continued their first-quarter recovery until the beginning of July, on average gaining around 15 percent in U.S. dollar terms during the second quarter. Equity prices in Latin America weakened again in early July, as investor sentiment toward the region turned more negative. Mexico was relatively little affected, and there, equity prices by the middle of September had strengthened by more than 30 percent in U.S. dollar terms from the beginning of the year, outperforming other emerging markets in the Western Hemisphere. Among other emerging market economies, equity prices in the Czech Republic, Hungary, and the Slovak Republic rebounded from lows registered in February–March amid renewed foreign investor interest, but continued to lag other emerging equity markets in the region. These include, in particular, the Turkish market, which strengthened on improved prospects for macroeconomic stabilization, and also the Polish market, which experienced a sustained increase in prices from early March through mid-July, and the South African market, which was virtually unscathed by the Brazilian crisis last January and where prices rose by around 20 percent in the year through mid-September. The Russian stock exchange staged a sharp rally from February through July, supported by higher oil prices, abundant liquidity in the banking sector, and an absence of alternative investment opportunities in domestic fixed income markets. Following a correction owing to increased political and financial uncertainties, the Russian market in mid-September was still up by around 110 percent in U.S. dollar terms from the beginning of the year.

The recovery in domestic financial markets and exchange rates in the emerging market economies in the first half of 1999 has only partly extended to *conditions in international capital markets*, including the terms of private market access offered to borrowers and the volume of private capital flows to recipient countries. These conditions reflect a combination of economic and financial factors in both the recipient and capital exporting countries.[2] In the first half of 1999, these factors were conducive to some recovery

Figure 2.3. Emerging Market Economies: Equity Prices

(U.S. dollar terms; logarithmic scale; January 1996 = 100)

Equity prices in emerging market economies have strengthened considerably since the beginning of 1999. The gains in Asia have been particularly strong.



Source: International Finance Corporation (IFC), Emerging Markets Database.

[2]For an overview of these factors, see Michael Mussa and Anthony Richards, "Capital Flows in the 1990s Before and After the Asian Crisis," paper presented at the World Bank/International Monetary Fund/World Trade Organization Conference on Capital Flows, Financial Crises, and Policies, April 15–6, 1999 (Washington: World Bank).

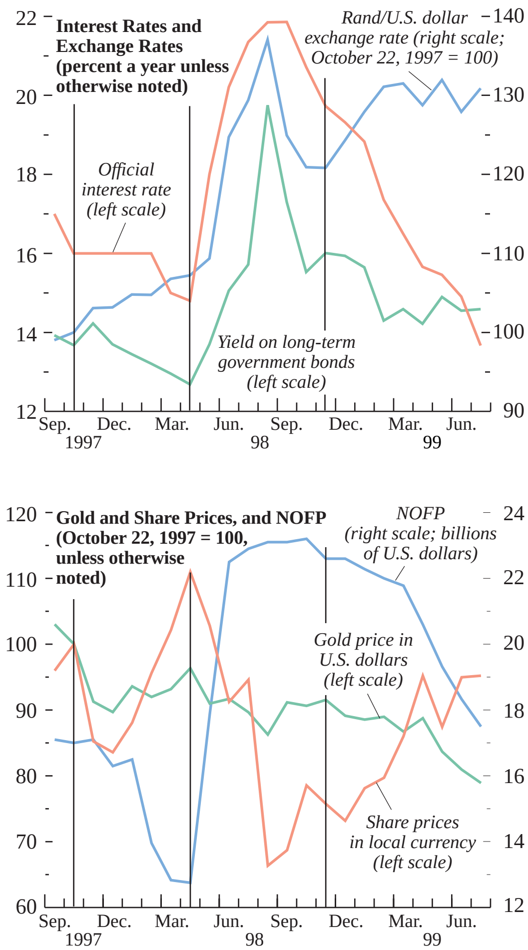
Box 2.1. The Emerging Market Crises and South Africa

Financial markets in South Africa were first affected by the recent emerging market crises in October 1997, when the Asia crisis erupted in full force. Domestic long-term bond yields rose by 105 basis points, share prices declined by about 14 percent, and the rand depreciated against the U.S. dollar by 3 percent (see figure). The limited extent of the impact, in spite of South Africa's relatively open capital account, is attributable partly to *favorable initial conditions*—including a floating exchange rate that was not seriously misaligned (the rand had depreciated in real effective terms by about 12 percent in the year through October 1997), a modest current account deficit (1.5 percent of GDP in 1997), a sound and well-regulated banking system, and an ongoing process of fiscal consolidation—and partly to an *appropriate policy response during the crisis*, which involved allowing the rand to depreciate and market interest rates to rise in response to tighter liquidity conditions.

In early May 1998, investor confidence weakened again, with a new bout of contagion, despite favorable initial conditions. The impact on South Africa was more severe than in the previous episode, reflecting in part the strength of the contagion, but also the policy response. Initially, the authorities intervened heavily in the foreign exchange market, leading to a rise of nearly US$10 billion in the net foreign exchange liabilities of the South African Reserve Bank, also known as its net open forward position (NOFP).[1] This was combined with an uneven monetary policy response, related in part to technical difficulties with the new repurchase system for influencing domestic liquidity conditions, which led to large swings in the repo rate. Together, these actions may have contributed to uncertainty about exchange rate policy and affected investor sentiment. Subsequently, the authorities raised interest rates substantially and maintained tight policy until clear signs emerged that the pressures had subsided. Between end-May and end-August, when the impact on South African financial markets reached a peak, at the time of the Russian crisis, the rand depreciated by 25 percent against the U.S. dollar, interest rates rose by about 670 basis points, and share prices declined by close to 50 percent in U.S. dollar terms.

Since September 1998, financial market conditions have improved considerably. Neither the crisis in Brazil nor the South African presidential elections had a significant im-

South Africa: Impact of Emerging Market Crises, September 1997–July 1999[1]



Sources: Reuters; and net open forward position of the Reserve Bank (NOFP), South African Authorities.

[1]The vertical lines refer to the three stages of the emerging market crises.

[1] The NOFP is defined as net forward foreign exchange liabilities less net international spot reserves.

of flows, but their volume nevertheless remained lower than before the Asian crisis and the terms of financing less favorable. Subsequently, the gross flows slowed anew in the July–August period. In emerging markets, many borrowers, sovereigns in particular, have reduced their external financing needs since the crises erupted. Other borrowers have lost access to international markets altogether; these include the Russian and Ukrainian sovereigns and private companies undergoing restructuring in the former crisis countries of east Asia. Also, the abandonment of currency pegs in Brazil and several east Asian countries appears to have led to a more realistic perception of currency risk. In mature markets, investors' attention pact on financial markets. A strong fiscal performance in 1998/99 and a prudent budget for 1999/2000, despite pressures in advance of the elections, have helped consolidate policy credibility. Capital inflows have resumed, with net purchases of bonds and equities by nonresidents amounting to US$3.5 billion during the first half of 1999 compared with a sale of US$0.5 billion during the second half of 1998. Two successful global bond issues by the South African Government at an average spread of about 370 basis points above benchmark paper, a turnaround in the current account balance, and privatization receipts from the partial selloff of South African Airways have helped strengthen the external position. This resulted in a decline in the NOFP to US$17.5 billion by end-July 1999. Official interest rates recently have been below their pre-1998 crisis levels, while the rand has traded in the R6–6.3 per U.S. dollar range during the last 12 months.

Apart from the emerging market crises, South African financial markets have also been adversely affected since 1997 by the decline in the price of gold—the country's main export commodity—and its large net official foreign exchange liability position. Nevertheless, during the period, interest rate increases and the depreciation of the currency were smaller than in many other emerging market countries, and the required adjustment in the current account was also considerably less. These relatively muted effects partly reflect the favorable initial conditions and flexible exchange rate policy: the greatest pressures appear to have been experienced during the brief episode of heavy intervention by the authorities in the foreign exchange markets, which heightened uncertainty about its exchange rate policy. The impact on economic activity has also been muted. Real GDP, which grew by 1 percent in the year through mid-1998, declined in the second half of 1998 by about 1 percent. Output appears to have turned up in early 1999, and by the fourth quarter it is projected to be 2½ percent higher than a year earlier, but its growth in 1999 as a whole is projected at only ¾ of 1 percent. In spite of the limited impact of the crises, South African economic activity has therefore generally remained weak, and a reinvigoration of structural reforms, notably in relation to the labor market, privatization, and trade, is essential to boost the trend growth rate of the economy to levels that can make a dent in the unemployment problem, increase incentives to save and invest, and reduce the country's vulnerability to adverse external developments.

to risk appears to have increased significantly in the wake of the crises, as reflected in an increasing differentiation among instruments and borrowers.[3] In addition, in recent months, higher long-term interest rates in the United States have helped to make mature capital markets relatively more attractive.

Reflecting these factors, the terms and conditions of primary market access for emerging market borrowers in the first eight months of 1999, while improved compared with late 1998, continued to be generally less favorable than prior to the Russian crisis. This was the case for Latin America borrowers in particular, with international bond markets beginning to show saturation for regional issues in recent months. However, with increased differentiation by investors according to credit quality, Hungary, Mexico, Uruguay, and the Philippines were able in the first half of 1999 to issue sovereign bonds at terms comparable with those issued a year earlier. Chile and South Africa were also successful in regaining access to international financial markets at relatively favorable terms, as evidenced by bond issues at spreads of about 180 and 370 basis points, respectively, in the second quarter.

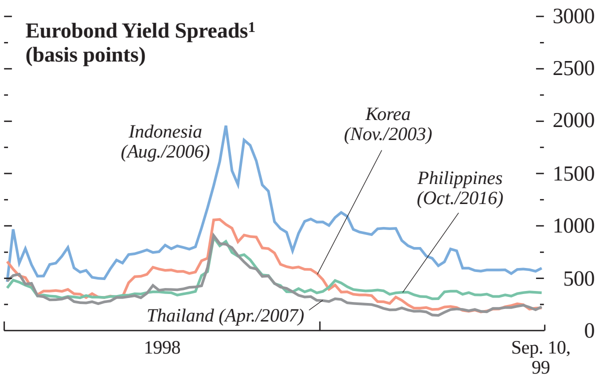
In secondary markets, yield spreads have come down since the beginning of the year, but they remain above levels in early 1998, between the peaks of the Asian and Russian crises. Average spreads (as commonly measured by the JP Morgan EMBI + index) fell from more than 1500 basis points in mid-January, 1999 to the 1050–1250 basis point range in June–August, well above the 450–600 basis point range observed in the first half of 1998. As a further indication of investor differentiation, however, spreads for some instruments—such as sovereign bonds issued by Korea, Mexico, and Thailand—have narrowed to below early-1998 levels, while spreads for South American countries remained relatively high in the first half of 1999 and tended to increase again in July–August, reflecting higher U.S. interest rates, increased political uncertainties, and fiscal policy concerns (Figure 2.4). At the same time, the average differential between secondary and primary market yields remains wide, at around 600 basis points, suggesting that some potential borrowers have been facing availability constraints at prevailing primary market interest rates. This is the case for private and unrated borrowers in particular.

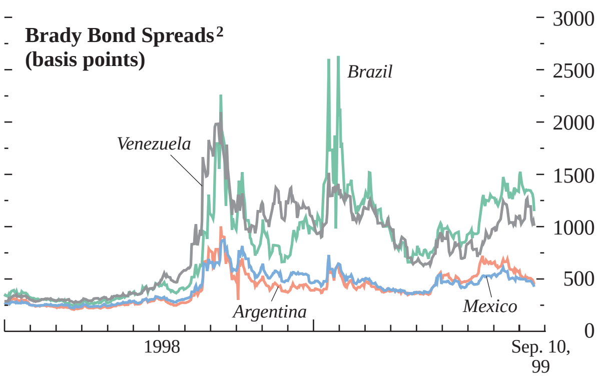
Associated with the less favorable pricing conditions, *gross private financing flows* (not including foreign direct investment (FDI) or interbank flows) to emerging market economies remained subdued in the first eight months of 1999, at around $157 billion at an annual rate, $40 billion higher than the low reached in the second half of 1998, but still only somewhat more than half the level recorded in 1997 (Table 2.1). Recoveries in financing flows in the first eight months of 1999 were observed in three out of the four major regions, Asia in particular, but not in the European emerging markets, owing in part to Russia's loss of access in the wake of the

[3]See *International Capital Markets: Developments, Prospects, and Key Policy Issues*, Chapter III (Washington: International Monetary Fund, 1999).

Figure 2.4. Selected Emerging Market Countries: Eurobond Yield Spreads and Brady Bond Spreads

Yield spreads have come down since the Brazilian crisis. In east Asia they have generally fallen below levels preceding the Russian crisis, while in Latin America they remain considerably higher.





Sources: Bloomberg Financial Markets, LP; Reuters; and Salomon Brothers.

[1]Spreads are calculated relative to a U.S. treasury bond of comparable maturity.

[2]Stripped yields are adjusted to exclude both the value of collateral held as security against repayment of the bond and the value of coupon payments. Spreads are calculated relative to a U.S. treasury bond of comparable maturity.

August 1998 crisis. Following an upturn in the first half of 1999, flows to Western Hemisphere countries fell back significantly in July–August as conditions facing these countries deteriorated. The composition of flows also changed noticeably between the second half of 1998 and the first eight months of 1999. Issuance of bonds increased by 80 percent to reach \$87 billion at an annual rate, or around 55 percent of the total, while syndicated loan commitments contracted by 20 percent to \$47 billion or less than one third of total flows, accelerating a decade long decline in the share of syndicated loans in emerging market financing.

In line with the evolution of gross flows in the first eight months of the year, the volume of *net private capital flows* to emerging market economies is projected to remain stable at some \$65–70 billion in 1999, less than one-third of the decade's high of \$214 billion recorded in 1996 (Table 2.2). A more substantial recovery is projected for next year as growth is expected to accelerate in many emerging market economies, but to weaken somewhat in the industrial countries. The projections show considerable variation across the major components and emerging market regions (see Box 2.2). Net direct investment is expected to be somewhat below 1997–98 levels in both 1999 and 2000, reflecting lower projected flows to Brazil and China, while net portfolio investment is projected to decline further this year, but then to rebound in 2000. Other net investment flows are projected to turn less negative both this year and next, as repayments to commercial banks are expected to slow. On a regional basis, net inflows into the Western Hemisphere are projected to fall in 1999 as a whole but to rebound in 2000. The emerging market economies of Asia, on the other hand, are expected to see net outflows slow in 1999 and outflows broadly balance inflows in 2000, with only the former crisis countries continuing to experience net outflows next year. These five countries are also projected to add further to their international reserves both this year and next.

In part reflecting the still reduced availability of private financing, the combined *current account deficit of the emerging market economies* is projected to fall to a decade low of around \$25 billion in 1999 from \$42 billion in 1998, before increasing, as financing constraints ease, to around \$45 billion in 2000, still well below the levels of 1995 to 1997. The projected evolution of the combined current account position of the emerging market economies reflects the significant narrowing of surpluses in Asia in both 1999 and 2000,[4] which this year—but not next—is

[4]In view of the tension in the global current account projections, which show a widening in the negative discrepancy that is unlikely to materialize, the actual surpluses of the east Asian countries may turn out to be significantly larger, and the discrepancy accordingly smaller, than those projected in the baseline scenario.

Table 2.1. Gross Private Financing to Emerging Market Economies
(Billions of U.S. dollars)

				1998				1999			
	1996	1997	1998	Q1	Q2	Q3	Q4	Q1	Q2	July	Aug.
Total	**218.4**	**286.1**	**148.5**	**39.5**	**50.9**	**30.5**	**27.2**	**32.6**	**49.7**	**14.6**	**6.7**
Asia	118.5	127.5	34.1	7.1	14.1	5.5	7.5	11.9	15.3	7.1	3.9
Europe	21.3	37.5	36.1	7.5	12.7	9.9	6.1	3.1	7.8	4.8	4.8
Middle East and Africa	15.5	30.8	13.7	3.3	2.4	4.9	3.2	4.4	6.8	–0.7	–3.5
Western Hemisphere	63.1	90.3	64.6	21.7	21.8	10.2	10.5	13.2	19.8	3.4	1.6
Bond issues	**101.9**	**128.1**	**77.7**	**25.3**	**28.0**	**14.1**	**10.3**	**21.8**	**25.5**	**6.1**	**3.4**
Asia	43.1	45.5	11.5	2.7	6.7	0.3	1.8	7.0	6.3	2.4	1.7
Western Hemisphere	47.2	54.4	38.3	14.8	13.3	5.1	5.2	10.8	13.1	3.2	1.1
Other regions	11.6	28.2	27.9	7.8	8.1	8.7	3.3	4.1	7.1	0.6	0.6
Other fixed income	**9.4**	**10.0**	**0.5**	**0.1**	**0.4**	—	—	—	—	—	—
Asia	9.4	9.8	0.5	0.1	0.4	—	—	—	—	—	—
Western Hemisphere	—	—	—	—	—	—	—	—	—	—	—
Other regions	—	0.2	—	—	—	—	—	—	—	—	—
Loan commitments	**90.7**	**123.2**	**60.4**	**11.0**	**18.7**	**16.2**	**14.2**	**8.4**	**17.6**	**3.4**	**2.2**
Asia	56.2	58.9	17.7	2.5	5.0	5.2	4.9	3.5	5.1	2.3	1.1
Western Hemisphere	12.3	30.9	26.1	6.9	8.5	5.0	5.3	2.2	6.7	0.1	0.4
Other regions	22.2	33.4	16.6	1.5	5.2	6.0	4.0	2.7	5.8	0.9	0.6
Equity issues	**16.4**	**24.8**	**9.9**	**3.1**	**3.7**	**0.2**	**2.8**	**2.4**	**6.6**	**5.1**	**1.2**
Asia	9.8	13.2	4.4	1.7	1.9	—	0.7	1.4	5.6	2.4	1.0
Western Hemisphere	3.7	5.1	0.2	—	0.1	0.1	—	0.2	—	0.1	0.2
Other regions	3.0	6.5	5.3	1.4	1.7	0.2	2.0	0.8	0.9	2.6	0.1

Source: Capital Data Loanware and Bondware.

offset in part by reductions in the deficits of the emerging market economies of the Western Hemisphere and the Middle East and Europe and of the countries in transition. The current account position of the African countries is projected to be broadly unchanged.

