WORLD ECONOMIC AND FINANCIAL SURVEYS

WORLD ECONOMIC OUTLOOK

May 1998

A Survey by the Staff of the International Monetary Fund

INTERNATIONAL MONETARY FUND
Washington, DC

©1998 International Monetary Fund

World economic outlook (International Monetary Fund)
World economic outlook: a survey by the staff of the International Monetary Fund.—1980– —Washington, D.C.: The Fund, 1980–

v.; 28 cm.—(1981–84: Occasional paper/International Monetary Fund ISSN 0251-6365)
Annual.
Has occasional updates, 1984–
ISSN 0258-7440 = World economic and financial surveys
ISSN 0256-6877 = World economic outlook (Washington)
1. Economic history—1971– —Periodicals. I. International Monetary Fund. II. Series: Occasional paper (International Monetary Fund)

HC10.W7979 84-640155
338.5’443’09048–-dc19
AACR 2 MARC-S

Library of Congress 8507

Published biannually.
ISBN 1-55775-740-2

The cover, charts, and interior of this publication were designed and produced by the IMF Graphics Section

Price: US$36.00
(US$25.00 to full-time faculty members and students at universities and colleges)

Please send orders to:
International Monetary Fund, Publication Services
700 19th Street, N.W., Washington, D.C. 20431, U.S.A.
Tel.: (202) 623-7430 Telefax: (202) 623-7201
E-mail: publications@imf.org
Internet: http://www.imf.org

recycled paper

Contents

	Page
Assumptions and Conventions	**vii**
Preface	**ix**
Chapter I. Global Economic Prospects and Policy Considerations	**1**
The Asian Crisis	3
Advanced Economies	8
Developing Countries	15
Countries in Transition	17
Appendix: Countdown to EMU—Progress Toward Convergence and Challenges Remaining	18
Chapter II. Global Repercussions of the Asian Crisis and Other Issues in the Current Conjuncture	**23**
The Global Growth Outlook	23
Prospects for Global Inflation (or Deflation)	33
Implications of Recent Currency Realignments for Countries' International Competitiveness	37
Prospects for Global Flows of Funds and Current Account Balances	40
Outlook for Japan	43
Emerging Market Countries: Selected Issues	45
Chapter III. The Business Cycle, International Linkages, and Exchange Rates	**55**
Business Cycles	56
The Relationship Between Business Cycles and Exchange Rates	62
Implications for Policy and Surveillance	71
Chapter IV. Financial Crises: Characteristics and Indicators of Vulnerability	**74**
Types of Crises	74
Identifying Crises	75
Origins of Currency and Banking Crises	79
Currency Crises and Contagion	83
Indicators of Vulnerability	88
Stylized Behavior of Macroeconomic Variables Before and After Crises	89
Early Warning Signals of Vulnerability to Currency Crises	94
Chapter V. Progress with Fiscal Reform in Countries in Transition	**98**
From Stabilization to Sustainability	98
Transition and Government Revenue	104
Transition and Government Expenditure	106
Intergovernmental Fiscal Relations	117
Legal Reform, Transparency, and Accountability	119

	Page
Annexes	
I. Transparency in Government Operations	**121**
Why Fiscal Transparency?	121
Institutions and Behavior	121
Government Accounts	123
Indicators and Projections	123
Overall Trends and Priorities	124
Role of the IMF in Promoting Fiscal Transparency	124
II. Recent Developments in Primary Commodity Markets	**125**
Effects of the Asian Crisis	125
Effects of Weather	126
Developments in Specific Markets	126
Near-Term Outlook	129

Boxes

Chapter

I	1. The Role of Hedge Funds in Financial Markets	4
	2. Moral Hazard and IMF Lending	8
	3. International Monetary System: Measures to Reduce the Risk of Crises	10
II	4. Policy Assumptions Underlying the Projections for Selected Advanced Economies	26
III	5. Evaluating Exchange Rates	64
IV	6. Resolving Banking Sector Problems	80
	7. Effective Banking Prudential Regulations and Requirements	84
	8. The Current Account and External Sustainability	86
V	9. Russia's Fiscal Challenges	100
	10. Pension Reform in Countries in Transition	114

Statistical Appendix	**131**
Assumptions	131
Data and Conventions	131
Classification of Countries	132
List of Tables	143
Output (Tables A1–A7)	145
Inflation (Tables A8–A13)	156
Financial Policies (Tables A14–A21)	164
Foreign Trade (Tables A22–A26)	173
Current Account Transactions (Tables A27–A32)	181
Balance of Payments and External Financing (Tables A33–A37)	193
External Debt and Debt Service (Tables A38–A43)	204
Flow of Funds (Table A44)	214
Medium-Term Baseline Scenario (Tables A45–A46)	219

Tables

Chapter

I	1. European Union: Convergence Indicators	19
II	2. Overview of the *World Economic Outlook* Projections	24
	3. Advanced Economies: Real GDP, Consumer Prices, and Unemployment Rates	25
	4. Major Industrial Countries: General Government Fiscal Balances and Debt	29

		Page
	5. Selected Developing Countries: Real GDP and Consumer Prices	33
	6. Countries in Transition: Real GDP and Consumer Prices	34
	7. Recent Exchange Rate Movements on Bilateral and Multilateral Bases	38
	8. Developing Countries, Countries in Transition, and Newly Industrialized Economies: Net Capital Flows	41
	9. Gross Private Financing to Emerging Market Economies	42
	10. Selected Economies: Current Account Positions	43
	11. Selected Latin American Economies: Macroeconomic Indicators	49
	12. Sub-Saharan Africa: Selected Economic Indicators	50
III	13. Major Industrial Countries: Business Cycle Indicators	58
IV	14. Selected Crises: Costs of Restructuring Financial Sectors and Nonperforming Loans	78
	15. Costs of Crises in Lost Output Relative to Trend	79
	16. Significance of Early Warning Indicators of Vulnerability to Currency Crises	95
V	17. Countries in Transition: General Government Balance	98
	18. Countries in Transition: General Government Revenue	99
	19. Countries in Transition: General Government Expenditure	99
	20. Selected Countries in Transition: Scenarios for Fiscal Sustainability	103
	21. Selected Countries in Transition: Main Items in the General Government Revenue Structure, 1996	105
	22. Selected Countries in Transition: Registered Unemployment	109
	23. Selected Countries in Transition: Estimated Poverty Headcount and Poverty Deficit, in 1993–95	110
	24. Selected Countries in Transition: Main Items in the General Government Expenditure Structure, 1996	112
	25. Selected Countries in Transition: Life Expectancy at Birth	113
	26. Selected Countries in Transition: Shares of Education and Health in Total Employment	117
Annex		
II	27. Price Declines for Individual Commodities and Countries Most Affected in Foreign Exchange Earnings	128
Box		
9	Russian Federation: Summary Operations of the General Government	100
10	Public Pension Systems in Countries in Transition	114
	Countries in Transition: Public Pension Expenditure, 1993 and 1996	115

Figures

Chapter		
I	1. World Output and Inflation	1
	2. Nominal and Real Interest Rates in the Prospective Euro Area	15
	3. European Union: Average Inflation and General Government Balance	20
	4. European Union: General Government Budget Positions	21
II	5. Selected Asian Economies: Bilateral U.S. Dollar Exchange Rates and Equity Prices	23
	6. Major Industrial Countries: Output Gaps	28
	7. Major Industrial Countries: Indices of Monetary Conditions	30
	8. Selected European Union Countries and the United States: Indicators of Consumer and Business Confidence	31
	9. Selected European Countries: Real Total Domestic Demand	32

		Page
	10. Major Industrial Countries: Nominal Interest Rates	35
	11. Selected Advanced Economies: Inflation	36
	12. Advanced Economies: Inflation and Commodity Prices	37
	13. Major Industrial Countries: Effective Exchange Rates	40
	14. Japanese Banking Sector: Selected Indicators	45
	15. ASEAN-4 plus Korea: Aggregate Trade Balance	47
	16. Paths of Output Gaps in Cases of Financial Sector Shocks	47
	17. Selected Latin American Countries: Short-Term Interest Rates and Exchange Rates	48
	18. Egypt: Basic Macroeconomic Data	52
III	19. Major Industrial Countries: Output Gaps	56
	20. Major Industrial Countries: Unemployment, Inflation, and Output Gaps	57
	21. Business Cycles and Output Gaps	61
	22. Three Major Industrial Countries: Real Effective Exchange Rates and Selected Relative Cyclical Variables	66
	23. Selected Major Industrial Countries: Temporary Dollar Appreciation Scenario	69
	24. Three Major Industrial Countries: Variability in Effective Exchange Rates	70
IV	25. Incidence of Currency and Banking Crises	77
	26. Macroeconomic Characteristics of Currency Crises	90
	27. Macroeconomic Characteristics of Banking Crises	92
	28. Asian Currency Crisis: Indicators of Vulnerability	96
V	29. Countries in Transition: General Government Revenue and Expenditure, 1997	102
	30. Countries in Transition: Government Revenue, 1997	107
Annex		
II	31. Selected Asian Countries’ Shares in World Consumption of Primary Commodities	125
	32. Commercial Stocks of Petroleum in OECD Countries	127
	33. Real Commodity Prices and World Output	129

***World Economic Outlook* and *Staff Studies for the World Economic Outlook*, Selected Topics, 1992–98** **222**

Assumptions and Conventions

A number of assumptions have been adopted for the projections presented in the *World Economic Outlook*. It has been assumed that real effective exchange rates will remain constant at their average levels during February 9–March 4, 1998 except for the bilateral rates among the European exchange rate mechanism (ERM) currencies, which are assumed to remain constant in nominal terms; that established policies of national authorities will be maintained (for specific assumptions about fiscal and monetary polices in industrial countries, see Box 4); that the average price of oil will be $14.59 a barrel in 1998 and $15.94 a barrel in 1999, and remain unchanged in real terms over the medium term; and that the six-month London interbank offered rate (LIBOR) on U.S. dollar deposits will average 6.1 percent in both 1998 and 1999. These are, of course, working hypotheses rather than forecasts, and the uncertainties surrounding them add to the margin of error that would in any event be involved in the projections. The estimates and projections are based on statistical information available at the end of March 1998.

The following conventions have been used throughout the *World Economic Outlook*:

. . . to indicate that data are not available or not applicable;

— to indicate that the figure is zero or negligible;

– between years or months (for example, 1997–98 or January–June) to indicate the years or months covered, including the beginning and ending years or months;

/ between years or months (for example, 1997/98) to indicate a fiscal or financial year.

"Billion" means a thousand million; "trillion" means a thousand billion.

"Basis points" refer to hundredths of 1 percentage point (for example, 25 basis points are equivalent to ¼ of 1 percentage point).

In figures and tables, shaded areas indicate IMF staff projections.

Minor discrepancies between sums of constituent figures and totals shown are due to rounding.