The narrowing of surpluses in Asia is accounted for mainly by Korea, whose surplus is projected to fall by around $16 billion to $24 billion in 1999, owing to the recovery of domestic demand and the appreciation of the won from its lows, and China, whose $33 billion surplus in 1998 is projected to narrow to around $13 billion in 1999, owing to a weakening of export performance. The projected improvement in the overall current account position of the emerging market economies of the Western Hemisphere in 1999, though quite widespread, is largely due to reductions in the current account deficits of Brazil and Mexico, mainly reflecting in the former case the depreciation of the real and the compression of domestic demand, and in the latter case higher oil prices and continued strong U.S. import demand.

Patterns of Recovery in Asia and Latin America

While economic activity in most of the emerging market economies affected by the recent crises has begun to turn around, the patterns of recovery have been quite diverse. Output bottomed out in the east Asian crisis countries and also in Singapore in the second half of 1998. Four-quarter growth rates turned positive in the first quarter of 1999 in Korea, where the rebound has been particularly strong, and also in the Philippines, Singapore, and Thailand (Figure 2.5). In Hong Kong SAR, output bottomed out in early 1999 and, on a year-on-year basis, real GDP growth turned positive in the second quarter. China and Taiwan Province of China both experienced moderate decelerations of activity in 1998 and continued to register positive growth through early 1999.

In Latin America, in spite of the contagion from the Asian crisis, growth did not begin to weaken significantly in most cases until mid-1998, but marked contractions followed in several countries. This was the case in Argentina, where the decline in real GDP continued through the second quarter of 1999 and where industrial production in April–May was 10½ percent lower than a year earlier. In Brazil, real GDP bottomed out in the last quarter of 1998 and output began to recover in the first half of 1999—a much better outcome than expected in the aftermath of the January crisis. In Chile, the index of economic activity in the first five months of 1999 was 3.1 percent lower than a year earlier. In Venezuela, output is expected to contract further in 1999 despite the recent uptick in oil prices. Ecuador has continued to suffer financial instability in the wake of its financial crisis in February, and Colombia devalued its currency in

Table 2.2. Emerging Market Economies: Net Capital Flows[1]

(Billions of U.S. dollars)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Total										
Net private capital flows[2]	118.1	120.6	176.3	143.4	192.9	213.8	148.8	66.2	68.3	118.5
Net direct investment	31.5	35.3	57.9	84.7	93.0	113.5	142.6	132.4	118.5	128.4
Net portfolio investment	24.7	55.6	98.7	104.9	38.3	74.0	66.7	27.1	21.6	40.2
Other net investment	62.0	29.7	19.6	–46.3	61.7	26.4	–60.5	–93.3	–71.8	–50.1
Net official flows	36.0	23.1	19.1	8.6	28.8	–17.9	24.4	43.6	9.4	–2.4
Change in reserves[3]	–51.2	–58.8	–70.3	–64.0	–118.0	–108.7	–74.2	–49.9	–51.1	–76.1
Memorandum										
Current account[4]	–85.1	–75.4	–115.7	–73.3	–85.8	–92.1	–77.2	–42.0	–24.7	–45.2
Africa										
Net private capital flows[2]	6.1	3.4	9.7	3.5	2.6	9.2	19.4	13.2	11.7	18.3
Net direct investment	2.1	0.6	1.9	2.3	2.1	4.7	7.4	4.8	8.4	8.7
Net portfolio investment	–2.0	1.3	–1.6	2.3	6.6	3.1	4.1	6.6	2.4	4.7
Other net investment	6.1	1.6	9.4	–1.2	–6.1	1.4	7.9	1.7	0.9	4.8
Net official flows	9.1	12.1	8.3	13.5	11.7	0.2	–4.7	2.2	4.8	–3.5
Change in reserves[3]	–3.0	0.3	–2.2	–5.6	–0.7	–10.1	–14.2	–2.5	–1.4	–8.2
Memorandum										
Current account[4]	–7.4	–10.3	–11.6	–11.9	–16.1	–6.2	–7.1	–18.8	–18.8	–15.2
Asia[5]										
Crisis countries[6]										
Net private capital flows[2]	24.8	29.0	31.8	36.1	60.6	62.9	–22.1	–29.6	–18.1	–8.2
Net direct investment	6.2	7.3	7.6	8.8	7.5	8.4	10.3	9.7	9.4	8.4
Net portfolio investment	3.2	6.4	17.2	9.9	17.4	20.3	12.9	–7.3	4.5	5.6
Other net investment	15.4	15.3	7.0	17.4	35.7	34.2	–45.3	–32.0	–32.0	–22.2
Net official flows	4.4	2.0	0.6	0.3	0.7	–4.6	30.4	20.2	–4.5	–0.6
Change in reserves[3]	–8.3	–18.1	–20.6	–6.1	–18.3	–5.4	30.5	–52.1	–39.9	–29.9
Memorandum										
Current account[4]	–25.2	–16.1	–13.5	–23.2	–40.5	–53.4	–24.3	68.8	49.3	29.4
Other Asian emerging markets										
Net private capital flows[2]	7.4	–9.4	24.6	27.7	30.2	39.3	25.4	–14.7	–11.5	4.9
Net direct investment	8.3	8.4	26.3	38.8	41.1	45.8	50.9	46.9	32.2	34.7
Net portfolio investment	–2.0	2.6	4.5	1.1	–6.1	–8.3	–11.8	–12.3	–12.8	–8.5
Other net investment	1.2	–20.4	–6.2	–12.2	–4.7	1.8	–13.8	–49.2	–30.8	–21.3
Net official flows	6.5	8.3	7.9	10.2	6.0	4.1	–0.4	7.3	4.1	2.9
Change in reserves[3]	–31.5	–7.8	–17.9	–48.3	–26.9	–43.6	–46.5	–17.6	–2.3	–17.4
Memorandum										
Current account[4]	23.7	14.0	–8.2	16.8	16.2	17.8	43.9	43.2	26.2	26.4

late June in response to strong exchange rate pressures. In contrast with most of Latin America, Mexico has weathered the international financial turmoil well over the past two years, and output continued to expand in the first half of 1999, albeit at a decelerating pace.

The divergences in cyclical patterns between and within the two regions stem not only from the differences in the timing of their financial crises and in contagion, but also from a number of other factors relating to the economic characteristics of the countries concerned. A first set of factors pertains to differences in *financial and trade linkages* and external competitiveness. In Asia, a relatively high degree of openness to foreign trade and close intra-regional trade links—important contributors to the region's successful growth record—exacerbated the effects of financial market contagion on economic activity.[5] In 1997–98, the decline in world prices of these countries' main export products together with faltering import demand in the region's crisis-hit economies hampered export growth and placed the burden of current account adjustment in the region mostly on the import side.[6] By the same token, more recently, with the general recovery throughout Asia, sustained improvements in competitiveness, the bottoming out of world commodity prices (Figure 2.6),

[5]For a discussion of international financial contagion, see Chapter III of the May 1999 *World Economic Outlook*.

[6]Intra-regional exports accounted for about 50 percent of east Asia's total exports just prior to the 1997 crisis. In some economies, such as Indonesia and Taiwan Province of China, the share of intra-regional exports in total exports was significantly higher, at 58 and 63 percent, respectively. See World Bank, *East Asia: Road to Recovery*, Chapter II (1998).

Table 2.2 *(concluded)*

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Middle East and Europe[7]										
Net private capital flows[2]	65.7	38.8	29.1	16.1	8.0	6.4	17.0	10.3	17.4	11.1
Net direct investment	1.2	0.9	4.1	6.0	5.4	2.0	2.8	2.6	3.8	9.5
Net portfolio investment	10.8	14.9	8.8	9.0	2.4	1.8	3.7	–8.6	6.5	6.2
Other net investment	53.7	22.9	16.1	1.1	0.1	2.6	10.4	16.3	7.1	–4.7
Net official flows	3.9	–1.2	2.2	–1.5	–1.5	–1.1	–0.8	–1.1	–1.7	–2.0
Change in reserves[3]	–3.9	–9.0	1.0	–1.8	–9.1	–20.9	–19.7	11.5	–6.8	–5.1
Memorandum										
Current account[4]	–64.2	–26.7	–31.1	–7.2	–5.4	5.1	3.3	–20.9	–8.9	–9.2
Western Hemisphere										
Net private capital flows[2]	24.1	55.7	61.4	44.1	46.7	79.7	86.1	73.8	47.2	62.7
Net direct investment	11.3	13.9	12.0	23.4	23.1	38.9	51.3	48.1	42.8	43.1
Net portfolio investment	14.7	30.3	61.1	61.8	4.6	37.9	36.2	39.7	12.0	23.6
Other net investment	–2.0	11.4	–11.7	–41.1	18.9	2.9	–1.4	–14.0	–7.7	–4.0
Net official flows	2.7	–1.7	0.7	–3.4	21.1	–14.1	–8.4	4.1	4.8	–0.1
Change in reserves[3]	–17.4	–22.6	–21.3	4.2	–25.5	–28.1	–14.5	12.9	6.7	–4.1
Memorandum										
Current account[4]	–16.9	–34.5	–45.8	–51.6	–37.0	–38.7	–66.7	–89.1	–56.5	–56.5
Countries in transition										
Net private capital flows[2]	–9.9	3.1	19.7	15.9	44.8	16.3	23.1	13.2	21.6	29.7
Net direct investment	2.4	4.2	6.0	5.4	13.6	13.7	19.8	20.3	21.9	23.9
Net portfolio investment	—	0.1	8.7	20.6	13.3	19.1	21.5	9.0	9.0	8.6
Other net investment	–12.3	–1.1	5.0	–10.1	17.8	–16.4	–18.3	–16.1	–9.3	–2.8
Net official flows	9.3	3.6	–0.7	–10.5	–9.1	–2.4	8.2	10.8	1.9	1.1
Change in reserves[3]	13.0	–1.6	–9.3	–6.4	–37.6	–0.6	–9.8	–2.1	–7.4	–11.5
Memorandum										
Current account[4]	4.9	–1.7	–5.4	3.8	–2.9	–16.7	–26.3	–25.1	–16.1	–20.2

[1]Net capital flows comprise net direct investment, net portfolio investment, and other long- and short-term net investment flows, including official and private borrowing. Emerging markets include developing countries, countries in transition, Korea, Singapore, Taiwan Province of China, and Israel. No data for Hong Kong SAR are available.
[2]Because of data limitations, "other net investment" may include some official flows.
[3]A minus sign indicates an increase.
[4]The sum of the current account balance, net private capital flows, net official flows, and the change in reserves equals, with the opposite sign, the sum of the capital account and errors and omissions.
[5]Includes Korea, Singapore, and Taiwan Province of China. No data for Hong Kong SAR are available.
[6]Indonesia, Korea, Malaysia, the Philippines, and Thailand.
[7]Includes Israel.

and continuing buoyant demand from North America, exports from China, Korea, Malaysia, Singapore, and Taiwan Province of China have begun to recover. Also, several of the Asian economies depend strongly on the electronics industry and benefit from the upturn in the global electronics sector. And data on overall export orders point to a further strengthening of demand in the second half of the year.

In Latin America, by contrast, intra-regional trade has generally played a more limited role as a business cycle transmission mechanism. While the bilateral trade links between Argentina and Brazil are extensive, and may have played a role in economic spillovers and financial contagion between the two economies, in both countries exports account for only some 8–10 percent of GDP. In the case of Chile, with copper accounting for 40 percent of exports and 9 percent of GDP, the key development emanating partly from the emerging market crisis has been the weakness of world copper prices.[7] In Mexico, exports account for a higher share of GDP (about 27 percent), but over 80 percent of the total is traded within NAFTA. Pulled by buoyant demand in the U.S. and Canada, Mexico's exports have continued to grow through 1998 and the first half of 1999.

The second set of factors that helps explain the different recovery patterns is the strength of *economic fundamentals at the onset of the crisis.* In most of Asia, relatively strong fiscal positions allowed governments to pursue counter-cyclical policies in

[7]Between 1996 and the first quarter of 1999, copper prices declined by 39 percent in U.S. dollar terms; they are projected to decline further in the second half of 1999, but to gradually recover in 2000. For an analysis of the impact of copper prices on the Chilean economy, see Antonio Spilimbergo, "Copper and the Chilean Economy: 1960–1998," IMF Working Paper 99/57 (Washington: International Monetary Fund, April 1999).

Figure 2.5. Selected Emerging Market Economies: Real GDP
(Percent change from four quarters earlier)

Crisis and recovery patterns have been diverse across Asia. In Latin America the crisis came later, but it had a significant impact in the main emerging markets in the region with the exception of Mexico.

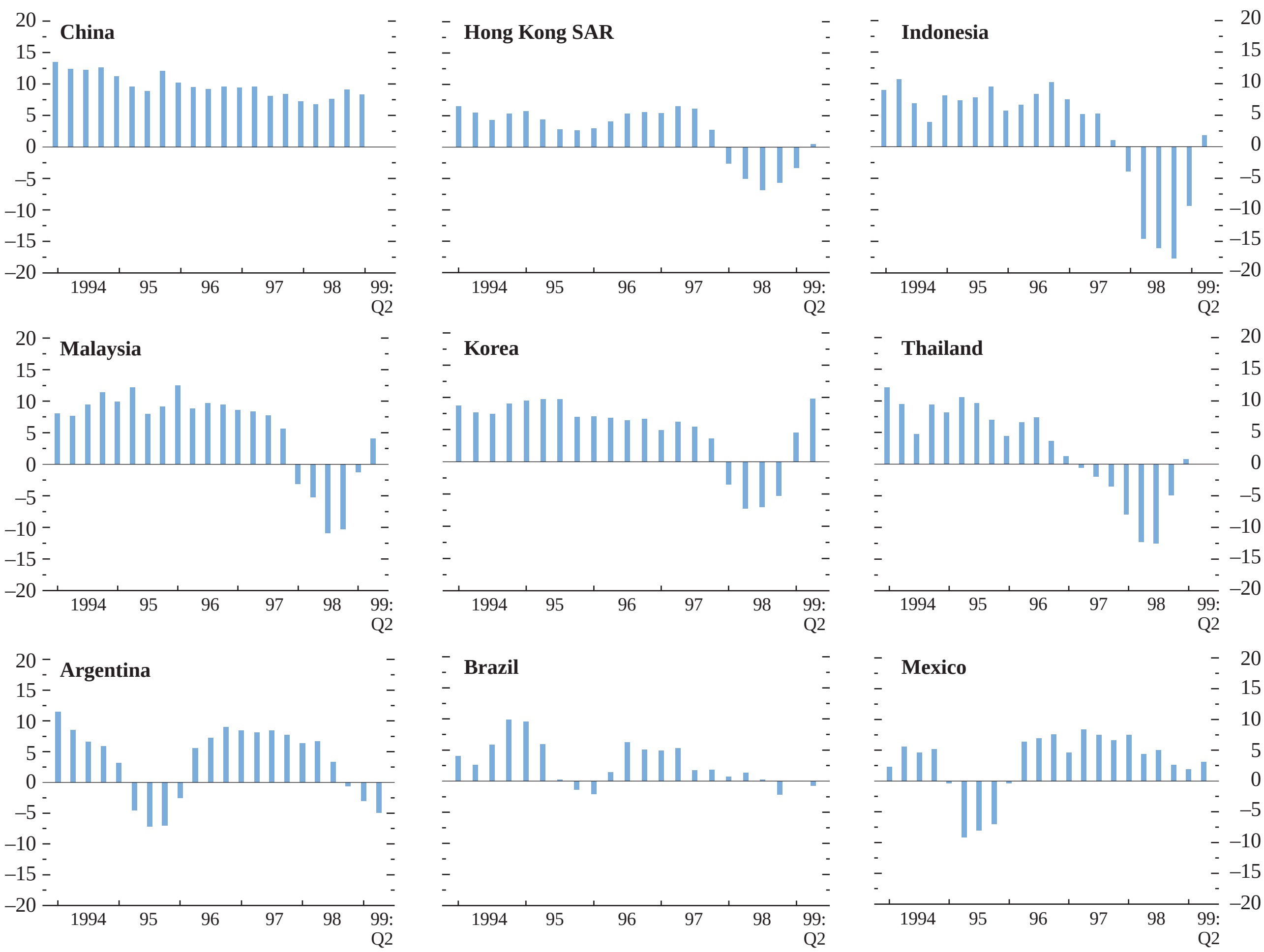
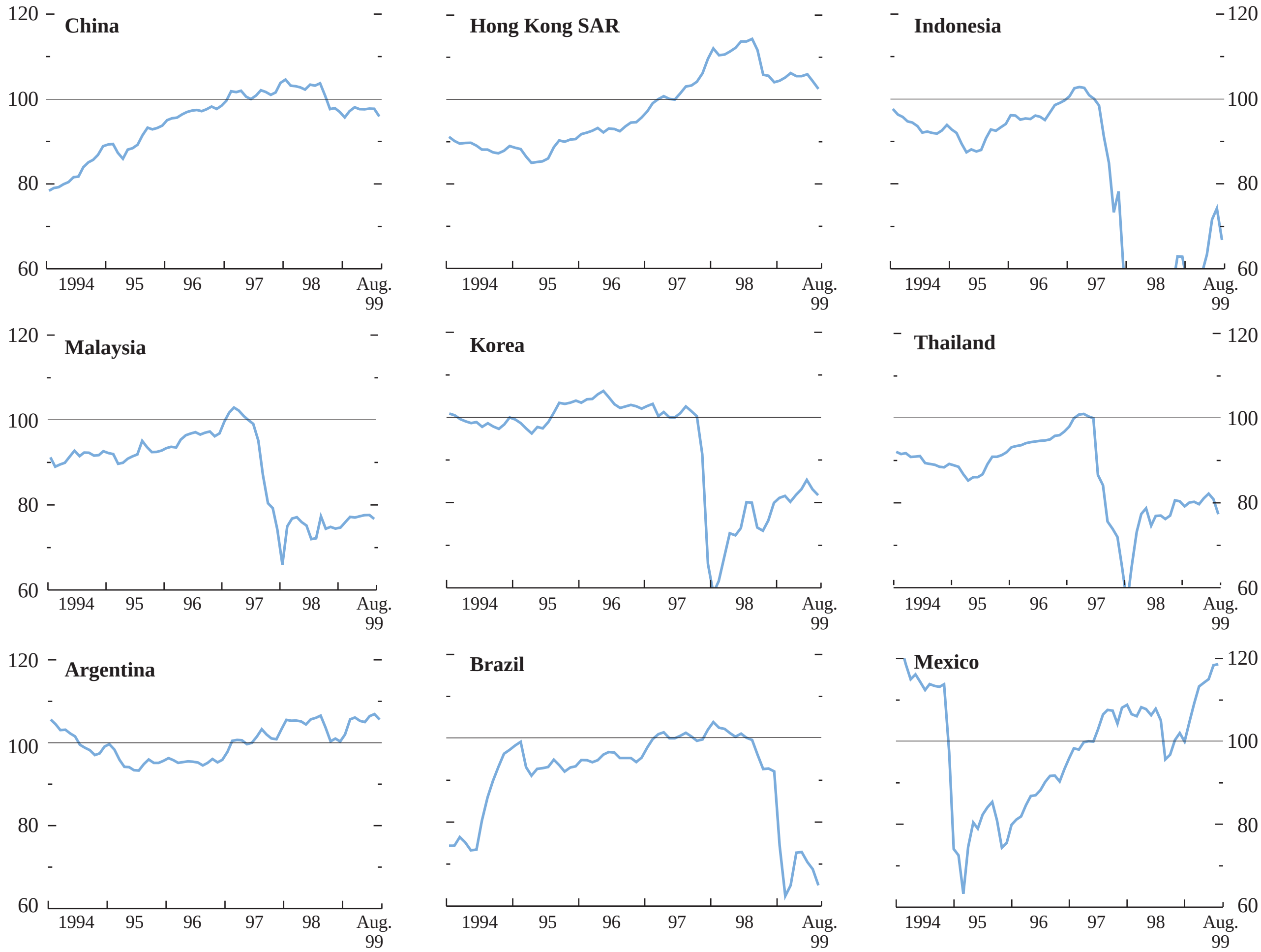


Figure 2.6. Selected Asian and Latin American Economies: Real Effective Exchange Rates[1]
(June 1997 = 100)

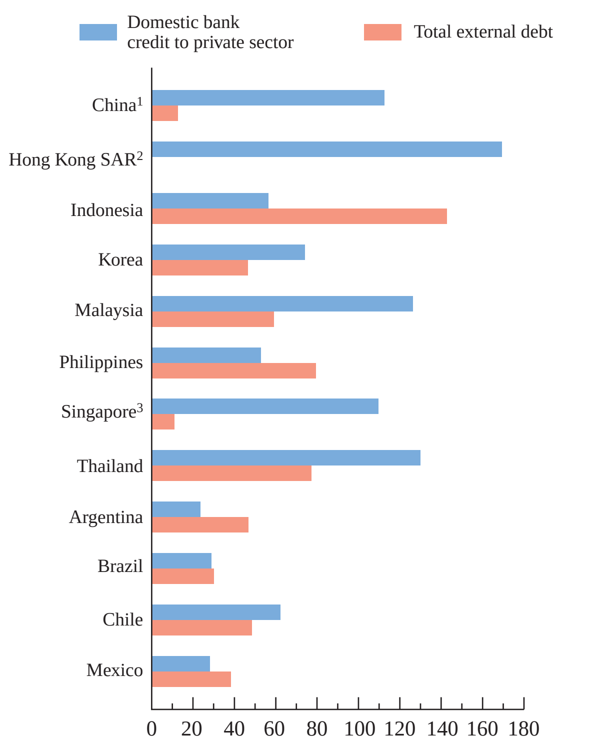
Real effective exchange rates in Asia remain below precrisis levels.



Source: IMF staff estimates.
[1]Defined in terms of relative consumer prices based on 1988–90 trade weights.

Figure 2.7. Selected East Asian and Latin American Countries: Bank Credit to the Private Sector and Total External Debt, 1998
(Percent of GDP)

Private sector indebtedness is generally lower in Latin America than in most Asian countries, while differences in external debt positions in the most indebted countries in both regions are less marked.



Sources: IMF, *International Financial Statistics*, and IMF staff estimates.
[1]In China, bank credit to private sector includes lending to state owned enterprises and collectively owned enterprises.
[2]Total external debt data are not available.
[3]External debt only covers external bank and trade-related non-bank claims of the Bank of International Settlements (BIS) reporting countries.

the wake of the crises and to commit large public funds to recapitalize banking systems and speed up financial sector restructuring. The strength of economic fundamentals nevertheless varied widely across the region. In Singapore, a long tradition of prudent fiscal management had been accompanied by a strong external position and a well capitalized and regulated banking system. In Korea, a favorable fiscal position and a moderate current account deficit on the eve of the crisis made room for subsequent fiscal expansion and noninflationary financing of banking and corporate restructuring. By contrast, in Indonesia and Thailand, combinations of large current account deficits and poorly regulated banking sectors contributed both to the greater severity of the 1998 downturns and to more subdued recoveries relative to Korea. While possessing a well-regulated and capitalized banking system, Hong Kong SAR was particularly vulnerable to the slowdown in regional trade, and the need to keep interest rates high at times to defend the peg exacerbated the negative impact from trade.

In Latin America, there are broad differences in economic fundamentals by comparison with Asia, and the strength of economic fundamentals has varied more widely across countries. Well-capitalized and significantly smaller (than in Asia) banking sectors in Argentina, Brazil, and Chile, combined with low levels of private sector indebtedness (Figure 2.7) helped mitigate contagion from the 1997 Asian crisis. But external current account deficits in excess of 4 percent of GDP in all three countries, together with sizable external and public sector debt in Argentina and Brazil, and the latter's large fiscal deficit rendered the region vulnerable to financial pressures. In Chile, the strength of public finances and the financial system, and benign private sector debt profiles all bode well for robust recovery, but in Brazil, large, albeit declining, fiscal imbalances have kept real interest rates high and also prevented the use of fiscal policy to support demand. In Argentina, concerns about the current account deficit and relatively high public sector financing needs in 1999 and 2000 have also restrained the use of fiscal policy as a counter-cyclical instrument, while an expansionary monetary policy is ruled out by the currency board arrangement, and monetary conditions more broadly have been kept tight by the strength of the dollar.

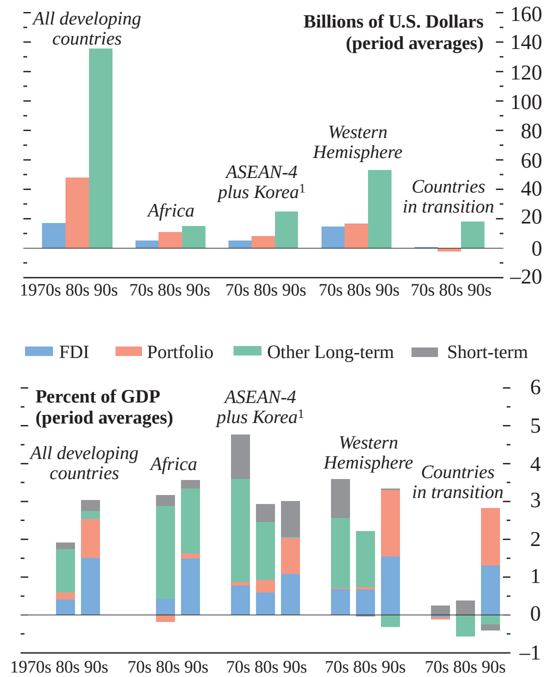
Third, wherever room for maneuver was provided by initial fundamentals, *macroeconomic and structural policies* have had an important role in fostering recovery. The role of structural policies is discussed below in the context of east Asia, and is in addition illustrated by the example of Argentina (Box 2.3). With regard to monetary policy, the recovery has tended to proceed faster in countries that could lower interest rates without weakening the exchange rate. In an effort to stabilize the exchange rate and prevent a de-

Box 2.2. Capital Flows to Emerging Market Economies: Composition and Volatility

Net international capital flows (private and official) to emerging market economies have increased sharply in absolute terms since the 1970s (see figure). The increased supply of foreign financing has enlarged the resources available to these countries for capital accumulation and economic growth. On the other hand, the increase in net capital flows to emerging market economies has rendered the recipients more vulnerable to volatility in these flows. The financial crises that have erupted in emerging market economies in recent years have again raised the question of whether large exposure to international capital flows, in particular short-term flows, should be avoided because of their volatile nature.

The theoretical distinction between short-term and long-term capital flows is usually intended to differentiate between flows that are easily reversible and sensitive to fluctuations in expected risk-adjusted international yield differentials—flows that are sometimes referred to as speculative or "hot money"—and flows that are not easily reversible and that are determined more by longer-term fundamentals. In practice, in balance of payments statistics, the distinction between short-term and long-term flows—a distinction drawn for "other net investments," which excludes foreign direct investment (FDI) and portfolio flows—is based on the maturity of the instrument or asset involved, with short-term flows relating to instruments with a maturity of less than one year.[1] However, such a definition fails to capture the notional distinction between short- and long-term flows: thus "short-term" loans are often rolled over repeatedly. And there is some debate in the literature about whether portfolio or short-term capital flows are more volatile than FDI and other long-term flows.[2] Thus although the usual categories of capital flow may give useful information about the maturity and type of the underlying assets, they may be of limited use in distinguishing between volatile and more stable flows. To illustrate, the table shows some summary statistics measuring the mean and volatility of net capital flows in recent decades. It indicates that while FDI has in most cases been the least volatile category of

Emerging Market Economies: Net Foreign Financing and Its Composition



[1]For ASEAN-4 plus Korea, the 1970s do not include 1970.

flow, other flows classified as "long-term" have been just as volatile as those classified as "short-term." For example, for developing countries as a whole other long-term investment flows have been more volatile than short-term investment flows in the 1990s, as measured by the standard deviation in percent of GDP, the coefficient of variation, and the number of sign changes.

FDI and portfolio flows account for the larger part of the increase in net capital flows to developing countries as a whole since the 1970s, and to the main regional groups. FDI has shown a steep increase and it is now the single largest component of long-term capital flows in many developing countries. The growing importance of FDI as a source of foreign financing has been the result of a number of factors, such as macroeconomic and trade reforms, which have made many emerging market countries more attractive destinations for foreign investment; privatization; and advances in information technology,

(continued on next page)

[1]*Balance of Payments Manual*: Fifth Edition (Washington, DC: IMF, 1993).

[2]Stijn Claessens, Michael P. Dooley, and Andrew Warner, "Portfolio Capital Flows: Hot or Cold?" *World Bank Economic Review*, Vol. 9 (January 1995), pp. 153–174, found in most of the cases they examined that short-term capital flows were not more volatile than other capital flows. For empirical evidence in support of the contention that short-term flows are more volatile than long-term flows see, for example, Philip Turner, "Capital Flows in the 1980s: A Survey of Major Trends," BIS Economic Papers 30 (Basle: Bank for International Settlements, Monetary and Economic Department, April 1991), or Chapter 1 of World Bank, *Private Capital Flows to Developing Countries: The Road to Financial Integration* (Washington: World Bank, 1997).

preciation-inflation spiral, monetary policy was tightened in a number of Asian countries between late 1997 and early 1998. But once it became clearer that the pass-through of earlier devaluations onto prices would be limited, that the risks of further exchange rate instability dissipated, and as foreign exchange re-

Box 2.2 *(concluded)*

Emerging Market Economies: Volatility of Net Capital Flows[1]

	Mean		Volatility: Standard deviation		Volatility: Coefficient of variation[2]		Volatility: Number of sign changes	
	1980s	1990s	1980s	1990s	1980s	1990s	1980s	1990s
	(In percent of GDP)				*(Ratio)*			
FDI								
Developing countries	0.4	1.5	0.1	0.6	0.3	0.4	0	0
Africa	0.3	0.9	0.2	0.5	0.6	0.5	2	0
ASEAN-4 plus Korea	0.6	1.1	0.3	0.3	0.5	0.2	0	0
Latin America	0.7	1.5	0.2	0.8	0.3	0.5	0	0
Transition economies	0.0	1.3	0.0	0.8	. . .	0.6	2	1
Portfolio								
Developing countries	0.2	1.0	0.1	0.6	0.7	0.6	0	0
Africa	–0.2	0.1	0.1	0.3	–0.8	2.8	2	3
ASEAN-4 plus Korea	0.3	0.9	0.3	0.9	1.0	0.9	4	2
Latin America	0.1	1.8	0.3	1.0	5.3	0.6	2	0
Transition economies	0.0	1.5	0.0	1.2	. . .	0.8	0	2
Other net investment[3]								
Developing countries	1.3	0.5	0.5	1.2	0.4	2.4	0	3
Africa	2.9	2.5	1.0	1.6	0.3	0.7	0	0
ASEAN-4 plus Korea[4]	2.0	1.0	2.0	3.0	1.0	3.1	2	1
Latin America	1.5	–0.3	1.7	1.0	1.2	–3.7	1	4
Transition economies	–0.2	–0.4	0.2	1.4	–1.4	–3.4	3	7
Of which:								
Other long-term[5]								
Developing countries	1.2	0.2	0.5	0.8	0.4	3.6	1	4
Africa	2.6	2.3	1.0	1.8	0.4	0.8	0	0
ASEAN-4 plus Korea	1.5	0.0	1.1	1.3	0.7	. . .	2	5
Latin America	1.5	–0.3	1.1	1.1	0.8	–3.5	1	6
Transition economies	–0.5	–0.3	0.3	1.4	–0.5	–5.4	0	2
Short-term								
Developing countries	0.2	0.3	0.4	0.6	2.5	2.2	4	1
Africa	0.3	0.2	0.5	2.2	1.7	9.8	3	4
ASEAN-4 plus Korea	0.5	0.9	1.1	3.3	2.4	3.5	2	1
Latin America	0.0	0.0	1.3	0.6	. . .	. . .	4	1
Transition economies	0.4	–0.2	0.1	0.4	0.3	–2.6	0	7
Total net flow								
Developing countries	1.9	3.0	0.4	1.0	0.2	0.3	0	0
Africa	3.0	3.6	1.0	1.0	0.3	0.3	0	0
ASEAN-4 plus Korea	2.9	3.0	2.2	3.2	0.8	1.1	2	1
Latin America	2.2	3.0	1.9	0.9	0.9	0.3	0	0
Transition economies	–0.2	2.4	0.3	1.5	–1.3	0.6	1	2

[1]Categories of capital flow are in accordance with *Balance of Payments Manual*: Fifth Edition (Washington, DC: International Monetary Fund, 1993).
[2]Standard deviation divided by mean.
[3]Is a residential category including financing from official and private sources. Instruments in this category are usually not traded in secondary markets, in contrast to instruments classified with portfolio investment.
[4]The ASEAN-4 countries are Indonesia, Malaysia, the Philippines, and Thailand.
[5]Includes financing from official and private sources.

which have made it easier for foreign investors to acquire information about investment opportunities around the world, and which has also facilitated the control that multinational enterprises can exert over their subsidiaries abroad. Net portfolio flows have grown considerably since the 1980s reflecting, in addition to the above factors, the development of stock markets in a number of emerging market economies, but this has been less im-

serves recovered, successive cuts in central bank target rates followed. In Korea, by mid-1999 the Central Bank's call rate had been lowered to around 5 percent and real interest rates were below precrisis levels. Meanwhile, the won strengthened from its lows, reflecting the rising current account surpluses, restored portant than the increase in FDI. Other short-term flows to developing countries as a whole have also increased in this period, but this increase is largely accounted for by the east Asian crisis economies—the ASEAN-4 plus Korea. In most other regions, other short-term flows have declined since the 1970s.