As used in this report, the term "country" does not in all cases refer to a territorial entity that is a state as understood by international law and practice. As used here, the term also covers some territorial entities that are not states but for which statistical data are maintained on a separate and independent basis.

* * *

Inquiries about the content of the *World Economic Outlook*, including questions relating to the World Economic Outlook database and requests for additional data, should be sent by mail, electronic mail, or telefax (telephone inquiries cannot be accepted) to:

World Economic Studies Division
Research Department
International Monetary Fund
700 19th Street, N.W., Washington, D.C. 20431, U.S.A.
E-mail: weo@imf.org Telefax: (202) 623-6343

Preface

The projections and analysis contained in the *World Economic Outlook* are an integral element of the IMF's ongoing surveillance of economic developments and policies in its member countries and of the global economic system. The IMF has published the *World Economic Outlook* annually from 1980 through 1983 and biannually since 1984.

The survey of prospects and policies is the product of a comprehensive interdepartmental review of world economic developments, which draws primarily on information the IMF staff gathers through its consultations with member countries. These consultations are carried out in particular by the IMF's area departments together with the Policy Development and Review Department and the Fiscal Affairs Department.

The country projections are prepared by the IMF's area departments on the basis of internationally consistent assumptions about world activity, exchange rates, and conditions in international financial and commodity markets. For approximately 50 of the largest economies—accounting for 90 percent of world output—the projections are updated for each *World Economic Outlook* exercise. For smaller countries, the projections are based on those prepared at the time of the IMF's regular Article IV consultations with those countries or in connection with the use of IMF resources; for these countries, the projections used in the *World Economic Outlook* are incrementally adjusted to reflect changes in assumptions and global economic conditions.

The analysis in the *World Economic Outlook* draws extensively on the ongoing work of the IMF's area and specialized departments, and is coordinated in the Research Department under the general direction of Michael Mussa, Economic Counsellor and Director of Research. The *World Economic Outlook* project is directed by Flemming Larsen, Deputy Director of the Research Department, together with Graham Hacche, Assistant Director for the World Economic Studies Division.

Primary contributors to the current issue include Francesco Caramazza, John H. Green, Staffan Gorne, Mark De Broeck, Paula De Masi, Jahangir Aziz, Ramana Ramaswamy, Ranil Salgado, Phillip Swagel, and Cathy Wright. Other contributors include Susan J. Adams, Barry Eichengreen, Peter Isard, George Kopits, Thomas Krueger, Douglas Laxton, Donogh McDonald, Guy Meredith, Gian Maria Milesi-Ferretti, Ceyla Pazarbasioglu, Blair Rourke, and Andrew Tweedie. The Fiscal Analysis Division of the Fiscal Affairs Department computed the structural budget and fiscal impulse measures. Sungcha Hong Cha, Jeffrey Gable, Gretchen Gallik, Mandy Hemmati, and Anthony G. Turner provided research assistance. Allen Cobler, Nicholas Dopuch, Isabella Dymarskaia, Yasoma Liyanarachchi, and Olga Plagie processed the data and managed the computer systems. Susan Duff, Caroline Bagworth, Margaret Dapaah, and Lisa Marie Scott-Hill were responsible for word processing. James McEuen of the External Relations Department edited the manuscript and coordinated production of the publication.

The analysis has benefited from comments and suggestions by staff from other IMF departments, as well as by Executive Directors following their discussion of the *World Economic Outlook* on March 25 and 27, 1998. However, both projections and policy considerations are those of the IMF staff and should not be attributed to Executive Directors or to their national authorities.

©1998 International Monetary Fund

I

Global Economic Prospects and Policy Considerations

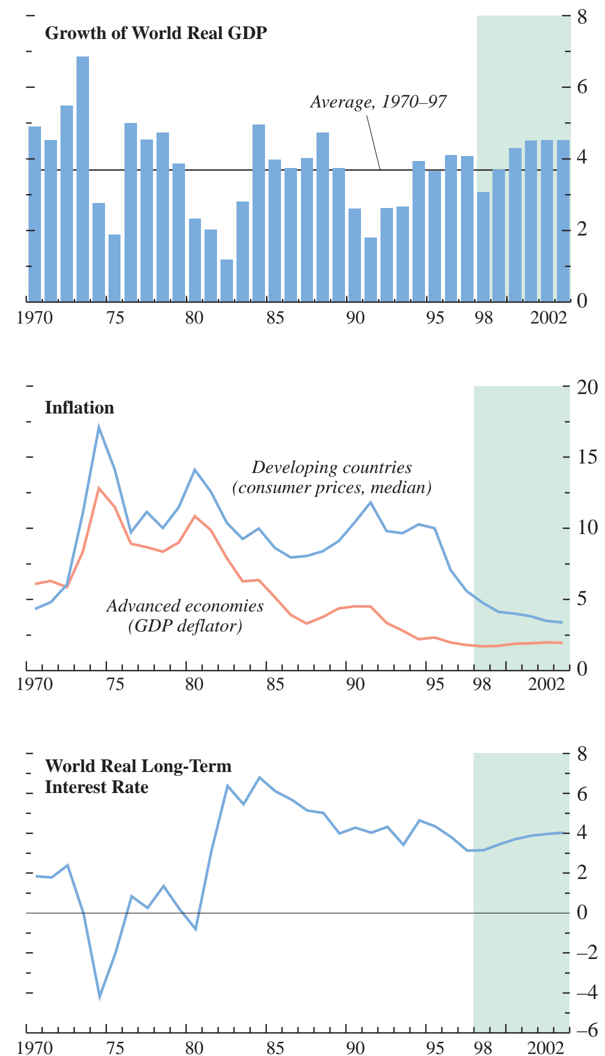
The financial turmoil in Asia that erupted in mid-1997 has abated since January, and markets have partially recovered from their troughs. Nevertheless, currency and asset values in the countries involved have been left far below precrisis levels, and considerable uncertainty remains about the resolution of the crisis and its global repercussions. It is already apparent that the crisis and its likely effects are more severe than they initially appeared and that some of the downside risks identified in the December 1997 *World Economic Outlook: Interim Assessment* have materialized. It still seems, however, that the global outcome will be a slowdown in economic growth that will be much less pronounced than the slowdowns of 1974–75, 1980–83, and 1990–91 (Figure 1). Important reasons why the projected global slowdown is relatively mild include the solid prospective growth of domestic demand in most industrial countries and the limited spillover effects of the Asian crisis in other regions. In the medium term, global economic growth is still projected to exceed the average rate seen since 1970, reflecting a continued strengthening of growth in the countries in transition and maintenance of the relatively strong performance of the developing world in the early and mid-1990s.

This issue of the *World Economic Outlook* projects world output growth in 1998 at just over 3 percent, compared with projections of 3½ percent in the December *Interim Assessment* and 4¼ percent in the October 1997 *World Economic Outlook* (see Table 2 in Chapter II). The largest downward revisions have been for the three economies most affected by the crisis—*Indonesia, Korea,* and *Thailand*—where the drying up of private foreign financing, together with the large currency depreciations and declines in asset prices that have occurred, is causing sharp contractions of domestic demand, which will be only partially counterbalanced by increased net exports. Similar forces, but on a smaller scale, have also lowered near-term growth prospects for *Malaysia,* the *Philippines,* and a number of other countries in east Asia. All these countries will experience sharp slowdowns of domestic demand and imports in 1998, with real GDP likely to decline in the countries worst hit. In Indonesia, continuing uncertainties about the course of policies have hindered a decisive turnaround in financial markets, but elsewhere among the countries worst affected there appears already to have been some improvement

Figure 1. World Output and Inflation[1]

(Annual percent change)

The Asian crisis is expected to result in only a moderate and short-lived slowdown in world growth.



[1]Shaded areas indicate IMF staff projections. Aggregates are computed on the basis of purchasing power parity (PPP) weights unless otherwise indicated.

in sentiment. Although there are painful adjustments yet to come, there are grounds for expecting a continuing recovery of confidence in these economies in the year ahead, followed by a moderate pickup in activity in 1999. These expectations are based on increasing evidence of the commitment of the authorities of these countries to the implementation of needed stabilization and reform measures, and on the economies' strong underlying growth potential, which should reassert itself once earlier excesses have been corrected, critical weaknesses have been addressed, especially in the financial sector, and confidence has been restored.

Contagion and spillover effects have altered the outlook for other emerging market countries. Reduced availability of foreign financing, increased interest spreads on foreign borrowing, lower stock market prices, and policy tightenings to reduce vulnerability to disruptive changes in market sentiment have weakened near-term growth prospects widely, including in some of the transition countries. In general, the adverse effects seem likely to be moderate, with growth remaining positive, but there are risks of a sharper slowdown if the crisis in Asia were to deepen. The effects of the crisis are also being felt through weaker commodity prices, including for oil. For developing and transition countries that are net importers of these products, there will be helpful terms of trade gains, but for many net exporters there will be negative effects on growth, and on current account and fiscal positions, that will be significant in some cases.

Among the advanced economies, the near-term outlook for *Japan* has deteriorated further. Though exacerbated by the difficulties of many of its Asian trading partners, the faltering of Japan's recovery last year can be largely attributed to homegrown problems, including financial sector weaknesses and bad-loan difficulties, delays in the implementation of structural reforms needed to reinvigorate the economy, and a large withdrawal of fiscal stimulus in 1997 when the recovery was still fragile. In spite of measures that have been taken to address financial sector problems and to support domestic demand, overall activity is now projected to stagnate in 1998. Further measures are urgently needed to bring about an early resumption of growth.

Fortunately, growth in North America and western Europe has been well sustained and appears likely to remain so in the period ahead. Domestic demand conditions—robust in the *United States, Canada,* and the *United Kingdom,* and strengthening in much of continental western Europe—will facilitate the adjustment of current account positions that is needed in the Asian emerging market countries because of the sharp declines in capital inflows. The adjustment process in the emerging market countries will reduce net exports from North America and Europe, and also reduce inward foreign direct investment (from Asian companies in difficulty) in some cases. But on the other hand, the redirection of financial investments toward mature markets has helped to reduce real interest rates, while terms of trade gains will also help to support domestic demand. It remains to be seen how confidence will be affected as export orders from Asia and other emerging markets decline, and as some financial institutions feel the effects of difficulties experienced by Asian borrowers. On balance, the Asian crisis is likely to exert a moderate contractionary and disinflationary effect on the industrial, as on other, economies, thus reducing the risk of overheating in those countries operating at high levels of resource utilization, in particular the United States.

Although the threat to global growth from the Asian crisis still appears to be limited, there are clearly downside risks. Policy slippages in the crisis economies may further undermine confidence, unsettle financial markets, and delay recovery. The crisis, together with recent commodity price movements (particularly the decline in oil prices) will bring about some large adjustments in external positions, with painful consequences for some countries, and it is important that countries whose external balances deteriorate do not impose barriers to trade or allow competitive currency depreciations. Such defensive reactions would be counterproductive, slowing the adjustment process of the countries in crisis and impairing growth worldwide.