The change in the composition of net capital flows to developing countries appears to have had no significant, systematic effect on the volatility of total net flows: in some groups of countries (the ASEAN-4 plus Korea, and the countries in transition), the increases in the shares of FDI and portfolio flows have coincided with increases in the volatility of total net flows, whereas in other groups of countries (notably, Latin America) they have coincided with more stable net foreign financing.[3] FDI flows are historically the least volatile category of international capital flows—as indicated in the table, both in terms of variation around the mean of the flow (the coefficient of variation) and in terms of the number of sign changes in the net flow—and an increase in their share in the total might be expected to result in less volatile foreign financing. The fact that this has not generally been the case may suggest, for instance, that FDI flows are correlated with more volatile "other short-term" flows, for example, because foreign investors are hedging their earnings.[4]

Some support for this explanation is provided by the data. As the table shows, FDI and portfolio flows in percent of GDP increased in all regions in the 1990s, but short-term flows increased only in the ASEAN-4 plus Korea, where the increase in FDI was associated with an increase in the volatility of total net flows.[5] It is unclear whether the increase in short-term flows to the east Asian crisis economies has been causally linked to the increase in FDI flows, but this experience demonstrates that increases in FDI flows do not automatically lead to more stable net foreign financing.

[3]Compare the standard deviations in percent of GDP, the coefficients of variation, and the number of sign changes of the total net flow for the different groups of countries between the 1980s and 1990s in the table.

[4]See also Box 2.2 of the 1998 *International Capital Markets Report* (Washington, DC: IMF, 1998) for a discussion on the stability of FDI flows and hedging.

[5]Annual data, not shown here, indicate that the volatility of net foreign financing fell in all regions in the early 1990s, but that it rose again in the east Asian crisis economies with the sharp reversal of short-term flows in the second half of the decade. Volatility of net foreign financing also increased in Africa in the second half of the 1990s, which appears to be associated with the growing share of private sources in total financing.

credibility in macroeconomic policy, and the substantial progress in banking sector restructuring. Similarly in Thailand, the overnight interbank rate has fallen below 1 percent from 20 percent in early 1998. However, partly because of the high incidence of problem loans in the financial system and banks' more cautious attitude toward new lending, lending rates have fallen by much less, to around 10 percent. Interest rates have also been lowered considerably in Singapore.

In each of these cases, external capital accounts remained broadly open and foreign ownership rules were liberalized so as to attract foreign investment into the financial and corporate sectors and help rebuild investor confidence. A somewhat different path was followed by Malaysia: selective capital controls were introduced in September 1998, following which monetary policy was eased (see Box 2.4). In addition, a ceiling on loan spreads was imposed on banks, and targets for credit growth were set for the banking system as a whole. However, as the maximum loan spread failed to reflect banks' risk assessments and because institutions with capitalization problems had difficulties in extending new credit, the measures fell well short of achieving the targets for credit growth.

A combination of interest rate cuts and tighter capital controls was also adopted in China. Deposit rates were reduced by 1¼ percentage points in 1998 and by a further 1 percentage point in June 1999, with the benchmark one-year interest rate falling some 3½ percentage points below corresponding U.S. dollar rates—a differential made possible by stringent capital controls. In Hong Kong SAR, the maintenance of the currency board arrangement entailed significant increases in interest rates at various times of turbulence in the past two years. The general improvement in investor sentiment toward the region has permitted an easing of monetary conditions since late 1998, but, with inflation negative, real interest rates have remained the highest in the region. In Indonesia, owing to a combination of political turbulence and extreme financial system weaknesses, it took longer to stabilize the rupiah and lower interest rates.

Fiscal policy, which was initially restrictive after the eruption of the crises partly owing to underestimation of their contractionary impact, was subsequently eased considerably in all countries in the region.[8] The most significant shifts in fiscal stance took place in Indonesia, Korea, Singapore, and Thailand.

Among emerging market economies in the Western Hemisphere, monetary conditions in Argentina tightened considerably in the wake of the Russian crisis. As in Hong Kong SAR, the real economy has been adjusting to a combination of tighter financing conditions and a fixed exchange rate against a strong U.S.

[8]Timothy Lane et al., *IMF-Supported Programs in Indonesia, Korea, and Thailand: A Preliminary Assessment,* Occasional Paper 178 (Washington: International Monetary Fund, July 1999).

Box 2.3. Structural Reforms in Latin America: The Case of Argentina

The severe macroeconomic crises in Latin America during the 1980s brought into sharp relief the need for deep-seated reforms to restore fiscal and monetary discipline and increase reliance on market mechanisms for resource allocation. Starting in the late 1980s, most countries in the region embarked on ambitious reform agendas, which ranged from streamlining the public sector and liberalizing foreign trade and financial markets, to increasing the flexibility of labor markets and improving governance. Since then substantial progress has been made in downsizing the state through deregulation and privatization, lowering trade barriers, and promoting the internationalization of domestic capital markets. Total factor productivity has risen significantly in most reformed countries, in some cases drastically reversing previous trends toward stagnation of per capita income levels.[1]

Notwithstanding these advances, the reform agenda in most of Latin America is far from complete. Close scrutiny of particular reform areas across different countries indicates that the reform process has been quite uneven: progress in labor market reform and in key areas of fiscal reform has lagged behind considerably in most cases, while progress with banking sector reforms has been far more substantial in some countries than others.[2]

Argentina is one of the countries where structural reforms have advanced the most. Having started in 1989/90, the reform process gained momentum from 1991 with the introduction of a currency board arrangement—the centerpiece of the government's stabilization program. In the following years, unprecedented progress was made on three important fronts. On public sector reform, virtually all state enterprises were privatized and the social security system reformed; together with widespread deregulation, and simplification and enforcement of the taxation system, this helped lower significantly the share of general government expenditure in GDP and bring the central government deficit down to under 2 percent of GDP in 1993–94, from double-digit levels in 1989–90. On the external front, capital account restrictions were eliminated and average import tariff rates lowered to around 10 percent,[3] helping to increase trade and financial integration with the world economy. In the area of banking sector reform, capital adequacy requirements were tightened, regulations on reserve and liquidity requirements were rationalized and enforced, and the transparency of financial institutions enhanced through the obligation of making public their monthly balances as well as periodical ratings from authorized agencies; at the same time, a number of undercapitalized private institutions were closed, several provincial public banks were privatized, and the participation of large international banks in domestic credit markets has become larger than that of local banks, thereby helping to strengthen confidence in the financial system.

By enhancing the credibility of the government's stabilization program, promoting competition in goods and credit markets, and attracting substantial capital flows into the country, the reforms boosted productivity, and real GDP expanded by 5¼ percent a year on average between 1990 and 1995, despite the severity of the 1995 "tequila" crisis. At the same time, institutional support for the overall tightening of macroeconomic policies made possible by the reforms helped to reduce inflation and firm up confidence in the currency board regime.

These major strides were followed by several measures to strengthen further the banking system in the aftermath of the "tequila" crisis, and by the passage in late 1998 of a well-balanced tax reform which, *inter alia*, has made

[1]For evidence on the correlation between structural reforms and the growth of total factor productivity, see Pablo Fajnzylber and Daniel Lederman, "Economic Reforms and Total Factor Productivity Growth in Latin America and the Caribbean, 1950–1995: An Empirical Note," World Bank, Policy Research Working Paper 2114 (Washington: 1998).

[2]For a broad review of recent progress in these different reform areas across Latin America and the Caribbean, see Norman Loyaza and Luisa Palacios, "Economic Reform and Progress in Latin America and the Caribbean" (Washington: World Bank, 1997). For a review of advances in trade reforms across the region in the 1990s, see Claudio Loser and Martine Guerguil, "Trade and Trade Reform in Latin America and the Caribbean in the 1990s," *Journal of Applied Economics*, Vol. II (1999), pp. 61–96.

[3]See Marcelo Garriga and Pablo Sanguinetti, "Es el Mercosur un bloque natural? Efectos de la politica comercial y la geografia sobre el intercambio regional," *Estudios*, XVII, No. 73, April/June 1995.

dollar through lower activity and deflation (Figure 2.5). In contrast, monetary policy has been eased considerably in Brazil and Chile since early 1999, as noted earlier. In Chile, the easing of monetary policy has been warranted by the marked weakening in economic activity and declining inflation since late 1998, while in Brazil, the so-far limited pass-through of the January 1999 devaluation onto prices and some tightening of the fiscal stance have enabled the authorities to lower interest rates without fueling inflation. Yet, monetary easing in both Brazil and Chile started from much higher levels of interest rates in nominal and real terms in the second half of 1998, and its full effects on economic activity could take some time to be felt. Monetary policy in Mexico has been kept tight during 1999, reflecting the country's relatively good growth performance and the need to lower inflation from the double-digit rates experienced recently.

Fiscal policy has also been eased in Argentina and Chile but only modestly. In Chile, a deficit of 1.7 percent of GDP is projected for 1999, compared with a some room for a reduction in payroll taxes (see below). Nevertheless, reforms in labor legislation and in institutional arrangements to ensure fiscal discipline in the longer term have fallen well short of expectations. Flexible labor markets are an essential condition for the smooth functioning of a fixed exchange rate regime and yet Argentina's labor market legislation continues to be characterized by a centralized bargaining process, high dismissal costs, and a host of payroll taxes and contributions that, even taking into account the reductions scheduled for the remainder of 1999, impose a mark-up of close to 60 percent on net wages.[4] Although a new labor law introduced in 1998 goes some way toward reducing dismissal costs, it has effectively increased the rigidity of the collective bargaining process, restricted considerably the scope for temporary contracts and apprenticeship programs, and failed to eliminate certain mandatory contributions that add to the wage bill. There is evidence that the coexistence of rapid output growth and double-digit unemployment rates in recent years (see Figure 2.5 and figure in Box 2.6) has been due not only to transitional factors pertaining to economic liberalization and industrial restructuring, but also to the high cost of labor relative to capital resulting from high payroll taxes and some other payroll contributions, as well as from the stringent constraints to hiring and firing perpetuated by the existing legislation.[5] The adverse effects of insufficient labor market flexibility on external competitiveness and the trade balance have also been significant, particularly given the currency depreciations in trading partners and terms of trade shocks that have occurred in the past two years, rendering the country more vulnerable to contagion.[6]

The long-term viability of the currency board arrangement in Argentina depends not only on labor market flexibility but also on institutional arrangements that effectively restrict public indebtedness and reduce the incentive to default or inflate the debt away. In early August 1999, a law to cap the size of budget deficits (the so-called "fiscal convertibility law") was approved by congress calling for a gradual decline in the fiscal deficit, leading to a balanced budget in 2003. The law only covers the central government, and as the Argentine fiscal system is highly decentralized as far as spending is concerned (with nearly half of total noninterest spending being managed by the provinces), it is crucial that checks and incentives for fiscal discipline apply to the provincial government level as well. At present, most revenues continue to be raised and transferred from the federal government to the provinces through a predetermined formula that provides little incentive for provincial governments to increase their own revenue base or limit their spending accordingly. Moreover, the present revenue-sharing scheme includes a minimum floor to the transfers that limits the provinces' revenue losses during recessions. This tends to strain central government finances during cyclical downswings (as a larger share of total revenues is transferred to the provinces to maintain the minimum revenue floor), while also reducing incentives for fiscal discipline by provincial administrations.

In sum, Argentina has implemented far-reaching structural reforms in the 1990s. While overall progress has been impressive, advances in key areas—notably the fiscal relations between federal and provincial governments, and labor market reform—have fallen short of what would be desirable. Substantial progress still needs to be made on these fronts, if satisfactory economic growth and the currency board regime are to be compatible and sustainable in the longer term.

[4]See FIEL, *El Empleo en la Argentina. El rol de las instituiciones laborales,* Fundacion de Investigaciones Economicas Latinoamericas (Buenos Aires, 1997), pp. 43–44. The above estimate has been adjusted for the 6 percentage point reduction in payroll tax rates introduced in the first three quarters of 1999 and by an additional 4 percentage point reduction scheduled for December, which were not taken into account in the FIEL (1997) estimate.

[5]For a comprehensive discussion of labor market developments and determinants of unemployment in Argentina in recent years, see, for instance, Pessino, Corrola, "Argentina: The Labor Market During the Economic Transition," in Sebastian Edwards and Nora C. Lustig, eds., *Labor Markets in Latin America: Combining Social Protection With Market Flexibility* (Washington: Brookings Institution, 1997), pp. 151–200.

[6]See Luis Catão and Elisabetta Falcetti, "Determinants of Argentina's External Trade," IMF Working Paper (forthcoming, 1999).

0.1 percent surplus last year.[9] In Argentina, the projected increase in central government deficit to 1.8 percent of GDP in 1999, from 1.3 percent in 1998, represents a significant tightening of the fiscal stance given the sizable contraction of economic activity. In Brazil, there has been a sharp rise in interest expenditures stemming from the combination of higher interest rates in the past year and the composition of the country's public debt, which makes interest payments very sensitive to changes in short-term interest rates and the exchange value of the U.S. dollar. A number of new revenue and spending measures have therefore been needed to secure an increased primary surplus, and this has imparted a negative fiscal impulse to the economy. In Mexico, despite the projected slowdown in economic activity in 1999, the government deficit is budgeted to remain unchanged at 1.3 percent of GDP, entailing some tightening in the stance of policy.

[9]Figures are based on staff projections which treat the use of the copper stabilization fund as a financing item, rather than an above-the-line component as in the official figures.

Box 2.4. Malaysia's Response to the Financial Crisis: How Unorthodox Was It?

The imposition of capital controls in Malaysia in September 1998—they were partially relaxed in February 1999—has been characterized by many observers as marking the choice of a distinctly different and unorthodox response to the Asian financial crisis. This box examines the differences in Malaysia's policy approach and in the macroeconomic outcomes to date. It concludes that, with the exception of the capital controls, the policies implemented in Malaysia were broadly similar to those in the other crisis countries. Likewise, while yield spreads for Malaysia have remained higher, relative to Korea and Thailand, than before the imposition of controls, and capital inflows have been relatively subdued, macroeconomic developments to date in Malaysia and the other crisis countries have been broadly similar, making it difficult to identify, at least in the short time that has elapsed since the imposition of the controls, any effects that they may have had. This may be considered not altogether surprising, both because capital outflows had abated markedly by the time the controls were imposed, and because the effects of such controls can usually be judged only over a longer period.

Initial conditions in Malaysia were stronger than in the other crisis countries in some respects, but there were also common signs of weakness

At the time the crisis hit, the Malaysian economy had many strengths, including—in comparison with its regional neighbors—a high national saving rate, large fiscal surpluses, relatively low external debt, and low inflation (see figure). Indicators of banking system soundness—such as nonperforming loans and capitalization levels and corporate sector vulnerability measured by ratios of debt to equity—also suggested greater strength than in its neighbors. However, there were also areas where Malaysia, like Thailand and Korea, showed signs of vulnerability, such as high rates of private sector credit growth, a large external current account deficit, an "overheating" economy as evidenced by a negative output gap, and asset price inflation, in both real estate and equities.

Malaysia's initial interest rate policies were not as aggressive as those in the other crisis countries, while the fiscal policy responses were similar

The initial manifestations of the crisis were similar across all the crisis countries. Each country experienced severe losses in investor confidence and large capital outflows, which resulted in sharp declines in reserves, stock market collapses, and currency depreciations. The immediate policy responses to the crisis were also similar in the affected countries, and included defensive intervention in foreign exchange markets coupled with hikes in interest rates, followed by the floating of currencies. Some countries also tightened capital and exchange controls, particularly on forward or derivative transactions and their financing. These actions, which were generally inadequate to restore investor confidence and stem capital outflows, were followed by the adoption of adjustment packages that included tight monetary and fiscal policies and wide-ranging programs of structural reforms.

Although the monetary policy responses in Malaysia were broadly similar to the rest of the crisis countries, in the sense that nominal interest rates were increased, there were also some important differences. In particular, Korea and Thailand initially raised interest rates more sharply and maintained them at higher levels for some time, but were able to bring them down earlier and more rapidly. In contrast, nominal interest rates peaked later and reached a lower peak in Malaysia than in other countries. The downward movement in interest rates began in March 1998 in Korea and Thailand, while Malaysia began lowering interest rates in August 1998. Furthermore, interest rates in Korea and Thailand were brought down to precrisis levels earlier than in Malaysia.

With respect to fiscal policy responses—measured by changes in the planned central government balances in 1998—all countries shifted from initially planned surpluses to sizable deficits, as the depth of the output collapse in 1998 came to be appreciated. The shift toward deficits to provide a stimulus to economic activity took place as early as February and March 1998 in the case of Korea, Thailand, and the Philippines. In Indonesia and Malaysia, the shifts in fiscal policy toward stimulus took place somewhat later—in April and July 1998, respectively.

Malaysia kept pace with the other crisis countries in structural reforms

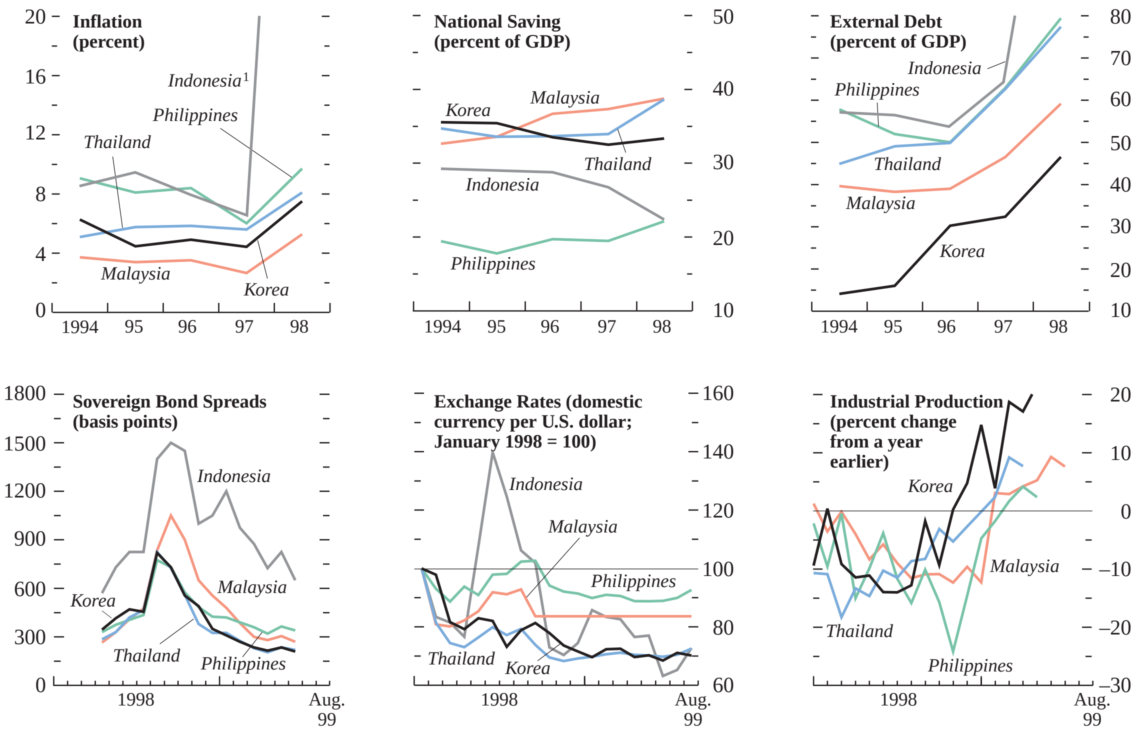
Another common feature of the adjustment efforts in all countries was the focus on structural reforms aimed at strengthening the financial sector and improving the efficiency of financial intermediation. Measures in-

Thus, in comparison with Asia, where both monetary and fiscal policies have been clearly countercyclical since the middle of 1998, in Latin America, partly because of the constraints imposed by less favorable initial fundamentals, there has only been limited scope for macroeconomic policies to support aggregate demand and speed up economic recovery.

Structural Reform Requirements in Crisis-Hit Asian Economies: Conditions for a Durable Recovery

While it is clear that a significant recovery in economic activity is now underway in most Asian countries, the extent to which the underlying structural problems in these economies have been ad-

Asian Crisis Economies: Macroeconomic Indicators, 1994–98



Sources: Deutsche Bank, *Asian Economic Weekly;* IMF staff estimates; and WEFA, Inc.
[1]In 1998, Indonesia's inflation reached 59.6 percent.

volved tightening prudential regulations, including loan classification and provisioning guidelines and capital adequacy standards; enhancing transparency with regard to the disclosure of key economic, financial, and corporate sector information; and strengthening the social safety net. Efforts to restructure corporate sector debt were also made, but they were begun later than the financial sector reforms. Despite a later start than in the other crisis countries, Malaysia has kept pace with Korea and Thailand in implementing structural reforms, especially with respect to the purchase of nonperforming loans and bank recapitalization.

The role of capital controls in Malaysia

By July–August 1998, some measure of stability had returned to financial markets in the crisis countries. By that time, currency and stock markets had broadly stabilized after another round of severe instability in April–May 1998, resulting primarily from the political turmoil in Indonesia, the fall in the Japanese yen, and fears of a devaluation of the renminbi. Sovereign bond spreads had peaked for Korea, Thailand, and the Philippines, and in Malaysia and Thailand, the offshore swap differential was clearly trending down. Importantly,

(continued on next page)

dressed is more difficult to assess, and there are fewer indications of clear progress. Structural reforms take time to design and implement. Their initial impact may well be painful for those that have benefited from the many distortions that the reforms seek to remove, while their benefits may be more dispersed, less apparent, and spread over a longer time frame. As a result, significant political courage is often needed to see such a reform process through to its conclusion.

Of particular concern is that recent favorable macroeconomic developments could weaken support for the reform agenda, and that the poor banking and corporate sector practices at the root of the crisis could continue. Public sector deficits and debt have increased substantially as authorities have taken action to boost

Box 2.4 ***(concluded)***

the currencies remained stable even as interest rates were gradually being lowered, and capital outflows had abated markedly.

In September 1998, Malaysia imposed capital controls aimed primarily at drying up the offshore ringgit market. Although the ringgit had remained broadly stable when monetary policy was eased beginning in August, the authorities remained concerned about the existence of a significant offshore market for the ringgit that they believed was instrumental in fueling speculative outflows of ringgit and constraining their ability to bring interest rates down more rapidly. Consequently, controls were imposed, requiring all ringgit funds abroad to be brought onshore by end-September 1998. A one-year holding period was imposed on all funds in these accounts. Care was taken from the start to exempt bona fide current account transactions and transactions related to FDI flows. The capital controls were accompanied by the pegging of the exchange rate at the rate of RM 3.8/$, implying an appreciation of the ringgit relative to the then-prevailing market rate. The controls were modified in February 1999, with the shift from a mandatory holding period on the principal amount of capital inflows to a system of graduated exit levies.

With the exception of foreign capital inflows, economic outcomes to date have been broadly similar in Malaysia to the other crisis countries

In many respects, the evolution of key economic variables has been similar across the crisis countries. Growth declined sharply in 1998, but since the fourth quarter of 1998, there have been signs of recovery, of varying strengths, in all of them. Reflecting the collapse of domestic demand, inflationary pressures have been all but nonexistent (except in Indonesia, where they have abated markedly in recent months), notwithstanding the very large nominal exchange rate depreciations between mid-1997 and mid-1998. Private sector credit growth fell sharply in all cases in 1998, and is only very recently showing signs of revival in Korea, Thailand, and Malaysia.

In the fourth quarter of 1998, signs of returning investor confidence began to emerge in all countries. Bond spreads, which peaked in August for Korea, Thailand, and the Philippines and in September for Malaysia and Indonesia, have since come down, although, in contrast to the period prior to the imposition of capital controls, the premium for Malaysia is higher than that for Thailand and Korea. The exchange rates in all the countries stabilized in the fourth quarter of 1998, and, in the first half of 1999, all currencies except the ringgit experienced modest appreciations. Foreign exchange reserves in each of those countries rose markedly during this period, reflecting not only large current account surpluses but also, in varying degrees, capital inflows. The timing and extent of the recovery in stock markets since about September 1998 and through June 1999 was also broadly similar in all countries, and since then Malaysia has been outperformed by Korea.

One difference between Malaysia and the other crisis countries has been with respect to the volume of recent capital inflows. With Malaysia remaining out of key international investment indices, portfolio investment flows have remained subdued relative to the other countries. Furthermore, preliminary data indicate that FDI inflows have failed to recover to earlier levels and have declined relative to Korea and Thailand. Although this difference in the volume of inflows has not yet had a major impact in Malaysia, looking ahead it could be a key factor that distinguishes Malaysia unfavorably from the rest of the region.

This review suggests (1) that Malaysia's policy response has, in most respects, not been unorthodox and (2) that its economic performance, at least to date, has been broadly similar to that of the other crisis countries

The imposition of controls does not yet appear to have made a substantial difference—positive or negative—to economic developments, at least in the short time that has elapsed since their introduction. This seems to be partly because the effects of the controls were limited by the timing of their imposition: capital outflows had already abated following the return of investor confidence to the region in late 1998. The stabilization of the currencies in the region and the undervaluation of the ringgit, together with large current account surpluses, further boosted confidence to the benefit of the capital account. More important, however, Malaysia has made good progress in financial and corporate sector restructuring, strengthening regulation and supervision of financial markets, and implementing corporate governance reforms. Thus any negative impact of the capital controls may have been offset by the increase in confidence from the acceleration of structural reforms and by generally sound macroeconomic management. However, Malaysia's interest rate spreads remain relatively wide, and the recovery of capital inflows relatively subdued.

domestic demand and rehabilitate banking sectors. While these countries' generally strong public finances at the onset of the crisis gave them scope for providing such support, the room for maneuver in this regard has certainly narrowed. With the costs of the crises and their aftermath still unclear, the authorities could face difficulties in containing the fiscal impact and ultimate costs to taxpayers if publicly funded support had to be maintained at a high level. Financial sector reforms need to be combined with government efforts to recover a significant share of the cost of bank recapitalization from privatizations, through the disposal of non-performing assets, and, where possible, from previous owners.

A longer-run question concerns the extent to which the east Asian economies can again reach and sustain the high growth rates that prevailed before the recent crisis. In this regard, it would be unrealistic to expect a return to growth based largely on a rapid rate of capital accumulation, given the financial and corporate sector weaknesses that have been uncovered. As discussed in the October 1998 *World Economic Outlook*, Chapter III, there is still substantial scope for productivity catch-up in these economies. But this potential can be realized only if wide-ranging structural reforms are implemented.

The Financial Sector

The economic crisis in Asia exposed major weaknesses not just in the balance sheets and operations of the region's financial institutions but also in the supervisory and regulatory regimes under which they functioned. Improving regulatory frameworks has therefore been a key element in the reform process and a prerequisite for the needed restructuring. In this respect, the design of reforms is generally well advanced. The authority and independence of supervisory authorities have been strengthened, with more harmonized systems of supervision across all financial institutions. In Korea, for example, a Financial Supervisory Commission (FSC) was established in 1998 to take full responsibility for the supervision, restructuring and (more recently) licensing of all bank and non-bank financial institutions, including the power to revoke licenses. In Indonesia, Malaysia, and Thailand, supervisory responsibilities remain with the central banks, with new legislation in place (in Indonesia[10]) or being prepared (Thailand) to enhance their authority in this area. Prudential regulations, including minimum capital adequacy ratios, rules for classifying and provisioning against nonperforming loans, and exposure limits have generally been strengthened in terms of their stringency, coverage, and enforcement.[11] The Philippines, while less hard-hit by the financial crisis, has also taken steps to enhance banks' ability to withstand shocks, strengthen the prudential and regulatory framework, and streamline the resolution process in the case of troubled banks. There have also been moves (for example, in Malaysia) toward conducting supervision on a consolidated basis across all the activities of each financial institution. With accounting and disclosure standards being brought closer to international best practices, the ability of supervisory authorities to assess compliance with prudential standards has been substantially improved.

With improved regulatory frameworks largely in place, the momentum of restructuring itself has increased. Nevertheless, substantial diversity is apparent both across countries, and, within each country, across different parts of the financial sector. Some details of bank restructuring in the four countries most affected by the 1997 crisis are provided in Box 2.5. Indonesia has faced the severest problems in terms of banking sector insolvency and recapitalization requirements (Table 2.3). The main area of concern is with the state banks and those taken over by the Indonesia Bank Restructuring Agency: together, these account for around 70 percent of total liabilities and nearly all of the system's insolvency. While some initial steps have been taken toward reorganizing these publicly controlled institutions, much remains to be done to restore their financial viability and prepare their privatization. Moreover, with ongoing operational losses, declining loan recovery rates, and increasing estimates of nonperforming loans, the cost of the restructuring process has continued to climb. Current estimates suggest that public bond issues equivalent to around 47 percent of GDP may be needed to rehabilitate the banking sector, but considerable uncertainty—and probably upside risks—surround such estimates.

Elsewhere in Asia, financial sector restructuring is generally on track, although, as noted in Box 2.5, the full costs of recapitalization are still unclear. In Korea, Malaysia, and Thailand, a large number of institutions, holding around 40 percent of system assets, have been merged, closed, or otherwise subject to official intervention (Table 2.3). Recapitalization (at end-March 1999) ranged from 31 percent of estimated total requirements in Korea to 51 percent in Thailand. The remaining financial institutions—especially the banks—are generally well capitalized, many have access to private as well as public funds, and they appear to be subject to a credible threat of intervention by the supervisory authorities if they are unable to meet the strengthened prudential standards. Nevertheless, progress is still required in several areas. The bank privatization programs in Korea and Thailand have been slower than earlier envisaged, although several sales are expected to be concluded in the second half of 1999. Due in part to prioritization in the reform strategy, reforms among nonbank financial intermediaries have been taking place at a slower pace than in banks. For example, in Korea, reforms now need to focus on investment trust companies, insurance companies, and leasing companies. While publicly owned asset management companies have been fulfilling their assigned role in purchasing impaired assets from financial institutions, the slow pace of selling these assets back to the private sector may delay the overall realignment of asset prices and other aspects of restructuring.

---

[10]A second phase of the comprehensive review of the banking law and related regulations in Indonesia is to be completed by end-1999.

[11]Going against the regional trend, as discussed above, and in the December 1998, *World Economic and International Capital Markets Interim Assessment*, Malaysia relaxed certain loan classification and provisioning requirements in September 1998; however, it appears that most financial institutions in Malaysia meet the more stringent international standards.

Table 2.3. Financial Sector Restructuring

(End-March 1999 or latest available data—percent unless otherwise indicated)

	Indonesia	Korea	Malaysia	Thailand
Capitalization				
NPLs/Total loans[1]	55	16	24	52
NPLs/GDP	22	23	35	53
Provisions/NPLs[2]	22	13	43	25
System capitalization[2]	–29	29	12	15
Financial Restructuring				
NPLs sold to AMC/Total NPLs	51	42	23	. . .
Average discount of NPL purchase[3]	100	55/97	40	. . .
System recapitalization/GDP	35	8	2	14
Of which: Public funds	33	8	2	7
System recapitalization/Est. recap. requirement[4]	—	31	40	51
Number of merged institutions[5]	5	4	12	18
Number of intervened institutions[6]	93	59	9	17
Number of closed institutions[7]	66	44	—	57
Merged institutions/system assets[8,9]	30	15	>20	16
Intervened institutions/system assets[9]	75	14	>20	12
Closed institutions/system assets	14	7	—	13

Sources: Data provided by country authorities; Fund staff estimates; and Merrill Lynch, *Asia-Pacific Banks: Progress in Bank Restructuring*, February 23, 1999.

[1]Includes nonperforming loans (NPLs) sold to asset management companies (AMCs), to better reflect the magnitude of the problem prior to balance sheet restructuring. In Indonesia, for example, NPLs on banks' balance sheets fell to 41 percent of total loans, and 11 percent of GDP, after some NPLs were transferred to the IBRA. For Korea, the NPL figure is based on market sources. For Thailand, the figure is for commercial banks.

[2]Figures for Korea and Thailand are for commercial banks only.

[3]In Korea, the KAMC acquired unsecured loans at a discount of 97 percent and secured loans at a discount of 55 percent.

[4]Estimated recapitalization requirements include recapitalization already undertaken; these are official estimates for Malaysia, and staff estimates for Korea and Thailand.

[5]Data for Indonesia in this and following rows are as of end-July, after the formation of Bank Mandiri (see Box 2.5).