There are also risks arising from developments in foreign exchange and financial markets in the industrial countries. Equity markets in many countries have recently risen to new highs, and the U.S. dollar has strengthened further. The redirection of financial flows toward mature markets may have contributed to these developments. But with the current account deficit of the United States expected to widen substantially this year, there is the potential for a change in sentiment toward the dollar at some future stage, which would reverse one of the temporary factors that has been helping to hold down U.S. inflation. If world commodity prices were to recover at the same time and labor market pressures continued to push up wage growth, the Federal Reserve could face the need for a significant tightening of monetary conditions, and both bond and stock markets might be subject to significant corrections. The strength of sterling points to similar concerns in the case of the United Kingdom. Thus, while the Asian crisis suggests a need for monetary conditions in the industrial countries to be somewhat easier in the period ahead than would otherwise have been warranted, policymakers will need to remain vigilant to prospective changes in inflationary pressure, including those arising from financial market developments. Further risks arise from the financial sector difficulties and fragilities being experienced in many emerging market countries and in some advanced economies, especially Japan.

This report extends and updates (in Chapter II) the analysis in the *Interim Assessment* of the global ramifi-

cations of the Asian crisis. Whereas the *Interim Assessment* discussed the factors contributing to the buildup to the crisis and examined the unfolding of the episode, this issue of the *World Economic Outlook* draws lessons (in Chapter IV) more broadly, from the most recent and earlier financial crises; one of the major policy questions in this context—the choice of exchange rate regime in emerging market economies—was considered in depth in the October 1997 *World Economic Outlook*. This issue of the *World Economic Outlook* also examines (in Chapter III) how exchange rate developments, particularly among the major currencies, are related to international divergences in business cycles—a question relevant to the assessment of the recent configuration of exchange rates among the major currencies. The most important development in foreign exchange markets in the coming year is likely to be the scheduled start of Stage 3 of European Economic and Monetary Union (EMU), which was treated extensively in the October 1997 *World Economic Outlook*; an appendix to this chapter examines some aspects of recent progress in this venture. Finally, this issue (in Chapter V) examines progress with fiscal reform in transition countries—an area where some of these countries' greatest policy challenges lie.

The Asian Crisis

The economies of east Asia at the center of the recent crisis have been some of the most successful emerging market countries in terms of growth and gains in living standards. With generally prudent fiscal policies and high private saving rates, these countries had become a model for many others. That this region might become embroiled in one of the worst financial crises in the postwar period was hardly ever considered—within or outside the region—a realistic possibility. What went wrong? Part of the answer seems to be that these countries became victims of their own success. This success had led domestic and foreign investors to underestimate the countries' economic weaknesses. It had also, partly because of the large-scale financial inflows that it encouraged, increased the demands on policies and institutions, especially but not only in the financial sector; and policies and institutions had not kept pace. The fundamental policy shortcomings and their ramifications were fully revealed only as the crisis deepened. Past success may also have contributed to a tendency by policymakers to deny the need for action when problems first became apparent.

Several factors—mainly domestic but also external, operating to different degrees in different countries, and exacerbated by contagion and spillovers among the countries involved—seem to have contributed to the dramatic deterioration in sentiment by foreign and domestic investors. As discussed in the *Interim Assessment,* the key factors appear to have been, first, the buildup of overheating pressures, which had manifested themselves in large external deficits and inflated property and stock market values; second, the maintenance for too long of pegged exchange rate regimes, which complicated the response of monetary policy to overheating pressures, and which came to be viewed as implicit guarantees of exchange value, encouraging external borrowing—often at short maturities—and leading to excessive exposure to foreign exchange risk in both the financial and corporate sectors; third, in financial systems, weak management and poor control of risks, lax enforcement of prudential rules and inadequate supervision, and associated relationship and government-directed lending practices that had led to a sharp deterioration in the quality of banks' loan portfolios; fourth, problems of data availability and lack of transparency, which hindered market participants from maintaining a realistic view of economic fundamentals, and at the same time added to uncertainty; and finally, problems of governance and political uncertainties, which exacerbated the crisis of confidence, the reluctance of foreign creditors to roll over short-term loans, and the downward pressure on currencies and stock markets.

External factors also played a role. Large private capital flows to emerging markets were driven, to an important degree, by an underestimation of risks by international investors, as they searched for higher yields during a period when investment opportunities appeared less profitable in Japan and Europe owing to sluggish economic growth that necessitated low interest rates. With exchange rates pegged to the U.S. dollar in several cases, the wide swings in the yen/dollar exchange rate between 1994 and 1997 also contributed to the buildup to the crisis through shifts in international competitiveness that proved unsustainable. In particular, losses in competitiveness associated with the dollar's appreciation, particularly against the yen, from mid-1995, contributed to the export slowdown experienced by a number of countries in the region in 1996–97. Finally, international investors—mainly commercial and investment banks—may in some cases have contributed significantly to the downward pressure on the currencies in crisis, alongside domestic investors and residents seeking to hedge their foreign currency exposures; but hedge funds appear to have played a significant role only in the case of the Thai bhat (Box 1). Many foreign investors have taken substantial losses.

To contain the economic damage caused by the crisis, the countries directly affected have needed to implement corrective measures, and the international community led by the IMF has provided financial support for policy programs in the countries worst hit—Indonesia, Korea, and Thailand. Unfortunately, in these cases the authorities' initial hesitation in the

Box 1. The Role of Hedge Funds in Financial Markets

Bouts of turbulence in international financial markets in recent years have drawn attention to the role played by institutional investors, especially hedge funds. Following both the 1992 crisis in the European exchange rate mechanism (ERM) and the turbulence in international bond markets in 1994, and again in the wake of the turmoil in financial markets in east Asia in mid-1997, it was suggested that hedge funds precipitated major movements in asset prices either directly through their own transactions or indirectly via the tendency of other market participants to follow their lead. Because information on hedge funds' activities is limited, IMF staff undertook a study of their role in recent market developments.[1] This box summarizes the main findings.

What Are Hedge Funds?

Hedge funds are private investment pools, often domiciled offshore to capitalize on tax and regulatory advantages. In the United States, they typically offer their shares in private placements and have fewer than 100 high-net-worth investors in order to make use of exemptions to regulations under the Securities Act of 1933, the Securities Exchange Act of 1934, and the Investment Company Act of 1940. They are managed on a fee-for-performance basis; typically, management is rewarded by a 1 percent management fee and 20 percent of profits, although management and investment fees vary. Most funds require shareholders to provide advance notification if they wish to withdraw funds: notice can vary from 30 days for funds with more liquid investments to three years for other funds.

Practices, however, vary enormously. Market participants distinguish two main classes of funds: macro hedge funds, which take large directional (unhedged) positions in national markets based on analyses of macroeconomic and financial conditions; and relative value funds, which make bets on the relative prices of closely related securities (treasury bills and bonds, for example) and are less exposed to macroeconomic fluctuations. Relative value funds tend to be more highly leveraged than macro funds because the amount of capital needed to establish a position is relatively small on the instruments they hold.

One problem with defining and describing hedge funds is that other investors engage in many of the same practices. Individual investors and their institutional investor counterparts (such as investment banks) buy stocks on margin. Commercial banks use leverage in the sense that in a fractional-reserve banking system their total assets and liabilities are several times their capital. The proprietary trading desks of commercial and investment banks take positions, buy and sell derivatives, and alter their portfolios in the same manner as hedge funds. A significant number of mutual funds, pension funds, insurance companies, and university endowments engage in some of these same practices and are among the most important investors in hedge funds.

Several commercial services do gather information specifically on hedge funds. Excluding "funds of funds" (hedge funds that invest only in other hedge funds), such data suggest that hedge fund capital was in the neighborhood of $100 billion as of the third quarter of 1997. Of that, some $25 billion was in the hands of the macro funds, which typically leverage their capital by borrowing by four to seven times. Although these numbers are large, they pale in comparison with the capital of other institutional investors such as pension funds, mutual funds, insurance companies, and investment and commercial banks, which, in the mature markets alone, exceeds $20 trillion. These other institutional investors are increasingly active in international markets.

What Are the Characteristics of Hedge Funds' Investment Strategies?

Although global macro hedge funds pursue a diversity of investment strategies, it is possible to point to several common characteristics.

First, global macro funds seek to identify countries where macroeconomic variables are far out of line with sustainable values, so that changes in asset prices (and the associated profits) will be large when they finally occur. Other investors are aware that global macro funds assume considerable risk, in return for which they expect considerable returns.

Second, managers are especially attracted to investments where the risk of large capital losses is effectively nil—for example, to an exchange rate that may be devalued but under no conceivable circumstances in the foreseeable future will be revalued.

Third, hedge funds are most likely to take large positions when the cost of funding is low. Cheap funding allows them to take and hold a position even when they are uncertain about the timing of events. For example, they may expect a country to devalue with significant probability but be uncertain about the date.

Fourth, hedge fund managers are attracted to liquid markets, where they can do large trades at low cost. In emerging markets, in particular, limited liquidity and the

[1] Barry Eichengreen, Donald Mathieson, and others, "Hedge Funds and Financial Market Dynamics," Occasional Paper 166 (Washington: IMF, 1998).

implementation of appropriate reforms and other confidence-repairing measures worsened the crisis by causing currency and stock markets to decline well beyond what was justified by any reasonable reassessment of economic fundamentals, even in the light of the crisis. This overshooting in financial markets exacerbated the panic and added to the difficulties in both the corporate and financial sectors,

limited size of accepted deals can constrain hedge funds and other investors who attempt to build up positions. Capital controls or restrictions on domestic banks doing business with offshore counterparties make it difficult for hedge funds to put on positions relative to commercial and investment banks that operate both offshore and onshore. Managers are also wary of being identified as being on the other side of the government's or central bank's transactions, and anonymity is particularly difficult to maintain in smaller, less liquid markets.

Do Hedge Funds Lead Other Investors?

One popular generalization is that hedge funds are nimble and quick off the mark. Their managers have a reputation for astuteness. The rumor that hedge funds are taking a position may thus encourage other investors to follow.

Systematic evidence on these relationships is scanty. An analysis of data reported to the U.S. Commodity Futures Trading Commission by broker-dealers, commercial banks, foreign banks, hedge funds, insurance companies, mutual funds, pension funds, and savings and loans who take large positions in futures markets found that hedge funds herd among themselves in the Standard and Poor's 500 index contract and the three-month Eurodollar contract. Smaller funds were detected as herding with larger ones in the Japanese yen contract and the Standard and Poor's 500 Index contract.[2]

An extension of the analysis to test whether there was a significant tendency for hedge funds to lead other categories of investors obtained mixed results. There is a negative correlation between the positions of hedge funds and the positions of other institutional traders in the same period, and there is little correlation between the positions of hedge funds in the immediate past period and the current positions of other traders.