[6]For Korea, "intervened" institutions are those under rehabilitation and excludes the numerous but relatively small Credit Unions and Mutual Savings institutions. For Malaysia and Thailand, they comprise recapitalized institutions.

[7]For Korea, this figure excludes the numerous but relatively small Credit Unions and Mutual Savings institutions.

[8]For Indonesia, this figure and those in the next two rows represent shares of total liabilities. The percentages add up to over 100 because some intervened institutions have subsequently been merged or closed. For Malaysia, the figure is proxied from the share of institutions loans in the system total.

[9]For Korea, these figures are for commercial banks only (sourced from Merrill Lynch) and are not directly comparable to the number of merged, intervened, and closed institutions above, which include merchant banks and insurance companies.

Financial sector restructuring cannot be looked at in isolation from the rest of the reform process. Restructuring in the corporate sector is less advanced, and an important remaining issue concerns the allocation of accumulated losses in this sector. If past experience is a guide, there is a major risk that a large share of these losses, rather than being borne by corporate shareholders, may be shifted to the financial system and ultimately to taxpayers through repeated recapitalizations of banks.

Corporate Restructuring

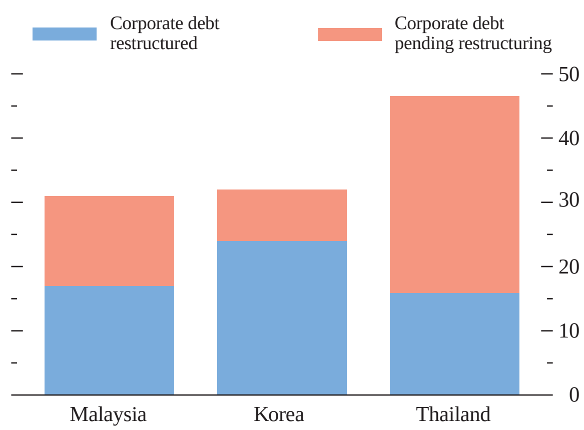
In contrast with the progress in the financial sector, corporate restructuring is at a relatively early stage in all the countries under consideration. Reform efforts to date have focused mainly on improving the underlying legal and institutional framework for financial and operational restructuring. Bankruptcy and foreclosure procedures have generally been strengthened, including through measures to increase the independence and authority of the judiciary. In Thailand, for example, specialized bankruptcy courts have been established and the bankruptcy law has been reformed to include and strengthen court supervised reorganization. In Indonesia, new anticorruption legislation and improved staffing practices (including higher salaries) are intended, in part, to increase the standing and effectiveness of the courts. Each of the countries has also put in place an improved framework for out-of-court settlements and voluntary debt restructuring, with quasi-public agencies taking a leading role in coordinating debt workout agreements between heavily indebted corporations and their creditors (especially the banks). Efforts are also being made throughout the region to improve corporate governance—for example, by upgrading accounting, auditing, and disclosure standards, and strengthening the rights of minority shareholders. Complementing these measures are reforms designed to increase competition in corporate operations and ownership, including strengthening antitrust procedures, increasing the scope for foreign investment in the economy, and preparing state-owned enterprises for full or partial privatization.

While the framework and strategy for corporate restructuring are generally in place, their implementation has been slow. Most of the progress to date has been in financial rather than operational restructuring of indebted enterprises, reflecting the closely related process of financial sector adjustment, the inherent complexities of introducing operational changes, and the resistance to such adjustments. Even with financial restructuring, though, much remains to be done: the amount of corporate debt that formally awaits restructuring (for example, as a result of applications to the workout committees set up for this purpose) represents a rather small proportion of total nonperforming loans—just over 30 percent in Malaysia and Korea, and 47 percent in Thailand—and there has been mixed success in concluding workout agreements (Figure 2.8). While comparable data are not available for Indonesia, progress there appears to have been particularly slow, both in applying the necessary improvements in corporate governance and in restructuring the very high level of corporate debt. However, implementation of a substantial privatization program is on track with more than half the targeted proceeds of $1.5 billion for 1999/2000 already achieved.

In Korea, while voluntary debt workouts among the second-tier chaebols have led to a substantial amount of debt being restructured, concerns have emerged about the workouts: some business plans have been overly optimistic; debt restructuring has not gone deep enough; management has at times remained in place; and there are cases where creditors have not properly monitored companies' performance and sanctioned those that went off track. Progress was initially even slower with the top five chaebols regarding both financial and operational aspects of restructuring. But following the emergence of severe difficulties at Daewoo, reform of the top five conglomerates has begun to accelerate. On the financial side there are several indications of progress: the large chaebols have eliminated cross-guarantees between affiliates in different industrial sectors, reduced their outstanding bank loans by over 25 percent in the year to April

Figure 2.8. Selected East Asian Countries: Progress with Corporate Sector Restructuring[1]
(Percent of total nonperforming loans)

There has been mixed progress in concluding debt workout agreements in the crisis-hit economies.



Source: IMF staff estimates.
[1]End-March 1999 or the latest available data. While the total amount of nonperforming loans to be restructured is unclear, a proportion less than 100 percent should be expected.

Box 2.5. Financial Sector Restructuring in Indonesia, Korea, Malaysia, and Thailand

In *Indonesia*, the program for recapitalizing private sector banks has been completed. Under an agreement reached in April 1999, seven large private banks have been recapitalized on the basis of an interim 4 percent capital adequacy ratio (with one further expected), private owners contributing 20 percent of the funds required and the authorities the rest (in return for a corresponding equity share). The remaining 74 smaller private banks have been assessed by the authorities as adequately capitalized, although around one-quarter of owners and managers failed the "fit and proper" test and are being replaced. Progress is slower in the case of the seven state banks and the 12 banks taken over by the Indonesian Bank Restructuring Agency (IBRA). These two groups account for around 75 percent of total deposits, and 90 percent of the estimated $40 billion negative net worth of the domestic banking system at end-March 1999. Four of the state banks were merged on July 31, and recapitalization of the new institution—which has a market share of around 30 percent—is intended in 1999 as its downsizing and other restructuring proceeds. Strategic decisions concerning the other three state banks are expected in August. The estimated costs of rehabilitating the banking sector have risen since earlier in the year as a result of higher estimates of nonperforming loans, lower loan recovery rates, and operating losses, but now seem to have stabilized. Overall, bonds totaling some $68 billion (around 45 percent of GDP) may need to be issued for the recapitalization of banks and resolution of closed institutions. The budgetary cost for 1999/2000 is estimated at 3 percent of GDP but, including quasi-fiscal items, the gross fiscal cost could be nearly double this level. A renewed effort is now being made to improve loan collection from the banks' major debtors in order to offset these costs to the extent possible.

In *Korea*, the rehabilitation and consolidation of the banking sector are generally well advanced, although the full extent of the problem is still uncertain because of ongoing corporate restructuring. As demonstrated by the recent near-bankruptcy of Daewoo, corporate weaknesses pose risks to the system. Five of the 26 commercial banks that operated at end-1997 have been closed, and the rest (including those that were nationalized and others receiving public support) are engaged in various forms of restructuring, including mergers and raising additional capital. Operational changes are substantial, involving a 25 percent reduction in the workforce, salary reductions, and branch closures. Negotiations have been underway since late-1998 for the sale of two nationalized banks; there have been difficulties in reaching final agreement with prospective foreign buyers, but a terms of agreement for the sale of Korea First Bank was signed in September 1999. The main area of policy attention now is with the nonbank financial intermediaries (such as investment trust companies), which accounted for just under one-half of financial sector assets at end-1997 and are heavily exposed to large chaebols such as Daewoo. The 11 remaining merchant banks (of the original 30) are all under rehabilitation plans approved by the Financial Supervisory Commission, as are all the investment trust companies and 16 of the remaining 45 insurance companies. Public funds equivalent to 16 percent of GDP have so far been allocated for financial restructuring, although the eventual resources required could be substantially above this

1999, and agreed to lower their debt-equity ratios to 200 percent by the end of this year—an ambitious objective given that this ratio was over 500 percent at end-1998.

In view of the slow pace of adjustment, some policy measures have recently been introduced in Indonesia, Korea, and Thailand to encourage financial institutions to speed up—or, at least, not block—the restructuring of corporate debt. The Indonesian authorities have directed state financial institutions to target restructuring efforts on their 20 largest delinquent borrowers, with explicit timetables and loan recovery goals. The authorities in Korea are pressing the major commercial banks to tighten the availability of credit to the largest chaebols, with credit supply tied in part to the chaebols' fulfillment of restructuring commitments, and, more generally, tax incentives for debt restructuring have been introduced for both creditors and debtors. Such incentives were also introduced in Thailand in late-1998, and the Thai government has made available Tier II capital support for financial institutions that restructure debt.

Social Policies

The strengthening of social support systems in the crisis-hit Asian economies has been motivated primarily by the need to combat the rise in poverty and ensure a minimum level of support for those worst affected by the economic downturn.[12] As discussed in Box 2.6, the crisis has resulted in significant output losses, which in turn have contributed to increases in unemployment. In addition, social expenditures can play a longer-term role in supporting stabilization and adjustment—for example, by reducing some of the uncertainties associated with structural change and job loss, and increasing economic flexibility against future macroeconomic shocks.

[12]Social policy developments are discussed in more detail in Sanjeev Gupta et al., "Mitigating the Social Costs of the Economic Crisis and the Reform Program in Asia," IMF Paper on Policy Analysis and Assessment 98/7 (Washington: International Monetary Fund, June 1998), and Timothy Lane et al., *IMF-Supported Programs in Indonesia, Korea, and Thailand.*

level—for example, if nonperforming loans turn out to be higher than current estimates. Financial sector restructuring in *Malaysia* also appears to be progressing well, probably helped by the limited number of institutions affected by the crisis and by Malaysia's relatively good prior record with such reforms. The government-owned entities charged with taking over nonperforming loans and recapitalizing banks have raised funds totaling around 9 percent of GDP, in line with current estimates of their requirements, and these are now being provided to institutions requiring support. As of April 1999, capital injections amounting to just over 2 percent of GDP had been distributed, with recapitalization scheduled for completion by end-June 1999. The restructuring process has emphasized the rapid purchase of nonperforming loans and recapitalization. Since January 1999, the central bank has assumed management control of four financial institutions, which remain open to customers, and is seeking suitable merger partners. For institutions receiving new capital, Danamodal (the bank recapitalization agency) participates directly in bank management through its representation on the board of directors. The number of finance companies has been reduced from 39 as of mid-1998 to 25 at present, and further mergers are planned involving these institutions along with the commercial banks and merchant banks.

In *Thailand*, implementation of the October 1997 and August 1998 financial restructuring plans is generally on track. The restructuring strategy emphasizes private sector-led recapitalization, with state support where necessary. In its January review of financial institutions' business plans, the Bank of Thailand determined that six private banks, with around 56 percent of total deposits, met current capital requirements and have access to sufficient funds (including from foreign owners) to meet higher future criteria. Two other private banks are raising private capital with assistance from the Tier-1 capital support scheme.[1] Two large state banks, holding 20 percent of deposits, have been formed through mergers of existing institutions, including 12 intervened finance companies. These banks are now being recapitalized, and the government intends to privatize them over the medium term. After some initial delays, privatization of the four remaining intervened banks is scheduled for completion by October 1999. The Financial Restructuring Authority (FRA) has conducted several rounds of auctions of assets taken over from the 56 finance companies that were closed in 1997, and expects to complete these sales by the third quarter of 1999. Reflecting the FRA strategy of auctioning off the simplest and best assets first, the recovery rate in asset sales has declined from just under 50 percent in the case of hire purchase loans and residential mortgages sold in mid-1998, to around 20 percent in more recent auctions of business loans. Related to this, a rising share of assets has been purchased by the government-owned Asset Management Company, acting as bidder of last resort.

[1]The Tier-1 and Tier-2 capital support schemes were discussed in the December 1998 *World Economic Outlook*, which also notes an estimated total cost of bank restructuring of 32 percent of GDP (in terms of the stock of public debt issued).

Public spending on social safety nets has increased substantially over the past two years, reflecting higher unemployment, the expansion of eligibility criteria, and increases in some benefit entitlements. In Indonesia and Thailand, for example, safety net expenditures are projected to rise by 0.5–1 percent of GDP in 1999 while, in Korea, these expenditures have roughly quadrupled compared with precrisis levels (from 0.4 percent of GDP in 1997 to 1.7 percent in 1999). In general, much greater emphasis is being placed throughout the region on the targeting of benefits, involving both cash and in-kind transfers to the most vulnerable. Correspondingly, the use of across-the-board benefits such as price subsidies has been reduced, although some subsidies—such as on rice and energy in Indonesia—remain an important part of the social policy framework. Along with increased targeting, administrative reforms have been (or are being) introduced to improve the monitoring of these programs. For example, Indonesia is to make greater use of local communities and independent civil groups as monitors.

Korea is the only crisis-hit country with an unemployment insurance system, and the potential coverage of its scheme has been doubled to around 70 percent of wage earners through extensions of eligibility to employees of small firms and to part-time workers. The duration of benefits has also been lengthened and qualifying periods for coverage shortened.

A further important development is the increase in employment-generating schemes. In Korea, funding for nearly half a million jobs has been provided by local governments and public corporations, with 150,000 jobs taken up in the final quarter of 1998; Korea and Indonesia are expanding special credit schemes for small enterprises, with Indonesia also introducing temporary, community-based employment programs; and Thailand is increasing funding available for temporary employment in such areas as construction and infrastructure rehabilitation. Attention is also being given to investment in human capital and infrastructure. Health and education spending has been increased throughout the region, and public pension schemes are being developed in Indonesia and extended in Korea.

Table 2.4. Russian Federation: Macroeconomic Indicators, 1996–99

	1996	1997	1998 Estimated	1999 Projected
	(Annual percentage changes)			
Production and prices				
Real GDP	–3.5	0.8	–4.5	0
Change in consumer prices				
Annual average	47.6	14.6	27.7	87.8
12-month	21.8	11.0	84.4	45.0
Change in GDP deflator	43.9	16.6	11.4	52.7
	(Percent of GDP)			
Public sector				
Federal government				
Overall balance (commitment)	–8.4	–7.1	–5.9	–5.2
Primary balance	–2.5	–2.5	–1.3	2.1
Revenue	12.5	12.3	10.7	13.0
Of which: cash	9.2	10.0	9.0	13.0
Expenditure	20.9	19.0	15.6	15.1
Interest (cash)	5.9	4.7	4.0	4.3
Noninterest	15.0	14.3	11.6	10.8
	(Billions of U.S. dollars unless otherwise indicated)			
External sector				
Total exports, f.o.b.	90.6	89.0	74.7	73.6
Total imports, f.o.b.	72.8	77.4	56.8	45.3
External current account (deficit–)	3.9	–3.0	2.5	14.4
Federal government external debt service due	17.5	15.9	17.5	18.6
As percent of exports of goods and services	17.0	15.4	19.9	21.9
Stock of federal government external debt	136.1	134.6	152.4	157.5
As percent of GDP	32.6	30.9	48.7	90.1
Gross reserves coverage (months of imports of goods and services)	2.0	2.2	2.0	3.7
	(Units as indicated)			
Memorandum				
Nominal GDP (billions of rubles)	2,146.0	2,522.0	2,685.0	4,100.0
Nominal GDP (billions of U.S. dollars)	417.4	435.5	313.0	174.8
Exchange rate (rubles per US$, period average)	5.1	5.8	9.7	. . .

Sources: Russian authorities; and IMF staff estimates and projections.

Russia and Neighboring Countries in Transition: Prospects for Recovery and Reform

In the wake of the August 1998 crisis, the Russian authorities faced a range of major challenges. They had to address the consequences of the crisis for domestic financial markets and the banking sector, and for the country's relations with international creditors. Moreover, they were confronted with the need to tackle the fiscal and structural problems that were at the root of the crisis. The subsequent record has been mixed. Monetary, and subsequently fiscal, policies were relaxed in the aftermath of the crisis, but were tightened again in the first half of 1999. Also, steps have been taken to revitalize domestic financial markets and to normalize relations with key international creditors. On the other hand, only limited progress has been made in restructuring the banking sector and in addressing the pervasive fiscal and structural problems, with back tracking in some areas.

The authorities' main achievement in recent months has been the measure of macroeconomic stabilization resulting from the move toward tighter macroeconomic policies in early 1999 (Table 2.4). The depreciation of the ruble against the U.S. dollar was halted in early May, and monthly CPI inflation declined from a peak of 38½ percent in September 1998 to 1¼ percent in August. Helped by this return to broad currency stability and relatively moderate inflation, and also the competitiveness gain from the ruble depreciation in the second half of 1998, industrial production has turned up, being more than 5 percent higher in January–August 1999 than in the same period a year earlier. Import-competing activities have benefited the most from the large real depreciation of the ruble with imports in U.S. dollar terms more than 40 percent lower in the first half of 1999 than in the same period of 1998, before the crisis. However, there has not been any pronounced recovery in exports or output in the export-oriented branches; in particular, production of oil and gas has broadly stagnated owing to extraction and transportation constraints. Output in major sectors other than industry, including agriculture and construction, in the first half of 1999 remained lower than a year earlier. As a result, real GDP in the first half of 1999 was 1 percent lower than a year earlier. Both macroeconomic stability and prospects for sustained recovery remain at risk unless further progress is made in addressing the fiscal and structural problems that were the root causes of the August 1998 crisis.