Should Hedge Funds Be Subject to Greater Regulatory and Disclosure Requirements?

Regulators in the United States and the United Kingdom, where the most important hedge funds operate, see little need for a specialized policy response to regulate and limit the funds' activities in order to increase financial market stability. In particular, in this prevailing view, hedge funds that take short positions against foreign currencies do so in response to evidence of inconsistent policies likely to render currency pegs unsustainable. However, insofar as hedge funds buy sharply depreciated currencies in the wake of a speculative crisis, they are sources of liquidity and stabilizing speculation that dampen market fluctuations.

Nevertheless, limited measures to strengthen supervision, regulation, and market transparency might be considered. For instance, it might be possible to strengthen and replicate the large-trader and position-reporting mechanisms in place in countries like the United States as a way of rendering hedge fund operations more transparent. Any system of detailed portfolio and position reporting, to convey useful information, would have to encompass, among others, commercial banks, investment banks, insurance companies, and pension funds as well. Reporting requirements would have to be applied by all countries; otherwise, market participants who regarded reporting as onerous could book their transactions offshore.

The ability of hedge funds to take positions in financial markets could also be limited by requirements that banks and brokers raise margin and collateral requirements. Similarly, it would be possible to limit the ability of hedge funds to take short positions in currency markets by restricting the ability of financial institutions to lend domestic assets to nonresidents. Again, however, for such requirements to affect the operation of the markets, they would have to apply also to banks, pension funds, insurance companies, and other participants.

Strong limits on position-taking, however, could prevent hedge funds and other international investors from acting as contrarians. While hedge funds may be among the first institutional investors to short a currency when there is evidence of inconsistent macroeconomic fundamentals and unsustainable currency pegs, they may also be among the first buyers to go back into the market after a crisis in which a depreciating currency overshoots. It is not clear, therefore, that discouraging position-taking by hedge funds would reduce volatility in currency or other asset markets.

The most important action policymakers can take to protect their economies against uncomfortable market movements is to avoid offering one-way bets in the form of inconsistent policies and indefensible currency pegs. They can also strengthen the ability of clearance, settlement, and payments systems to withstand asset-price volatility. And they can provide better information about government policy and private sector financial conditions in order to weaken the tendency for inadequately informed investors to "follow the herd" and thereby magnify the repercussions of the positions taken by large institutional investors, among which hedge funds are only one category.

[2]Laura E. Kodres and Matthew Pritsker, "Directionally Similar Position Taking and Herding by Large Futures Market Participants" (unpublished; Washington: IMF and Board of Governors of the Federal Reserve System, 1997).

especially by swelling the domestic currency value of foreign debt. More recently, however, while uncertainties have persisted in Indonesia, it is clear that elsewhere commitments to implement the necessary reforms and adjustment measures have strengthened substantially.

The strategies needed to restore confidence and support a resumption of growth include a broad range of

measures, which have to be tailored to address the specific weaknesses of each country. These are the basic ingredients of the IMF-supported programs in Indonesia, Korea, and Thailand:

- *Monetary policy* must be kept sufficiently firm to resist excessive currency depreciation, with its damaging consequences not only for domestic inflation but also for the balance sheets of domestic financial institutions and nonfinancial enterprises with large foreign currency exposures.[1] Excessive depreciation, by weakening the competitiveness of partner countries' currencies and contributing to downward pressure on them, also adds to the risk of a downward spiral of competitive depreciations, which bring no benefit to any country and monetary instability to all. As fundamental policy weaknesses are addressed and confidence is restored, interest rates can be allowed to return to more normal levels. Indeed, in Korea and Thailand some easing of monetary conditions has already been possible. But experience—including in the Asian crisis—shows that premature easing can be costly.
- Weaknesses in the *financial sector* are at the root of the Asian crisis and require particularly urgent attention, including a clearly announced reform agenda in each case. These weaknesses have arisen partly as a result of a variety of explicit or implicit government guarantees that encouraged excessive exposure to foreign exchange and other risks by financial institutions and their customers, and contributed to reckless lending. (These problems are not confined to Asia; they are widespread globally.) In many cases, weak but viable financial institutions will need to be restructured and recapitalized. Insolvent institutions will need to be closed or absorbed by stronger institutions to facilitate the restoration of confidence. Public sector rescue operations should be carried out in the context of comprehensive restructuring strategies that contain costs to taxpayers—partly by ensuring that equity holders, bond holders, and other lenders share losses appropriately—and tighten prudential regulations and oversight.
- Improvements in public and corporate *governance* and a strengthening of transparency and accountability are also essential. Recent difficulties in part reflect extensive government intervention in the economy and widespread political patronage, nepotism, and lax accounting practices. Strong and unambiguous signals from political leaders that such practices will no longer be tolerated, and the adoption of appropriate reforms, are critical to restoring confidence.
- *Fiscal policies* need to contribute to reductions in countries' reliance on external saving and to take into account the significant costs of restructuring and recapitalizing banking systems. While fiscal discipline is maintained, resources will need to be reallocated from unproductive public expenditures to spending that can help to minimize the social costs of the crisis, including the strengthening of social safety nets. The required degree and composition of fiscal adjustment will vary depending on circumstances in individual countries, and in the IMF-supported programs fiscal targets have been adjusted as circumstances have changed and been reassessed. A balance has to be struck between the need to restore macroeconomic stability (and to reassure domestic and foreign investors on that count) and the need to ensure that domestic demand is not unduly compressed.

The international financial institutions are providing unprecedented assistance to contain the damaging consequences of the crisis for the economies directly affected and for the global economy while seeking to limit the risk of moral hazard (Box 2). Substantial loans by the IMF to Indonesia, Korea, and Thailand are being supplemented by contributions from other multilateral agencies. Given the scale of the short-term debt of several of the crisis countries, however, it is unrealistic to expect that official assistance will be sufficient to permit an early redemption of short-term loans provided by international banks. Private creditors therefore need to contribute as well, both in the form of loan rollovers and lengthened maturities, and through the provision of new medium-term financing. In addition, creditors with claims on insolvent or illiquid borrowers may need to participate in debt restructurings. The recent agreement of Korea's private creditors to a voluntary debt exchange that restructured almost all bank debt (excluding trade credits) is therefore particularly welcome.

In all of the countries at the center of the turmoil, the consequences of the crisis are beginning to be evident in a substantial compression of investment and consumption with rapidly improving trade positions. For 1998 as a whole, the aggregate current account of Indonesia, Malaysia, the Philippines, Thailand (the ASEAN-4 countries), and Korea is now expected to be in surplus by about $20 billion, compared with deficits of $27 billion in 1997 and $54 billion in 1996, and the adjustment could well be larger than is projected. The forced improvements in external positions will help to offset the declines in domestic demand, but output is still expected to decline in Indonesia, Korea, and Thailand in 1998.

[1]For a discussion of the experience of countries that have pursued firm monetary policies in response to exchange market pressures, compared with countries that did not pursue such policies, see "Policy Responses to Exchange Market Crises," Box 5 in the *World Economic Outlook: Interim Assessment* (December 1997), pp. 42–43.

As the needed policies are implemented and external positions improve, confidence should recover gradually during 1998, paving the way for a moderate rebound in growth in 1999 and solid recovery by 2000. The experience of Mexico and Argentina following the "tequila crisis" of 1994–95 and the experience of many other countries in similar situations demonstrate that a start of economic recovery a year or so after a crisis peaks is a realistic and feasible outcome when policymakers are prepared to address the root causes of financial crises. The particular severity and importance of financial sector and other structural weaknesses in the Asian crisis mean that the necessary corrective measures, including institutional and legal reforms, may take longer to implement than in crises that can be resolved mainly by macroeconomic adjustment. But at the same time the deep declines that have occurred in currency and financial markets suggest scope for relatively sharp rebounds as confidence recovers.

Serious financial crises are not a new phenomenon, and they will occur again in the future. With the increasing globalization of financial markets and the apparent tendency for investors to react exuberantly to success, belatedly to emerging concerns, and eventually to overreact as sentiment changes, it may well be that the risk of crises is rising, including the scope for international contagion. Countering the potential for new crises is a considerable challenge that needs to be met through increased vigilance of national policymakers and private investors; the provision of fuller economic and financial information to the public by governments, financial institutions, and corporations; and enhanced international and regional surveillance of economic and financial developments and policies. Transparency in policy formulation and implementation is critical (see Annex I).

A key task for policymakers is to identify weaknesses and imbalances early enough to be able to address them before crises erupt, and the development and monitoring of early-warning indicators of vulnerability may be helpful in this regard. It may be impossible to detect and correctly interpret warning signals for all types of crises early enough, but many potentially serious crises have undoubtedly been avoided in the past through preemptive actions.

In some cases, modifying the exchange rate regime may need to be considered. Currency pegs, currency unions, and currency boards have served many countries well, including in the support of stabilization efforts; and the successful defense of a relatively fixed exchange rate arrangement can bring benefits that outweigh the shorter-run costs. But adjustable pegs have become increasingly difficult to maintain in the face of large-scale financial flows. And with the adoption of any peg or fixed-rate arrangement, not only do a number of preconditions have to be satisfied, but the peg and the rate at which it is set have to be appropriate, and policies have to be subordinated to the maintenance of the rate. For some economies, the balance of costs and benefits may be shifting in favor of greater exchange rate flexibility, partly because of the advantages of avoiding the risk that a fixed exchange rate may encourage excessive foreign currency exposure. However, the decision to exit from a fixed exchange rate regime is often difficult. Ideally, the exit should occur during a period of relative calm in exchange markets, but in practice many exits inevitably take place during periods of currency market stress. In these circumstances, in order to lessen the risk of excessive depreciation, it is essential to implement supporting policy measures and structural reforms and to put clearly in place a new anchor for price and exchange rate expectations.[2] And where exchange rate flexibility is increased, the exchange rate will necessarily remain a key concern of economic policy, with policy adjustments being taken at times to limit currency volatility.

All countries benefit from access to global capital markets and from the improvement in resource allocation that is associated with market-based competition for financing both within and among economies. These benefits include the promotion of competition in domestic financial sectors that is allowed by the entry of foreign firms. At the same time, however, it is clear that there are important preconditions for an orderly liberalization of capital movements. These include, first and foremost, a robust financial system underpinned by effective regulation and supervision of financial institutions. During the transition to an open capital account regime with a liberalized domestic financial sector, market-based instruments such as reserve requirements on foreign currency deposits and short-term borrowing may be helpful in moderating financial flows, as will prudential limits that are essential, in any case, on foreign currency exposure in the financial system, including exposure to customers with unhedged foreign borrowing. The liberalization of domestic financial systems that should precede or at least accompany the opening up to foreign investors will promote the development of domestic capital markets, and thereby reduce the risk that capital inflows become a substitute for the mobilization and effective intermediation of domestic financial resources.

As a result of the Asian crisis, fresh consideration is being given to possible ways in which the institutional architecture of the international monetary system could be adapted to help reduce the probability and severity of crises. The private sector, as well as national governments and international organizations such as the IMF, has a role to play in this regard (Box 3).

[2]See Barry Eichengreen, Paul R. Masson, and others, *Exit Strategies: Policy Options for Countries Seeking Greater Exchange Rate Flexibility,* Occasional Paper (Washington: IMF, 1998, forthcoming).

Box 2. Moral Hazard and IMF Lending

Some commentators have argued that the international community's assistance to countries experiencing financial crises will only encourage more reckless behavior on the part of borrowers, lenders, and investors—an example of the phenomenon known as moral hazard. Moral hazard exists when the provision of insurance against a risk encourages behavior that makes that risk more likely to occur. In the case of IMF lending, the concern about moral hazard stems from perceptions that the availability of financial assistance may weaken policy discipline, encourage international investors to take on greater risks in the belief that they will only partially suffer the consequences, or both.

The fundamental purposes of the IMF, as stated in Article I of its Articles of Agreement, include:

> To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.

The IMF's lending role stems from the public policy objective of limiting the economic and social costs of crises. The experience of the Great Depression taught policymakers that the damage caused by systemic financial crises can be devastating and that the devastation can spread globally. This provides a strong justification for a public policy role in order to avoid unnecessarily deep and damaging crises.

However, the potential availability of IMF financing could in some instances increase incentives for risk taking by both potential borrowers from the Fund, and by lenders to countries. Policymakers of a given country could pursue more risky policies, knowing that the IMF will be there if their policies fail. Lenders could take excessive risks in the belief that an IMF loan would be available to enable the government or the banks to pay their debt if the country got into financial trouble.

In considering the potential for moral hazard, it is important to distinguish between borrowers and lenders and between different investment instruments. From a borrower's perspective, it is hard to believe that a country would deliberately risk a financial crisis simply because it can count on IMF assistance. This seems highly unlikely given the huge economic and social costs of crises and the political costs of the reforms and adjustment measures needed to overcome them. There is, of course, reason for concern about the repeated failure of countries to request assistance at an early stage, when serious crises can still be averted through preemptive action. Indeed, as the problems mount, governments are often inclined to take measures that make the eventual crisis deeper and more costly. However, rather than moral hazard, such delays and actions probably reflect the great political reluctance to accept the need for policy changes and fundamental reforms until there is no other option.

International equity investors and holders of long-term debt instruments also do not seem to be substantially motivated by the prospect of international financial rescue operations. In fact, with stock markets and exchange rates plummeting, between mid-1997 and early 1998 the value of foreign portfolio investments in some Asian markets fell by half to two-thirds. There was never any reasonable basis for expecting that investors in equities would be shielded from such losses by government bailouts or international assistance. Similarly, bond investors clearly do not expect to be compensated for the immediate consequences of a crisis.

Advanced Economies

The advanced economies will all be negatively affected by developments in Asia. The impact on individual economies and the implications for policy will vary, however, depending on three sets of factors. The first is the importance of trade and financial links with the crisis economies; these links are generally closest in the Asia-Pacific region.[3] A second factor is the economy's starting position. The contractionary effects of adjustment in the crisis economies will be most damaging in economies where activity and confidence were already weak—notably Japan—but will contribute to the containment of inflationary pressures in countries operating close to full resource utilization, including the United States and the United Kingdom. And third, the impact on any country will depend on how it is affected by the developments in foreign exchange and financial markets that have accompanied the crisis—developments stemming partly from markets' anticipation of the economic effects of the crisis, but also related to the ways in which financial flows have been redirected. These developments include the general decline in bond yields, and the strength of the U.S. dollar and pound sterling.

In *Japan,* the crisis hit an economy whose nascent recovery had already stalled. After four years of stagnation, output in Japan had grown by 4 percent in 1996, and in the early part of 1997 it seemed that self-sustaining growth was taking hold. But activity declined sharply in the second quarter and remained below its first quarter level in the remainder of the year. The loss of growth momentum before the middle

[3]For example, in 1996, trade with the Asian newly industrialized and developing economies (average of merchandise exports and imports) represented 7 percent of GDP in New Zealand, 8 percent of GDP in Australia, and 5 percent of GDP in Japan, compared with 1½–3 percent in the major industrial economies of Europe and North America. See Box 3 of the December 1997 *World Economic Outlook: Interim Assessment,* pp. 34–35.

For short-term credit provided by international banks and other investors there is greater concern about possible moral hazard. There is no doubt that problems of illiquidity, insolvency, and default in the financial sector pose serious problems for public policy, particularly when there is a threat of contagion and of unwarranted damage to uninvolved parties. For example, governments sometimes provide extensive guarantees to banks' external creditors to convince them to roll over short-term claims, as was the case in several of the Asian countries in crisis. Even in such cases, however, the foreign banks are not completely protected. Moreover, some foreign bank claims on corporate borrowers in crisis countries are typically written down. The fall in earnings and increase in loan-loss provisions in the fourth quarter of 1997 for banks heavily exposed to Asian emerging markets provide an indication that the Asian crisis is indeed costly also for international banks.

To guard against and minimize moral hazard in the financial sector, adherence to the principles of sound banking is essential. In particular, financial institutions need to be adequately capitalized and regulated to ensure that shareholders and subordinated creditors bear the main consequences of imprudent financial decisions.

The IMF's policy advice seeks to ensure to the extent possible that the parties to private transactions bear the costs of their actions. Thus, policy advice on banking sector restructuring typically includes the closing of insolvent institutions and equity writedowns in institutions that are restructured. However, depositors may need to be protected up to certain limits, or more broadly if there is a genuine risk of a run on entire banking systems. With respect to banks' foreign creditors, it may be difficult to avoid moral hazard altogether, although there may well be scope for arrangements in which foreign banks agree to roll over short-term loans at reasonable risk premia at times when they would not normally choose to do so.

The issue of whether and how private creditors should assume a greater share of the burden of dealing with financial crises—the so-called bail in—will need to be considered carefully during the period ahead as suggested recently by the Group of Seven.[1]

Given the significant costs of financial crises for borrowers and most lenders alike, it seems unlikely that imprudent lending and investment decisions are primarily a result of moral hazard created by the presence of the IMF and other international financial bodies. It seems more likely that imprudent decisions reflect misjudgments or "irrational exuberance" that lead investors and banks to underestimate risks in emerging market countries (and then to overreact when sentiment begins to change). This underscores the need to ensure that investment decisions are supported by timely and accurate information so that investors, lenders, and borrowers are fully aware of a country's situation and vulnerabilities. (See Box 3.)

* * *

Limited as it may be, it is unlikely that moral hazard can be reduced to zero without substantially increasing the economic and social costs of crises—both for the countries directly concerned and, through contagion and spillovers, for the global economy. But it is critical to seek to minimize moral hazard, a concern that has been key in the design of IMF programs with the countries at the center of the Asian crisis.

[1]See communiqué released by Group of Seven Finance Ministers and Central Bank Governors following their meeting on February 21, 1998.

of the year may be attributed to a number of primarily domestic factors, including the increase in the consumption tax in April 1997, significant cuts in public spending, and fragilities in the financial system, which stemmed in part from the lingering effects of the collapse of asset prices since the beginning of the decade. In the latter part of the year and in early 1998, the Asian crisis (especially its spread to Korea), concerns about the domestic financial sector, and the renewed weakening of equity prices fed on each other, contributing to continued weakness in domestic spending. The crisis will also weaken exports, as has already begun to be apparent in trade data, both through the compression of demand in a number of important neighboring partners and through losses of competitiveness in relation to them. As a result of these difficulties, overall activity is now projected to stagnate in 1998. The projections have not been revised to take account of the proposals announced in late March for a fiscal stimulus package, because of insufficient information about the prospective measures to allow an assessment of their likely economic effects. Nor have they been revised to take account of data on the economy that appeared in late March and early April (notably the *Tankan* survey) suggesting greater weakness than had been assumed. On balance, it is clear that downside risks to the projections remain significant.

A number of policy ingredients will be needed to lift the Japanese economy from its stagnation. With regard to *monetary policy,* negligible underlying inflation, a large output gap, weak demand, weak credit growth, and the risk of a "credit crunch" all justify the maintenance of easy monetary conditions, with no increase in official interest rates in the near future; indeed, the limited scope that remains for reducing official interest rates further may need to be utilized, together with continued actions to ensure ample liquidity. In the area of *financial sector policies,* in late December the authorities announced several measures to restore confidence and raise the willingness of banks to lend,

Box 3. International Monetary System: Measures to Reduce the Risk of Crises

Although reforms at the national and international level cannot be expected to eliminate all risks of crises such as those now affecting several Asian economies, there is broad agreement on areas where reforms should be considered as potentially helpful in reducing the frequency and diminishing the costs of such crises.

Information Collection, Disclosure, and Transparency

Financial markets and institutions rely on information. When underlying information about the true economic and financial situation of enterprises, banks, and countries is poor, when disclosure of available information is limited, and when potentially damaging information can be disguised or withheld, national and international financial systems work less efficiently and are more prone to disruptive behavior. At the most basic level, improvements in information require efforts in the private sector, including especially implementation of sound accounting practices and of appropriate standards for disclosure to investors, financial institutions, official agencies, and the general public. Governments have a vital role in promoting these practices and standards, as well as in collecting and disseminating accurate economic and financial data with adequate detail and timeliness. Central to governments' responsibilities is the provision of comprehensive and transparent fiscal accounts, and there is scope for improvement in this area in many countries. Substantial efforts are also needed to improve the compilation of financial data, in particular data on external indebtedness, including its maturity. Through consultation with a wide range of public and private participants, and through technical assistance, the international community continues to encourage the development and promulgation of sound information practices, in accord with broadly accepted international norms. For its part, the IMF has created a voluntary Special Data Dissemination Standard (SDDS) to be met by countries currently or prospectively borrowing on international capital markets. Initiatives are already under way to improve the SDDS by extending its coverage of international reserves, adding prudential-type bank indicators, and specifying private external debt more clearly. The IMF has also taken a variety of steps to make its own operations more transparent, including the introduction of Press Information Notices (see below). There is also a need to strengthen the provision of information on institutional infrastructure, including the use of internationally comparable accounting standards, the adequacy of bank supervision and regulation, and the presence of a transparent and efficient bankruptcy process.