The authorities have also taken steps to restart the operation of the domestic fixed income markets and to avoid a further deterioration in relations with international creditors. A final conversion scheme for the domestic treasury bills that were frozen in the August 1998 debt restructuring was adopted in March 1999, and a reorganization of the treasury bill market completed in June. As a result of these steps, by the end of June the face value of outstanding treasury bills had been reduced by more than one-third (more than two-thirds when adjusted for inflation) and their average maturity extended to around 2¾ years from less than 1 year just prior to the 1998 restructuring. However, the domestic treasury bill market remains highly illiquid and secondary market yields, at more than 60 percent in early September, very high; reflecting these unfavorable conditions, the government has not returned to the market to raise new financing. In the context of the treasury bill conversion scheme, incentives were provided to major companies to issue domestic currency corporate debt instruments, opening the perspective of a revival of the corresponding market. But overall, among the domestic financial markets, only the equity market has as yet resumed activities on a substantial scale, with broad investor interest, including among banks, contributing to the sharp rally in Russian equity prices during 1999.

Some progress was also made on the external debt front. The authorities continued their dialogue with major international creditors, following the announcement in late 1998 that the country would be unable to make payments on Soviet-era debt but would fully honor debts incurred by the Russian sovereign. The dialogue has been successful in avoiding a formal default toward Paris or London Club creditors, although Russia has effectively failed in recent months to make a series of scheduled payments to both groups of creditors.[13] In the middle of June, in the context of the Cologne summit, the major industrial country members of the Paris Club announced their support for a restructuring (but not partial write-off) of the Soviet debt owed to official creditors, and an agreement to reschedule around $8 billion of this debt was reached at end-July. The June announcement was interpreted by investors as also improving the payment prospects for London Club debt and eurobonds, and secondary market prices for these instruments subsequently staged a significant recovery. The government has continued to meet its obligations on eurobonds, and also on the U.S. dollar-denominated domestic debt instruments issued in 1996.

Only limited progress has been made in restructuring the banking sector. The August 1998 crisis inflicted heavy losses on this sector, which was already structurally weak, and made comprehensive and large-scale restructuring even more urgent. The main vehicle for bank restructuring is the Agency for Restructuring Credit Organizations (ARCO), created in October 1998 and slated to acquire controlling stakes in banks in distress, manage bad assets, and initiate bank liquidations. However, the agency's resources are modest compared with the restructuring and recapitalization needs, and significant deficiencies in the legal framework governing banking sector reform remain. The central bank has been reluctant to withdraw licenses from ailing banks and place them under administration, although there has recently been some progress in this regard as part of the new IMF program. The central bank has also failed to act decisively against extensive asset stripping of insolvent institutions. The lack of progress in bank restructuring has further eroded commercial banks' willingness to extend new lending to households and firms, and new credit to the private sector has continued to decline in real terms since the crisis, from already very low levels. In the absence of investment opportunities other than equities, many commercial banks have built up large liquidity positions in their correspondent accounts at the central bank.

Long-standing fiscal problems were at the root of the August 1998 crisis, including the federal government's poor revenue performance and tax and expenditure arrears. Much remains to be done to address these problems; nevertheless, some signs of progress are apparent in the revenue and expenditure measures introduced to reach the targeted 2 percent primary surplus target included in the new stand-by arrangement. Moreover, the fiscal situation at the federal level has improved since the beginning of the year, with a strong recovery in revenues reflecting both the improvement in the macroeconomic environment, including higher oil prices, and reinforced tax collection efforts. Federal government revenues in the second quarter of 1999 were around 14 percent of GDP compared with less than 11 percent in the same quarter of last year, and revenue collection has further improved since then, exceeding nominal budget targets. In particular, cash revenues relative to GDP have risen from the very low levels recorded in the second half of 1998. Noninterest expenditures have been restrained further and the primary balance has swung

[13]A number of secondary market holders of London Club debt not represented at the London Club have formed a separate representation group, which is exploring the scope for default litigation against Russia.

Box 2.6. Counting the Costs of the Recent Crises

To quantify some of the costs incurred during the recent financial crises, the first table presents estimates of *cumulative output losses* for the four economies worst afflicted by the Asian crisis and also for Argentina and Mexico during the 1994–95 "tequila" crisis. The estimates refer to the four years following the respective crises, are based on current WEO output projections for years after 1998, and show cumulative output losses relative to hypothetical noncrisis output paths. The estimates therefore rely on counterfactual assumptions and projections.

In the estimation of output losses during the "tequila" crisis, it is assumed that in a noncrisis scenario output would have grown at 4 percent a year; this corresponds roughly to the average annual growth rate of real GDP in Mexico during 1990–94 and to the lower bound of potential output growth estimates for Argentina.[1] Despite the rapid recovery of output in both countries during 1996, 1997, and the first half of 1998, the output losses associated with the crisis were substantial, especially in the case of Mexico.

For the Asian economies, it is assumed that, in the absence of a crisis, output growth would have slowed down from rates in the 7–8½ percent range prior to the crisis to 4 percent a year from 1997 onwards—a hypothetical "soft-landing" scenario. The output losses implied by comparison with such a scenario are sizable, particularly for Indonesia and Thailand, where they appear to have far exceeded those incurred by Argentina and Mexico earlier in the decade.

Cumulative Output Losses of 1990s Crises
(In percent of "potential" output)

	Cumulative Four-Year Output Loss[1]
"Tequila" crisis	
Argentina	15
Mexico	30
Asian crisis	
Indonesia	82
Korea	27
Malaysia	39
Thailand	57

Source: International Monetary Fund, World Economic Outlook database; and staff estimates.

[1]Calculated as the sum of the output gap over a four-year period, starting with the crisis year. The output gap is defined as the percentage difference between the actual and the hypothetical (or "potential") level of real GDP for each country. Graphically, the cumulative output loss would thus be represented by the area between the "potential" and actual output paths, starting from the crisis year and expressed as a percentage of "potential" real GDP. It follows that accumulated losses will be positive, and possibly large, even in cases where output is back to "potential" at the end of the four-year period. In the counterfactual scenario, it is assumed that "potential" GDP grows at 4 percent per annum and that actual and "potential" output coincided within the two-year period preceding the crisis. "Actual" GDP during 1999–2002 refers to WEO projections.

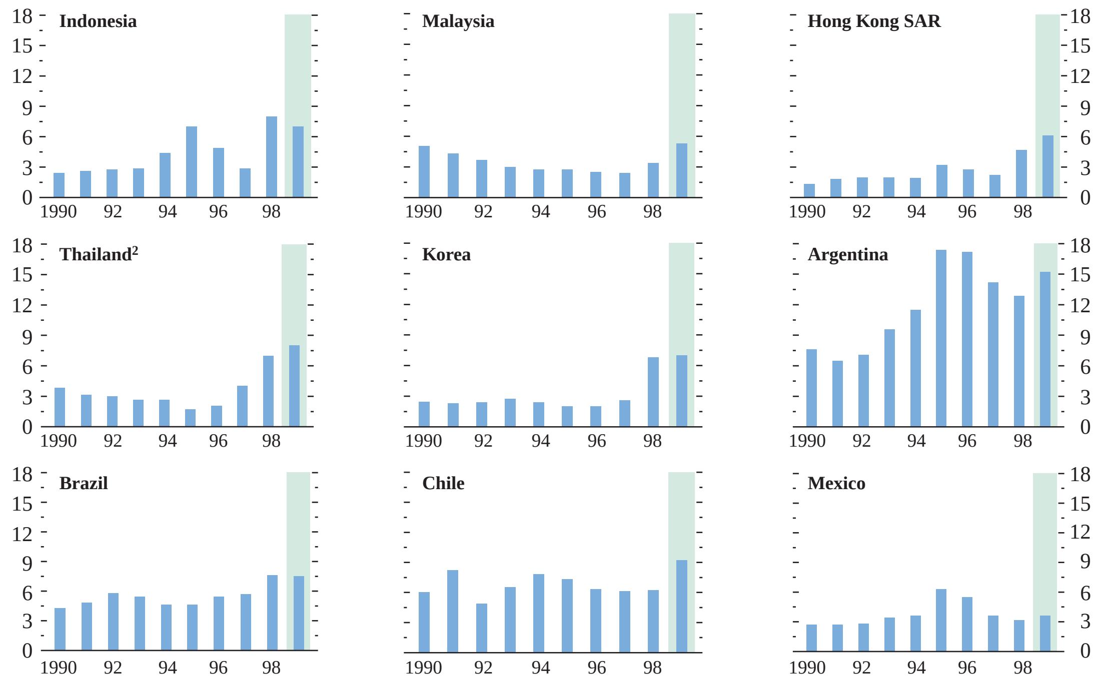
Increases in *unemployment* and the associated social costs have been important by-products of the 1997–98 crises in Asia, although they have not been as large as was widely feared when the crises were at their peaks. All the Asian countries considered here have witnessed marked rises in measured unemployment in the wake of the crises (see figure), often to the highest levels in over a decade. The increases in unemployment relative to output declines have been largest in Korea, Thailand, and Hong Kong SAR. In Korea and Thailand, job losses have been exacerbated by banking and corporate sector restructuring. In Hong Kong SAR, with the exchange rate peg having been maintained, adjustment called for declines in output prices, and in real and nominal wages. Output prices and—to a lesser extent—wages adjusted downwards, but unemployment still bore a significant part of the short-term burden of adjustment. In Malaysia, where measured unemployment has not risen commensurately with output declines, labor market adjustment has been facilitated by the repatriation of migrant workers to Indonesia as well as by a combination of falling real wages in the formal sector and the movement of workers into low-paying informal sector jobs.[2] Unemployment has also risen sharply in Brazil and Chile

[1]See IMF, *Argentina: Recent Economic Developments* (Washington, 1997).

[2]Tamar Manuelyan Atinc and Michael Walton, "Social Consequences of the East Asian Financial Crisis," available at http://www.worldbank.org/poverty (Washington: World Bank, 1998).

into surplus, in part due to the tight financing constraint since the government has lost access to new financing in domestic and international financial markets. However, federal revenues remained low as a percent of GDP, and the authorities have failed to benefit fully from the financial gains in the energy sector stemming from the ruble depreciation and higher energy prices. Also, recent cuts in noninterest expenditures have been mainly ad hoc (including through a less than full adjustment of wages and pensions to inflation) rather than being based on the comprehensive expenditure reduction plan introduced in early 1998. Interest expenditures, and hence the size of the overall deficit, have been kept artificially low as interest payments have been rescheduled and interest charges on debt held by the central bank have been maintained at below market rates. Finally, and most importantly, the authorities have continued to fail to

Selected Emerging Market Economies: Unemployment[1]
(Percent of labor force)



[1]Shaded areas indicate IMF staff projections.
[2]1998 data are IMF staff estimates.

since early 1998 in spite of some decline in real wages. In Argentina, buoyant economic activity through the first half of 1998 helped keep unemployment on a declining trend until late in the year, but the combination of weakening activity amidst deflationary pressures and labor market rigidities (see Box 2.3) raised the unemployment rate by 3 percentage points between October 1998 and May 1999.

The approximate magnitude of the social costs can be gleaned from a variety of socioeconomic indicators. Recent World Bank estimates[3] indicate that in Indonesia the share of the population living below the (nationally defined) poverty line increased from 11.0 percent in 1997 to 19.9 percent in 1998. In Korea, the share of the urban population living in poverty increased from 8.6 to

(continued on next page)

[3]See World Bank, 1999, "World Bank Poverty Update: Trends in Poverty," available on the Internet at http://wb.forumone.com/poverty/data/trends.

act decisively against tax delinquency and the use of noncash transactions.

The authorities have furthermore been unsuccessful in moving beyond the postcrisis standstill in other areas of structural reform. There has been little or no further progress in the liberalization of the economy or in enterprise restructuring, and there have been reversals in some areas, including in the enforcement of bankruptcy procedures, the regulation of infrastructure monopolies, and trade policy. The privatization effort has also slowed considerably, with no major sales thus far in 1999.

Without a reinvigorated effort to move ahead with banking sector rehabilitation, fiscal, and other structural reforms, the recent macroeconomic stabilization and turnaround in industrial output are unlikely to last. As set out in the new IMF program, banking sector rehabilitation needs to focus on the enforcement of sound

Box 2.6 *(concluded)*

Selected Emerging Market Economies: Average Growth of Real GDP and Its Volatility
(Percent a year)

	1962–1999		1979–1989		1989–1999	
	Mean	Standard deviation	Mean	Standard deviation	Mean	Standard deviation
Asia						
HongKong SAR	6.3	4.3	7.0	3.9	3.2	3.6
Indonesia	5.1	4.6	5.2	2.7	4.2	7.3
Korea	7.5	3.7	7.5	4.1	5.4	4.4
Malaysia	6.4	3.5	5.6	3.1	6.2	5.0
Philippines	3.7	3.4	1.9	5.2	2.6	2.3
Singapore	7.8	3.8	7.1	3.9	6.9	3.0
Taiwan POC	7.8	9.9	7.8	2.7	5.8	0.9
Thailand	6.6	3.6	7.1	2.9	5.0	5.8
Latin America						
Argentina	2.1	6.9	–1.0	4.9	4.2	4.7
Brazil	4.8	5.0	2.8	4.6	1.7	3.0
Chile	3.9	5.7	3.4	7.2	6.4	3.3
Mexico	4.6	3.7	2.2	4.3	3.2	3.6

Note: 1999 growth rates are IMF staff estimates.

19.2 percent over the same period. In Thailand—where the middle class seems to have been affected the most—the poverty headcount increased from 11.0 to 12.9 percent. Increases in poverty have therefore been significant in the countries most affected by the crisis, but they have not been as large as initially feared, and poverty rates have remained well below the levels of the 1980s.[4]

Marked increases in unemployment and in consumer prices following devaluations put considerable strain on existing social safety nets. As described in the main text, in all crisis-stricken countries with IMF programs safety nets have been put in place or extended to help mitigate the impact of the crises on living standards.[5] In Thailand, expenditure on social support measures, including food subsidy programs and direct budgetary transfers to the poor, is estimated to have doubled over the last two years adding to the deterioration in the fiscal balance between 1996 and 1998 by the equivalent of 1 percent of GDP. A fiscal cost of similar magnitude has been estimated for Indonesia. In Korea, on the basis of a broader definition of the social safety net, it has been estimated that higher social expenditures added the equivalent of some 2 percent of GDP to the deterioration of the fiscal position in the same period.[6]

Apart from the costs of the social safety net and the decline in revenues resulting from lower economic activity, the other main fiscal costs associated with the crises have been associated with banking sector restructuring.[7] Soon

[4]For example, in Indonesia, the share of the population below the poverty line was estimated to have been 32 percent in 1985. See *East Asia: The Road to Recovery* (Washington, DC: World Bank, 1998).

[5]For a more detailed description and estimates of the size of the respective social safety net programs, see Sanjeev Gupta et al., "Mitigating the Social Costs of the Economic Crisis and Reform Programs in Asia," *International Economic Policy Review* (Washington: IMF, 1999).

[6]See Timothy Lane et al., *IMF-Supported Programs in Indonesia, Korea, and Thailand. A Preliminary Assessment*, International Monetary Fund, Occasional Paper 178, 1999.

[7]No quantification of corporate losses is provided because of the lack of comprehensive data and uncertainty about how these costs will be distributed. In principle, these costs should be borne by shareholders but the experience of other countries is

regulatory policies, the referral of insolvent banks meeting specific criteria to ARCO for restructuring, and the swift closure of banks that cannot be saved. The structural reform agenda needs to focus on the full and prompt implementation of measures to tackle the nonpayment problem; stimulate industrial restructuring, private sector development, and investment; and strengthen the legal system. Fiscal reform, in turn, should focus on strictly enforcing tax payments; eliminating recourse to tax offsets; and prioritizing expenditures and controlling spending commitments made by ministries and agencies. While the authorities must give new impetus to a broad range of reforms, the highest priority should be given to bank restructuring and steps to address the nonpayment problem.

The Russian crisis has had significant spillover effects on neighboring countries in transition. These effects have been most pronounced in the countries that after the outbreak of the crises in 1997, it became clear that sizeable public sector disbursements would be needed in Indonesia, Korea, Malaysia, and Thailand to recapitalize banks and provide guarantees to depositors. Estimating the net costs of banking restructuring is not straightforward as it requires assumptions to be made, for example, about the present and future incidence of nonperforming loans, their recovery rate, and the amount of liquidity support. On a gross basis (i.e., excluding future proceeds from reprivatization, loan recovery, and repayment of the liquidity assistance provided by the government), *official* estimates of the cost of financial sector restructuring range from 15 percent of GDP in Korea to 41 and 45 percent of GDP in Thailand and Indonesia, respectively.[8] On the assumption that such disbursements are financed by the issuance of government bonds, the fiscal burden can be measured by the interest costs on an annual basis. These have been estimated as being in the neighborhood of 1 percent of GDP in Korea in 1999, 2 percent of GDP in Thailand, and 2.8 in Indonesia in 1999/2000.