Prudential Management and Supervision of Financial Institutions

Weak financial systems increase vulnerability to economic crises and deepen such crises when they occur. The main elements of necessary reforms are outlined in the Basle Committee on Banking Supervision's *Core Principles for Effective Banking Supervision*[1] and the IMF's *Toward a Framework for Financial Stability.*[2] The central objective is to support and enhance market discipline, which provides strong incentives for proper assessment and management of risks by banks and other financial institutions. Key elements of reform include rigorous standards for the recognition and disclosure of gains and losses, adequate capitalization to cover risks, strict limitation of public sector support in situations of systemic need, a clear early-exit policy for insolvent or very weak institutions, and autonomy of bank regulation from political interference. As the crisis in Asia has once again demonstrated the systemic risks arising from large-scale, short-term, foreign currency borrowing, it would appear that this issue merits special attention in an adequate system of prudential regulation.

Orderly Capital Account Liberalization

Openness of an economy to international capital flows generates substantial benefits, but it also poses significant risks. Risks are exacerbated when the opening is ill prepared or ill structured. Weaknesses in a financial system that has been sheltered from domestic and international competition and burdened with government intervention are often revealed following capital account liberalization. Speculative booms and subsequent collapses can be

[1]Basle Committee on Banking Supervision, *Core Principles for Effective Banking Supervision* (Basle, Switzerland: Bank for International Settlements, 1997).

[2]David Folkerts-Landau and Carl-Johan Lindgren, *Toward a Framework for Financial Stability* (Washington: IMF, January 1998).

including the provision of public funds (amounting to 6 percent of GDP) to protect depositors of failed institutions and to recapitalize weak but solvent ones. The willingness to use public funds was particularly welcome, and had some effect in raising confidence. An initial round of capital injection was completed at the end of March, involving most of the major banks, although the conditions were not very stringent. Rules-based and transparent criteria for the allocation of such funds are needed that would ensure that banks receiving assistance take the necessary steps to ensure their long-term viability. Strong steps will also be needed over the medium term to foster a competitive, dynamic, and market-based financial system in line with the Big Bang reform plans.

With regard to *fiscal policy,* it will be important to ensure that it supports growth in 1998. Despite tax rebates to be provided in the first half of the year, the fiscal stance budgeted for the year as a whole is contractionary to the tune of about ½ of 1 percent of GDP, as a result of continued spending restraint. While medium-term fiscal consolidation remains im-

generated when governments, business enterprises, and financial institutions make use of the opportunities provided by expanded access to international capital markets without adequate appreciation of the risks. To guard against these and other dangers, proposals for extending the IMF's jurisdiction to cover the liberalization of international capital movements generally envision a process under which structural reform of financial systems, including the introduction of appropriate safeguards, is undertaken along with, or in advance of, liberalization. Some of these safeguards (such as limits on foreign exchange risks for financial institutions) may be permanent features of a prudential regime that persists when capital account transactions are fully liberalized.

Macroeconomic Policies

As the experience in Asia unfortunately testifies, generally sound management of monetary and fiscal policy, even over an extended period, provides no absolute guarantee against major economic crises. Substantial current account deficits and overvalued exchange rates can develop despite prudent macroeconomic policies, and vulnerability to a crisis can escalate especially when domestic asset prices have become inflated and capital inflows take the form of short-term debt. When a crisis threatens, the issue is not how good policy has been, but how quickly and credibly it can respond to the threat. Countries that demonstrated the capacity for macro policies to react forcefully to recent pressures on capital flows to emerging markets have generally weathered the storm more successfully than those whose responses were weak and inconsistent. The resilience of the economy, and especially the financial sector, to a firming of monetary and fiscal policy, as well as the political willingness to tighten policies when needed, are critical to the ability to contain emerging crises.

With respect to exchange rate policies, many countries have benefited considerably from the maintenance of fixed exchange rates. Increasingly in recent years, however, more developing countries have shifted to a regime in which the exchange rate floats, usually with some government intervention. With greater openness to the pressures arising from fluctuations in capital flows, as well as fluctuations in world trade and in the exchange rates of the world's major currencies, more countries may wish to reconsider whether policy regimes with greater exchange rate flexibility (and with somewhat greater flexibility in other policies) would be better attuned to their needs and circumstances. Nevertheless, as emphasized in the October 1997 *World Economic Outlook,* the exchange rate must remain a key concern of economic policy, and emerging markets countries with flexible exchange rate systems need to be prepared to adjust policies readily to limit exchange rate volatility.

Second-Generation Reforms

Broadly based structural reforms—so-called second-generation reforms—are essential to sustain and enhance countries' longer-run growth performance, to reduce the risk of disruptive changes in investor confidence when economic or financial problems eventually appear, and to enhance the credibility of policy actions needed to forestall or contain crises.

Such reforms cover a number of areas that have been highlighted by the recent Asian crises, such as the need to reduce government intervention in the economy in areas where market forces provide greater efficiency, measures to address corruption and improve both private and public sector governance, improved transparency of government budgets (see Annex I), and strengthened efficiency and robustness of the financial sector.

Surveillance

Diagnosis of vulnerabilities to potential crises and prescription of appropriate remedies can be aided by the process of surveillance, to which the IMF, other multilateral organizations, and regional and other country groups all contribute. IMF surveillance takes place mainly through the annual Article IV consultation with each member country on the state of its economy. The report for the consultation is based on IMF staff research and on discussions between the staff and the authorities of the country. The Article IV staff report is then presented to and discussed by the IMF's Executive Board, whose 24 members represent the institution's 182 member countries. Recent events suggest that more emphasis in surveillance is needed on vulnerability to sudden shifts in international capital flows, on the particular dangers of short-term foreign currency debt, on the importance of sound financial systems and their informational

portant, the need to support recovery calls for additional measures to make policy significantly stimulative this year. Tax reductions, to be paid for by base broadening and spending cuts when the recovery becomes more firmly established, would have the advantage of promoting medium-term structural reform objectives as well as providing short-term stimulus. With regard to additional public expenditure, efforts should be made to ensure that it is efficiently used and boosts the productive potential of the Japanese economy. In the area of *structural reforms,* more rapid action is long overdue to improve Japan's medium-term growth potential, and it would promote recovery by increasing confidence and opening up new areas for investment. The economic package announced in November reinforced earlier initiatives with deregulation measures affecting telecommunications and land use. Further land market reforms would be particularly important for supporting efforts to strengthen the banks' financial position, while further reforms of the distribution system are needed to open the economy further.

Box 3 ***(concluded)***

infrastructure, and on the potential for spillover and contagion effects. In this context, there is greater scope in some cases for regional groups to provide peer pressure for countries to address emerging problems at an early stage. Also, to make surveillance more effective, it appears essential to strengthen incentives for national authorities to pay serious attention to the message from surveillance while problems are still manageable. This raises the delicate issue of the extent to which, and the means through which, messages from surveillance should be conveyed to financial markets, and to the general public. The introduction of Press Information Notices, which allow IMF members to release the IMF Executive Board's assessment of their economic policies following an Article IV consultation, is a step in this direction.[3]

Discipline on Private Capital Flows

Surges of capital toward emerging market economies have contributed to unsustainable booms, and rapid reversals of these flows have precipitated dire crises. To mitigate this phenomenon, it would appear desirable to make suppliers, as well as users, of international capital flows more aware of the risks, and to ensure that they jointly, rather than as innocent bystanders, bear the principal cost of a crisis if one occurs. Flows of equity capital present limited problems because movements in equity prices mainly absorb shifts in investor sentiment without the disruption of actual or threatened default on debt obligations. Debt flows to, and derivative transactions with, private entities need to be kept as private obligations subject to established (and hopefully efficient and transparent) mechanisms for resolving difficulties between private borrowers and lenders. This principle, however, has proved difficult to sustain when much of a country's financial system is threatened with default or when much of private business is in a similar situation. Prudential regulations that limit short-term (especially foreign currency) exposure are appropriate to protect against such situations—especially for the financial sector, where the government may need to act as lender of last resort. In addition, national bankruptcy laws need to be adopted to facilitate appropriate loss sharing. More generally, to avoid such situations, losses to private borrowers and lenders must be established as a regular and expected event when defaults occur—so that the risks of borrowing and lending may be properly appreciated by all parties and so that prudent management of such risks will become established practice. To contain moral hazard, in the event of a general crisis, government should avoid general bailouts of either private creditors or private debtors. Mechanisms to facilitate the participation of private creditors in the expeditious resolution of such crises, including appropriate loss sharing along with debtors, would be desirable but are difficult to design and implement. The premium is on avoiding such systemic crises.

Sovereign Indebtedness

Default by a sovereign borrower poses particularly great difficulties. There is no established mechanism to handle such situations in an expeditious manner, and the messy approach used in the debt crisis of the 1980s would be far less manageable now that much sovereign debt is in the form of bonds held by widely diversified groups of investors. To contain this problem, the key requirement is to keep the volume of sovereign debt, especially foreign currency debt, falling due in any year to manageable proportions, and to maintain adequate foreign currency reserves. The government should also seek to limit, through prudential regulations and liquidity requirements, obligations it might have to assume as a lender of last resort in the event of a systemic banking crisis. The heightened danger of litigation following a default on international sovereign bonds underscores the importance of a cautious approach to the waiver of sovereign immunities, particularly by central banks. In addition, as suggested by the report of the Deputies of the Group of Ten on *The Resolution of Sovereign Liquidity Crises,*[4] it might be useful to consider provisions in new loan contracts and bond covenants to encourage constructive collection action by creditors when a sovereign faces grave difficulties in meeting its obligations.

[3]Press Information Notices are posted on the IMF's public Internet site on the World Wide Web, at http://www.imf.org.

[4]Group of Ten, *The Resolution of Sovereign Liquidity Crises: A Report to the Ministers and Governors,* prepared under the auspices of the Deputies (Basle, Switzerland, 1996).

The other advanced economies in Asia and the south Pacific were generally in a stronger cyclical position than Japan when the Asian crisis erupted. In *Australia,* growth strengthened during 1997 against a background of subdued inflation, a budget close to balance, and a reduced current account deficit. As a result of the Asian crisis, the Australian dollar depreciated sharply against the currencies of other industrial countries in late 1997, but retraced some of this fall in early 1998. The overall gain in external competitiveness will attenuate the effects of the crisis on net exports and growth, and although the depreciation will also have an impact on prices, inflation is expected to remain within the official target range of 2–3 percent. A widening of the current account deficit is likely, but maintenance of the authorities' fiscal consolidation program remains appropriate, with the automatic stabilizers being allowed to absorb the adverse effects of the crisis. In *New Zealand,* as in Australia, monetary policy will need to strike a balance between supporting a pickup in growth in the face of Asia's slowdown and limiting the potential inflationary consequences of

currency weakness. New Zealand's current account deficit in 1997, at 7¾ percent of GDP, was the largest among the advanced economies, and fiscal tightening measures may be necessary to achieve the authorities' projected budget surpluses and to help maintain investor confidence.