Further costs may have arisen from any increase in actual or expected income volatility associated with the crises. Theoretically, even if long-run or "permanent" income is unaffected, increased volatility will lower welfare to the extent that it makes consumption-smoothing more costly, particularly in economies with less developed financial markets.[9] Also, insofar as higher output volatility increases uncertainty about future income streams, it will tend to raise precautionary saving and thus lower the path of private consumption in the long-run.[10]

The second table shows estimates of aggregate income volatility in terms of the unconditional standard deviation of year-on-year growth rates of real GDP for selected emerging market economies over 1963–99 and the two most recent decades individually. As one would expect, output volatility in the 1990s was noticeably higher than in the 1980s or the period as a whole in the Asian economies that were most severely affected by the 1997–98 financial crisis—namely, Indonesia, Korea, Malaysia, and Thailand. However, although the recent crisis also affected Hong Kong SAR, the Philippines, Singapore, and Taiwan POC, output volatility was actually *lower* in these economies during the 1990s than in the 1980s or the period since 1963 as a whole (see second table). But private consumption declined or decelerated sharply in 1998 in all the crisis-stricken countries. And it may be that even in the latter group of economies the severity of the recent recession, coupled with uncertainty generated by job dislocation during the reform process, raised precautionary saving and lowered private consumption over the past two years. On the basis of the present evidence, however, it is not possible to establish that weaker private consumption resulted from systematically higher output volatility in the 1990s.

In Latin America, output volatility fell in Argentina, Brazil, Chile, and Mexico in the 1990s, notwithstanding the severity of the 1994–95 Mexican crisis, the spillovers from the Asian and Russian crises, and the financial turmoil in Brazil itself. Particularly noteworthy is the drop in output volatility in Chile, where the standard deviation of year-on-year growth rates more than halved between the 1980s and the 1990s. Moreover, three out of the four major Latin American emerging market economies, the exception being Brazil, achieved higher output growth in the 1990s than in the 1980s, while also avoiding the more dramatic boom-bust cycles of the previous decade.

In sum, the economic and social costs of the 1997–98 Asian crisis in the countries directly affected, though less than widely feared around the peaks of the crises, have been substantial, with output losses exceeding those incurred by Argentina and Mexico as a result of the 1994–95 "tequila" crisis. But it is not clear, on the basis of simple measures of volatility of real GDP growth, whether macroeconomic instability has generally increased among emerging market economies in the 1990s, in tandem with the liberalization of capital flows and financial integration; nor is it obvious what effects the recent bouts of financial instability will have on consumption and saving in the longer term.

that the banking sector ends up absorbing part of these losses. Insofar as this leads to capital adequacy problems, and requires the injection of public sector funds to recapitalize banks, the costs may ultimately be borne by the taxpayer.

[8]Some market observers have estimated the costs to be considerably higher. See "Financial Sector Crisis and Restructuring—Lessons from Asia," mimeo (Washington: IMF, 1999). Narrower estimates of restructuring costs and other associated statistics are provided in Table 2.3.

[9]For a rigorous analytical treatment of this point, see A. Deaton, *Understanding Consumption* (Oxford: 1992).

[10]For a discussion of the impact of higher income volatility on precautionary saving and consumption growth, see Jonathan Ostry and Joaquim Levy, "Household Savings in France," in *IMF Staff Papers* (1995), pp. 375–97.

maintained extensive trade links with Russia prior to the crisis, namely the Baltics and the countries of the Commonwealth of Independent States (CIS) other than Russia. The depreciation of the ruble and fall in Russian import demand put significant pressure on these countries' currencies (apart from in the Baltics). With Kazakhstan having abandoned its managed float in early April 1999, the number of CIS countries, excluding Russia, that have switched to more flexible exchange rate regimes since the August 1998 crisis has risen to six, while in Belarus, where foreign exchange controls remain in place, the rate of devaluation of the currency has increased.[14] The associated cumulative losses in the value of the exchange rate versus the U.S.

[14]Apart from Kazakhstan, those countries are Georgia, the Kyrgyz Republic, Moldova, Tajikistan, and Ukraine.

dollar are in the 30–80 percent range, broadly according to the importance of each country's precrisis trade links with Russia. In all cases, the depreciations have led to sizable upturns in inflation. Armenia and, with some adjustment to the value of its currency in early July, Azerbaijan and also the Baltic countries have maintained their currency regimes in the wake of the crisis, and their exchange rates have appreciated sharply versus the ruble, while remaining broadly stable against the U.S. dollar. Declines in domestic currency prices of imports from Russia and other CIS countries have put downward pressure on inflation in these five countries, in Azerbaijan in particular, where consumer prices in August were around 9 percent lower than 12 months earlier.

In most CIS countries, both exports and imports remain well below precrisis levels. In the first half of 1999, exports in U.S. dollar terms were down by 20 percent or more compared with the same period of 1998 in Belarus, Kazakhstan, Moldova, and Ukraine, mainly reflecting the sharp contraction in import demand in Russia and their currencies' real appreciations against the ruble. Estonia and Latvia recorded declines in exports of more than 10 percent, and Lithuania—the Baltic country with the highest precrisis trade exposure to Russia—of around 25 percent in this period.[15] The decline in trade flows has in turn had a negative impact on activity in industry and the transit sector. As a result, real GDP fell in Kazakhstan and Ukraine by around 3 percent, and in Moldova by more than 5 percent, in the first half of 1999 year-on-year. In the Baltics, all three countries have had contractions in real GDP in the first half of 1999 compared with the first half of 1998, with the largest declines in Estonia, by around 4 percent, and in Lithuania, by around 5 percent.

Apart from its macroeconomic impact, the Russian crisis has also affected neighboring CIS and Baltic countries' banking sectors and financial markets, their access to international financial markets, and the pace of market-oriented reform more generally. Losses on assets with exposure to Russia and deposit withdrawals induced by declines in confidence have led to widespread banking problems that, except in the Baltic countries, have still to be addressed effectively. The development of domestic financial markets has suffered a setback as well. Prices and turnover in the equity markets of the Baltics and Ukraine have been depressed, while activity in the fledgling equity markets elsewhere in the CIS has virtually dried up. Except in the Baltics, domestic real interest rates have remained high, with negative consequences for the development of money and treasury bill markets. Conditions facing the Baltic countries in international financial markets have become less favorable, mostly so in Lithuania,[16] while elsewhere progress toward gaining access to such markets has come to a standstill or, in Moldova and Ukraine, been reversed. More negative investor sentiment toward the region has also affected FDI flows, delaying the sale of some large state enterprises to international investors. Finally, in a number of CIS countries,

Table 2.5. Countries in Transition: Average Annual Growth Rates in 1994–98, and 1998 GDP Per Capita in U.S. Dollar Purchasing Power Parity Terms

	Average Growth	Per Capita GDP
Central and eastern Europe and Baltics		
Croatia	5.5	6,839
Czech Republic	2.2	12,479
Estonia	4.2	7,607
Hungary	3.1	10,202
Latvia	3.2	5,557
Lithuania	2.1	6,437
Poland	6.0	7,658
Slovak Republic	5.9	9,817
Slovenia	4.3	14,305
Average	4.0	8,989
Southeastern Europe		
Albania	5.7	2,860
Bulgaria	–2.1	4,776
Macedonia, FYR of	0.4	4,432
Romania	0.2	5,646
Average	1.1	4,428
Russia	**–4.2**	**6,474**
CIS		
Armenia	5.7	2,162
Azerbaijan	–2.9	2,211
Belarus	–0.2	6,131
Georgia	3.1	3,330
Kazakhstan	–4.2	4,300
Kyrgyz Republic	–1.3	2,336
Moldova	–9.5	1,927
Tajikistan	–6.3	884
Turkmenistan	–11.1	3,169
Ukraine	–10.0	3,248
Uzbekistan	0.4	2,117
Average	–3.3	2,892
Mongolia	**3.7**	. . .
Memorandum		
EU15	2.5	20,031
Japan	1.1	23,979
U.S.A.	3.4	30,057

Source: OECD and IMF staff estimates.

[15]In the first half of 1999, Lithuania's exports to Russia in U.S. dollar terms had plummeted to one-fourth of their value in the first half of 1998, and Russia's share in the country's total exports had been reduced from 24 percent to less than 7 percent.

[16]In Lithuania, a five-year euro-denominated Eurobond issued in June 1999 carried a premium of 374 basis points above comparable Bunds, as against a premium of 117 basis points above U.S. treasuries for a five-year U.S. dollar–denominated Eurobond issued in the third quarter of 1997.

Table 2.6. Countries in Transition: Structural Reform Indicators, 1994–98 Averages

	EBRD Transition Indicators	FDI Per Capita[1]	Annual Growth of Fixed Investment	Broad Money to GDP Ratio	Private Sector Credit to GDP Ratio
Central and eastern Europe and Baltics					
Croatia	3.0	393	4.1	32	33
Czech Republic	3.5	818	6.2	72	60
Estonia	3.3	555	10.1	28	24
Hungary	3.5	1,113	6.9	43	23
Latvia	2.9	646	8.8	27	11
Lithuania	3.0	318	7.8	21	13
Poland	3.4	321	14.3	36	15
Slovak Republic	3.3	144	9.1	68	36
Slovenia	3.2	530	11.2	39	29
Average	3.2	538	8.7	41	27
Southeastern Europe					
Albania	2.5	103	. . .	50	4
Bulgaria	2.6	140	–6.2	32	13
Macedonia, FYR of	2.7	58	4.2	13	28
Romania	2.6	208	1.6	25	11
Average	2.6	127	–0.1	30	14
Russia	**2.7**	**92**	**–15.2**	**19**	**10**
CIS					
Armenia	2.3	64	8.0	10	8
Azerbaijan	1.8	406	32.6	21	2
Belarus	1.8	42	–7.0	24	11
Georgia	2.2	37	12.7	5	4
Kazakhstan	2.4	312	–15.4	11	10
Kyrgyz Republic	2.8	69	–15.4	14	8
Moldova	2.5	113	–13.2	17	8
Tajikistan	1.7	16	. . .	11	5
Turkmenistan	1.3	108	. . .	9	. . .
Ukraine	2.2	43	–18.4	16	4
Uzbekistan	2.2	23	4.2	16	26
Average	2.1	112	–1.3	15	9
Mongolia	**. . .**	**39**	**1.0[2]**	**23**	**11**

Sources: EBRD, UNECE, and IMF staff estimates.
[1]Cumulative FDI in U.S. dollars for the period 1994–98.
[2]Average for 1993–97.

the crisis has slowed the overall pace of structural reform. The taste for reform measures that involve short-term costs but only medium-term benefits has weakened in view of the lower short-term growth prospects and reduced access to financial markets which could smooth the impact of reforms on demand. In fact, pressures for backsliding—including the reimposition of price controls on basic commodities and the reintroduction of protectionist arrangements—have intensified.

The economic record of the Baltics and the CIS countries in the wake of the August 1998 crisis illustrates the importance of two factors in particular in shaping the spillovers from the Russian crisis—trade exposure and the pace of structural reform. The pronounced weakening in export and output performance in the Baltics and most CIS countries in late 1998 and early 1999 reflects the common role of trade linkages in transmitting the effects of the crisis, and suggests that trade-based contagion effects have been the main transmission channel from the Russian crisis for countries with a relatively high trade exposure to Russia. At the same time, a comparison of the Baltics with the CIS countries also shows how faster progress with structural reform, as in the Baltics, may have been important in limiting vulnerability to setbacks in financial development and other structural areas. The roles of the two factors are illustrated further by the experience of the countries of central and eastern Europe, which by virtue of the reorientation of their trade toward western markets, in part facilitated by geographical proximity, and their sustained structural reform efforts in recent years have by and large avoided any major impact from the Russian crisis beyond a modest and temporary slowdown in growth.[17] Their experience underscores the link between progress in structural reform and resilience to external shocks.

The Russian crisis has clearly exposed the vulnerabilities of those transition economies that have been relatively slow in making progress with structural reform. In recent years, a widening gap has developed between the economic performance of these slow reformers and those transition countries that have been generally successful in building a market economy and, in most cases, making significant progress toward meeting the criteria for EU accession. Thus, in 1994–98, the (unweighted) average annual GDP growth rate of the more advanced reformers of central and eastern Europe was 4.0 percent, but that of the countries of southeastern Europe only 1.1 percent, and that of the CIS countries other than Russia –3.3 percent (or –0.3 percent, if 1994, which was a particularly bad year for the CIS, is excluded) (Table 2.5, page 68). In 1998, average per capita GDP in central and eastern Europe and the Baltics was more than twice the level elsewhere in the transition region. Unless—and the Russian crisis could act as a catalyst—the less advanced reformers begin to catch up in their reform efforts, these differences in growth performance and living standards seem likely to remain or widen further.

This divergent growth performance, in addition to being the outcome of differences in initial conditions and in the number of years lapsed since the beginning of the transition, stems from uneven progress in structural reform, which is reflected in a variety of indicators covering such areas as institution-building, corporate restructuring, and financial deepening. A number of indicators, computed as the averages over the period 1994 to 1998, are presented in Table 2.6 (page 69). The EBRD transition indicators provide a measure of progress made in establishing an institutional and legal framework that ensures the effective operation of a market economy. The average scores reported for the countries in central and eastern Europe and the Baltics are notably higher than those for southeastern Europe and the CIS. Another criterion, the level of FDI per capita, and the associated transfer of resources and managerial skills, is indicative of the scale of corporate restructuring that has taken place. The annual growth of gross fixed investment is a proxy for the degree of capital stock renewal. According to both criteria, the restructuring and renewal process is significantly more advanced in central and eastern Europe and the Baltics. Financial sector development, finally, is another important dimension of the transition. Outstanding bank liabilities relative to GDP are an indicator of the financial sector's overall size, while bank credit to the private sector relative to GDP is a proxy for the information, monitoring, and risk management services provided by the sector.[18] The 1994–98 averages for both variables show financial sector development to be still in its initial stages outside central and eastern Europe.

Institutional reform, corporate restructuring, and financial sector development are all expected to improve productivity and international competitiveness.

Table 2.7. Countries in Transition: Indicators of Export Performance and Labor Productivity in Industry, 1994–98 Averages

	Average Annual Export Growth	Labor Productivity in Industry[1]
Central and eastern Europe and Baltics		
Croatia	6.8	9.2
Czech Republic	12.8	8.5
Estonia	29.7	7.9
Hungary	21.9	11.0
Latvia	15.3	9.4
Lithuania	26.9	5.4
Poland	18.6	9.9
Slovak Republic	12.2	6.5
Slovenia	8.6	7.1
Average	13.5	8.3
Southeastern Europe		
Albania	12.9	. . .
Bulgaria	4.1	2.0
Macedonia, FYR of	4.8	3.2
Romania	12.1	5.6
Average	8.4	3.6
Russia	**5.3**	**1.2**
CIS		
Armenia	9.5	13.9
Azerbaijan	–1.8	1.1
Belarus	32.3	4.0
Georgia	–3.3	1.2
Kazakhstan	7.8	3.4
Kyrgyz Republic	11.1	14.3
Moldova	8.0	–3.2
Tajikistan	8.4	–1.2
Turkmenistan	–22.0	–12.0
Ukraine	1.0	–1.1
Uzbekistan	5.5	5.0
Average	5.1	2.7
Mongolia	**6.7**	**9.4**[2]

Source: EBRD, UNECE, CIS Interstate Statistical Committee, and IMF staff estimates.

[1]Manufacturing in the countries of central and eastern Europe and the Baltics.

[2]Average for 1993–97.

[17]For an analysis of the, generally limited, spillovers from the Russian crisis on financial markets in central and eastern Europe, see R. Gaston Gelos and Ratna Sahay, "Comovements and Crises—Financial Market Spillovers in Transition Economies," IMF Working Paper (Washington: IMF, 1999, forthcoming).

[18]Thorsten Beck, Ross Levine, Norman Loayza, "Finance and the Sources of Growth," World Bank Policy Research Working Paper 2057 (Washington, February 1999).

Increases in labor productivity in industry and export growth can therefore be interpreted as indicators of the overall progress in these areas. The 1994–98 productivity and export numbers illustrate further the divide between the more advanced reformers, which, while reorienting trade towards western European markets, have made significant gains on both accounts, and the other transition countries, where labor productivity has been stagnant or even falling and export growth modest at best (Table 2.7). These findings provide strong evidence that structural reform efforts pay off and suggest that less advanced reformers can significantly improve their longer-term growth performance by narrowing the structural reform gap. The Russian crisis, which has highlighted the additional vulnerability of slow reformers to external shocks, further strengthens the case for a sustained effort to narrow this gap.