The newly industrialized economies of Asia have all been significantly affected by the crises in the region. Policies in the countries in crisis, which include Korea, have been discussed earlier. In *Hong Kong Special Administrative Region of China* (Hong Kong SAR), competitiveness has deteriorated somewhat as a result of regional currency depreciations, and interest rates have risen periodically to relatively high levels in the face of sporadic pressures on the currency. The recent corrections in equity and property markets, higher interest rates, and weaker external demand will act to reduce overheating pressures that had emerged in 1996–97, and to slow activity in 1998. The maintenance of the peg under the currency board arrangement will be facilitated by the flexibility of Hong Kong's product and factor markets, as well as by its strong international reserve position. The banking sector has been feeling the strains of the turmoil in the region but is protected by its strong fundamentals and regulatory framework. Strong financial sectors have also helped to limit the contagion of the regional crisis in *Singapore* and *Taiwan Province of China*. In both cases there has been significant currency depreciation vis-à-vis most of the industrial countries and a significant rise in domestic interest rates.

The advanced economies of North America and Europe will generally be less adversely affected by the crisis. In the *United States,* the crisis and its repercussions appear for the time being to have obviated the need for a tightening of monetary policy to restrain the growth of demand. U.S. economic performance in 1997 was exceptionally favorable, with the fastest growth in 9 years, the lowest inflation in 32 years (in terms of the GDP deflator), unemployment falling to its lowest level in 24 years, and virtual balance in the federal budget for the first time since the early 1970s. While there is some uncertainty surrounding the prospective moderation of growth this year, the current stance of monetary policy seems appropriate, especially given the restraining effects on inflation still expected to materialize from the strength of the dollar and the recent weakness of commodity prices. Further adjustment of official interest rates in either direction should await signs of continuing above-potential growth or a further acceleration of wage costs on the one hand, or an unexpectedly sharp slowdown on the other. One factor tilting the outlook in the former direction will be lower bond yields, which will tend to boost such interest-sensitive spending as housing and business investment. Tilting the outlook in the latter direction will be the effects on net exports of dollar appreciation and the Asian slowdown. To help contain the growth of aggregate demand, and also in view of the longer-term budgetary problems that the country faces owing to population aging, it is important that the small fiscal surpluses that are in prospect for 1998–99 be allowed to materialize. It would, indeed, be beneficial if the reform of entitlements was accelerated to improve the fiscal position further ahead of the deterioration expected in the next decade. Fiscal restraint will also help to contain the expansion of the external deficit and the associated risk of a disruptive correction of the dollar at some stage.

Canada also experienced strong growth in 1997, but, with significant slack remaining, inflation eased further. A considerable widening of the current account deficit, together with weak global commodity markets, contributed to downward pressures on the Canadian dollar that were intensified by the Asian crisis. Official interest rates were raised in November and December 1997 and in January 1998 to offset the consequences of the currency depreciation for monetary conditions. Fiscal policy remains on track following the substantial consolidation efforts of recent years, with the IMF staff projecting surpluses for 1998/99 and beyond. Given Canada's subdued inflation, significant output gap, and cautious fiscal stance, and also the negative spillover effects from the Asian crisis, actions to alter monetary conditions would not appear warranted at this time. If the expansion continues at a robust pace, monetary conditions may need to be tightened to ensure that inflation remains within the target range.

In Europe, there have continued to be notable divergences in cyclical positions. In one group of countries—including the United Kingdom, Denmark, Finland, Ireland, the Netherlands, and Norway—strong expansions have continued, and inflation has remained subdued even though spare capacity has been largely absorbed. A key challenge in these countries is to reduce the risk of overheating.

In the *United Kingdom,* above-potential growth last year reduced unemployment to a 17-year low, and although inflation has been generally close to its 2½ percent target, there has been a pickup in the growth of earnings. Growth slowed markedly and became increasingly unbalanced toward the end of last year as trade performance weakened while domestic demand remained strong; industrial production has fallen gradually from its mid-1997 peak. Sterling's substantial real appreciation since mid-1996, together with the Asian crisis, is expected to weaken net exports further this year, and domestic demand should slow as a result of last year's monetary tightening and the unwinding of the effects of consumer "windfalls." A faster-than-expected fall in government borrowing during 1997/98 means that most of the consolidation expected over two years has already taken place and that fiscal policy will have a smaller contractionary impulse this year than expected earlier. Striking the right

balance for monetary policy in these circumstances is a difficult challenge. A further tightening will be called for if domestic demand fails to moderate sufficiently to ensure that inflation remains under control; but monetary conditions should be allowed to ease if signs emerge of a sharp slowing of growth.

In a second group of European countries, which includes *Germany, France,* and *Italy,* growth has strengthened moderately since early 1997 after faltering in the course of the two preceding years. A key challenge now in these countries, especially given unemployment rates that are close to record highs, is to ensure that the momentum is maintained through stronger growth of domestic demand. This is particularly the case for *Germany* and *France,* where foreign demand has been providing the main stimulus to growth. In the period ahead, the Asian slowdown risks weakening net exports, although gains in competitiveness since 1995 will continue to provide support. In all three countries, a moderate strengthening of domestic demand growth is projected in 1998, supported by recent declines in bond yields and the likely absence of significant further fiscal consolidation. Such strengthening is already apparent in France, but less so in Germany. From the perspective of both countries, it would be appropriate for monetary policy to remain on hold for the time being. In Italy, even after the further reductions in official interest rates in late December, short-term rates are more than 2 percentage points higher than in Germany and France; the further declines in rates that are in prospect as convergence proceeds in the future euro area should not give rise to undue inflationary pressure.

Apart from these two main groups of countries, there is a variety of cyclical positions among the European economies. *Switzerland* has only begun to recover from six years of stagnation; with only modest growth in prospect, supportive monetary conditions will continue to be needed for some time. *Portugal* and *Spain,* by contrast, have been enjoying quite strong growth; with inflation subdued, the prospective further easing of monetary conditions in the run-up to EMU should not give rise to immediate concern. Meanwhile, moderate expansions have continued in *Austria, Belgium,* and *Sweden*.

Policy requirements in Europe in the period ahead have to be considered in the context of EMU, Stage 3 of which is due to begin on January 1, 1999 with the locking of exchange rates. The decision on initial participants will be made in early May (see Appendix). In late March, the European Commission recommended, on the basis of its own convergence report and that of the European Monetary Institute, that the 11 countries planning to participate at the outset of EMU (all EU countries other than Denmark, Greece, Sweden, and the United Kingdom) be judged qualified to do so. A decision on the bilateral exchange rates at which the currencies of the countries entering EMU will be locked will also be made in early May. In preparation for this, the central rate of the Irish pound in the exchange rate mechanism (ERM) of the European Monetary System (EMS) was revalued with effect from March 16. At the same time, as part of the Greek government's commitment to join the euro area in 2001, the drachma entered the ERM, following a devaluation against the European currency unit (ECU).

The prospect of EMU has implications for monetary, fiscal, and structural policies. In the area of monetary policy, this year is likely to see the continued convergence of interest rates among the prospective participants, with scope for some further decline in the average level of rates at short maturities (Figure 2). As this convergence occurs, close coordination of monetary policies will be needed to ensure that an appropriate balance is struck between minimizing the risk of overheating in those economies where expansions are mature and supporting recoveries where they are less advanced. The overall stance is likely to be compatible with a strengthening of economic performance in the prospective euro area as a whole, which should provide a helpful basis for the successful launching of the new currency (see discussion in Chapter III).

In the area of fiscal policy, the convergence process has in recent years brought substantial progress with budgetary consolidation. Last year, in particular, Italy achieved a deficit reduction equivalent to 4 percent of GDP, which has few parallels among industrial countries. With little further consolidation projected for 1998–99 in most prospective EMU members, however, structural deficits are projected to remain close to or above 1 percent of GDP, with actual deficits falling modestly below 3 percent of GDP. Thus EMU will begin with several countries in fiscal positions that circumscribe the scope for flexibility under the Stability and Growth Pact. This points to the need for some further budgetary consolidation; and these countries should take advantage of the present favorable cyclical conditions to move decisively in this direction. The prospective costs of population aging also point to the need for such action. In many cases, this should go hand in hand with urgently needed reforms of benefits, subsidies, and taxes that would help to raise employment and improve economic efficiency.

With regard to structural policies, there continue to be reasons for concern about the lack of progress toward greater flexibility of both product and labor markets. Poorly functioning labor markets characterize most of the prospective participating countries, including the three largest. Not only will labor market rigidities continue to impede progress in reducing high unemployment, but they will also hinder macroeconomic adjustment under a single currency and tend to produce further increases in joblessness. The failure to reform Europe's labor markets is clearly the Achilles' heel of

the EMU project.[4] The proximity of EMU has increased the urgency of reforms of tax and benefit systems, employment legislation, and training provisions that will enhance the supply and mobility of labor and improve incentives for job creation. By contrast, such measures as legislated reductions in work weeks and increases in minimum wages are likely to worsen rather than ease the problem of structural unemployment.

Developing Countries

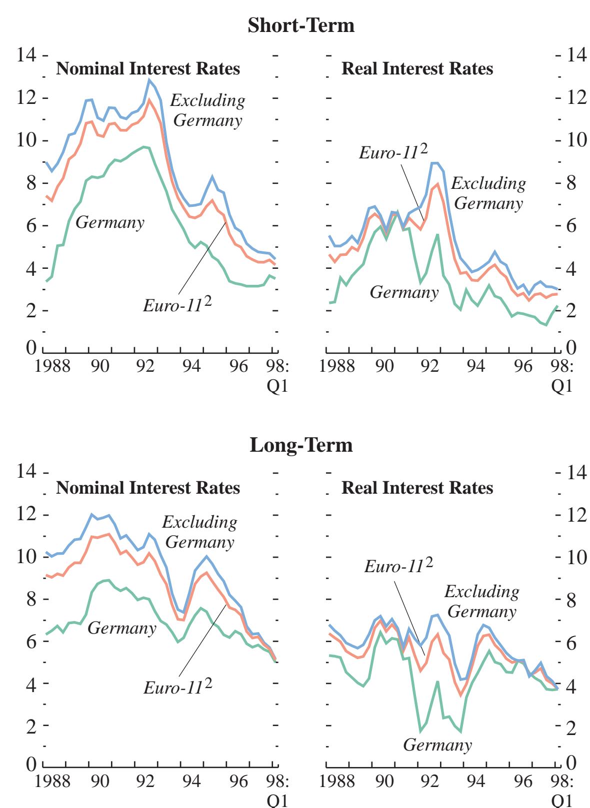
Developing countries in all regions are being adversely affected to varying degrees by the Asian crisis. Although it seems unlikely that international investors will substantially reduce their exposure to emerging market countries that are not at or near the center of the crisis, generally high risk premia, losses of competitiveness, lower commodity prices, and stepped-up efforts to address domestic and external imbalances are likely to cause most developing countries to experience at least moderate slowdowns in growth in 1998.

China has been relatively immune to contagion from the crisis, partly because its capital inflows consist primarily of direct investment while vehicles for financial speculation are limited. The real effective exchange rate has risen somewhat (by about 6 percent) as a result of the large depreciations in the region,[5] but the trade position remains strong, and international reserves are large. Growth is expected to slow moderately this year, owing to weakening domestic demand as well as the more difficult international environment. The authorities are committed not to devalue the renminbi, a policy that they appropriately view as critical to the restoration of stability in the region. Key policy challenges that must be met for rapid growth to be maintained include the need to restructure and enhance efficiency in state enterprises (including through diversifying ownership) and the related need to strengthen the banking system.

In *India,* the rupee has fallen by about 10 percent against the U.S. dollar since late 1997, partly as a result of spillovers from the regional crisis, but its exchange value is little changed on a real multilateral basis. Capital inflows are expected to be sustained, and there remains considerable potential for higher foreign direct investment. The recent slowing of growth, while partly attributable to cyclical factors, suggests that the boost given by the reforms initiated in 1991 has been wearing off. To put India on a sustainably faster growth path, stronger efforts are needed

Figure 2. Nominal and Real Interest Rates in the Prospective Euro Area[1]
(In percent)

Scope remains for further convergence of short-term interest rates in 1998.



[1]Real interest rates are defined as nominal rates deflated by the change in consumer prices over the preceding four quarters.

[2]Comprises Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain.

[4]See Chapter III of the October 1997 *World Economic Outlook,* pp. 55–57, for a discussion of the policy requirements of a successful EMU, including the importance of flexible labor markets.

[5]Uncertainty about the magnitude of the change in the trade-weighted exchange rate is discussed in Chapter II.

to reduce the large fiscal deficit, liberalize foreign trade and investment, alleviate infrastructure bottlenecks, deregulate domestic product markets, and reform the financial and enterprise sectors. In *Pakistan,* the external position remains fragile, and strong adjustment efforts are needed to reinforce the benefits of the structural reforms being undertaken.

In Latin America, in response to spillovers from Asia, *Brazil* tightened monetary and fiscal policies significantly in October and November, thereby restoring market confidence and halting the drain of foreign exchange reserves. Further privatizations should help to maintain capital inflows, and with a likely decline in the current account deficit (to 3¼ percent of GDP) in 1998, the risk of renewed pressures on the *real* has diminished. However, growth is expected to slow to 1½ percent this year. Continued efforts to contain fiscal and external imbalances are needed to strengthen growth and safeguard financial stability. In *Argentina* also, financial market pressures emerged in October, with a significant stock market correction and widening spreads on sovereign debt. Financial market conditions have subsequently eased and growth in 1998 is expected to moderate to 5½ percent from the 8 percent rate recorded in 1997, but the current account deficit is projected to widen further, which is an element of vulnerability.

In *Mexico,* the Asian crisis led to a marked increase in exchange market and interest rate volatility. A substantial, temporary increase in interest rates helped to stabilize the exchange rate, although the peso fell to new lows against the dollar in February while the equity market recovered some of its earlier losses. Growth is projected to slow moderately to about 4¾ percent in 1998, while the current account deficit is projected to widen somewhat, to 2½ percent of GDP. In *Chile,* the peso came under pressure in December but stabilized by late January after moderate official foreign exchange market intervention and a sizable increase in interest rates. Real GDP growth is expected to moderate slightly to 5½–6 percent this year, with inflation easing further, but the current account deficit is projected to widen because of the effects of the Asian slowdown on export earnings. The economic recovery in *Venezuela* gained momentum in 1997, with real GDP expanding by 5 percent. Progress in reducing inflation has been slower than expected, reflecting limited progress with fiscal adjustment as well as insufficiently tight monetary policy. Growth is expected to slow somewhat in 1998 owing to the drop in oil prices. *Bolivia* and *Guyana* are expected to receive assistance this year from the international community under the initiative for heavily indebted poor countries (the HIPC Initiative), along with a number of African countries (see below).

For the Middle East and Europe region, the direct spillovers from the Asian crisis have so far been limited, with temporary declines in equity prices in some countries, and a widening of interest spreads on internationally traded debt. The decline in oil prices, however, if sustained, would pose a serious risk to the growth outlook for the region, and particularly for the region's large oil exporters such as Saudi Arabia and Kuwait. In the *Islamic Republic of Iran,* expansion of real GDP slowed last year, reflecting cutbacks in government capital expenditures, stagnant non-oil exports, and delays in structural reforms, and growth is expected to remain subdued in 1998 in part because of lower oil prices. In *Turkey,* growth moderated to 5¾ percent in 1997, and is expected to slow further in 1998 as the government steps up its efforts to reduce inflation, which is running close to triple digits on an annual basis. With a continuing large fiscal deficit, the economy and its banking system remain vulnerable to shifts in market sentiment. In contrast, successful efforts at macroeconomic stabilization and structural reform in *Egypt* have resulted in significantly improved economic performance, but lower oil prices and weaker tourism earnings and remittances have weakened near-term growth prospects. *Jordan* continues to reap the benefits of the successful implementation of stabilization and reform policies, with robust growth in output, further declines in inflation, and a narrowing current account deficit.

In Africa, estimated growth in 1997 has been revised down to 3¼ percent from 3¾ percent in the October 1997 *World Economic Outlook*. The somewhat disappointing outcome for 1997 is attributable largely to the impact on a number of countries of adverse weather conditions and declines in commodity prices, and, in a few cases, armed conflicts. In *Kenya,* growth weakened partly as a result of financial market pressures, related to political uncertainties, in the third quarter of last year. Among the largest countries in the region, growth in *South Africa* slowed to 1¾ percent in 1997 from 3¼ percent in 1996, reflecting weakness in both domestic and external demand. In *Nigeria,* growth last year was close to 5 percent, but economic activity has been affected by power and fuel shortages, the investment climate has remained unfavorable, and a sharp slowdown is projected for 1998. In *Algeria,* growth slowed significantly last year mainly owing to the adverse impact of drought on agriculture and further delays in the recovery of industrial activity. Looking ahead, growth in many African countries is expected to be in the neighborhood of 5 percent in 1998 and to continue around this trend over the medium term, assuming the continued implementation of strong adjustment and reform policies, including efforts to strengthen governance. However, the weakness of commodity prices suggests that growth may again fall short of expectations this year. Inflation remains under control in most of the region, including in the countries of the CFA franc zone. Assistance under the HIPC Initiative is expected in *Uganda* this year, while commitments have been made for *Burkina*

Faso, Côte d'Ivoire, and *Mozambique* to receive resources under the initiative in 2000, 1999, and 2001, respectively. Preliminary discussions on assistance under the scheme to *Guinea Bissau* and *Mali* have taken place.

Countries in Transition

Spillover effects from the Asian crisis have been felt in the financial and foreign exchange markets of a number of the countries in transition, and in several cases short-term growth projections have been revised down mainly because of the expected effects of the crisis. These revisions nevertheless leave growth in the group on a rising trend, and it is also envisaged in the projections that the transition countries will continue to be able to finance moderate current account deficits. In 1997, both Russia and the transition countries as a group experienced positive growth for the first time in eight years. In 1998, for the first time since the transition began, none of the transition countries is expected to experience a decline in activity; and the overall expansion is expected to strengthen further in the medium term. This performance and outlook are testimony to the progress since early in the decade in most countries with stabilization and reform policies. Nevertheless, there are still significant differences among countries in the progress made.

Spillovers from the Asian crisis have been most apparent in Russia, Ukraine, and, among the Baltic countries, Estonia. In *Russia,* where the ruble came under attack in late October and November as the Asian crisis intensified, and again in late January, the authorities successfully defended the exchange rate by raising interest rates sharply. There were associated steep declines in the stock market. The pressures arose in spite of an external current account close to balance; they reflected a persistently weak fiscal position characterized in part by poor revenue collection, concerns about how the external position might evolve if the fiscal imbalance is not dealt with, and concerns also about financial sector weaknesses. To put Russia's fiscal policy finally on a sound footing, the fiscal action plan adopted by the government late last year, including the tax code, must be fully and speedily implemented. In *Ukraine,* while 1997 appears to have brought single-digit inflation and positive growth within reach, inadequate fiscal adjustment led to increased reliance on official short-term foreign borrowing. This heightened Ukraine's vulnerability to adverse developments, and, when the Asian crisis intensified late last year, exchange market pressures forced the authorities to tighten monetary conditions sharply. An early strengthening of the public finances has become essential for the country's financing difficulties to be resolved in a sustainable way. In Ukraine, as in Russia, structural weaknesses in the banking system have combined with financial market pressures arising from fiscal imbalances to increase the economy's vulnerability to shifts in market sentiment. In *Estonia,* domestic pressures on financial markets, which had been associated with a burgeoning current account deficit (13 percent of GDP in 1997) and a steep rise in equity prices, were exacerbated by contagion from the Asian crisis. Interest rates rose substantially in October and November, and the stock market dropped sharply. Since late last year, however, financial markets have stabilized and interest rates have fallen back somewhat, as the authorities have reinforced banks' prudential standards and tightened fiscal policies.

Many other transition economies have experienced little impact from the Asian crisis in their financial markets or in their access to external finance, in some cases because they remain relatively closed, but in other cases in spite of their openness to international capital markets and relatively large current account deficits. In fact, some countries, such as the Czech Republic, Hungary, and Poland, have experienced upward pressure on their currencies, suggesting that a reallocation of capital flows among emerging market economies may have been taking place. The explanation for the absence of a negative impact from Asia seems to lie largely in the efforts already under way in these countries to correct macroeconomic imbalances. The *Czech Republic,* for example, suffered a currency crisis in May last year and responded by tightening fiscal and monetary policies. The result has been a significant narrowing of the current account deficit, albeit at the expense of slower growth, and the Asian crisis brought only limited further turbulence. To sustain and extend the improvement in the Czech Republic's external accounts, and to strengthen growth, it will be important in 1998 to contain wage increases, to avoid slippages from budget plans, and to take measures to strengthen the banking system. *Hungary* also has experienced little exchange market pressure from the Asian crisis. Its positive experience may be attributed to the country's markedly improved fiscal, growth, and trade performance following the implementation of strong adjustment measures during 1995–97. The reduction of inflation (still 18 percent in 1997) remains a significant challenge, however. In *Poland,* also, following six years of solid economic expansion, recent financial market developments appear to have reflected confidence in the government's macroeconomic policies. For such expectations to be realized, a firm fiscal policy will need to be implemented, while monetary policy also will need to remain tight for further progress to be made in lowering inflation.

The critical role of adjustment and reform policies was demonstrated especially clearly in 1997 in *Albania* and *Bulgaria*. The financial crisis in Bulgaria that began in 1996, as a result of policy slippages, extended into 1997, and output declined for a second consecutive year. In Albania, the crisis that flared up in

March 1997 with the collapse of financial pyramid schemes also led to a drop in output last year. But in both cases, following significant policy improvements during 1997, macroeconomic imbalances have narrowed, and growth has already resumed. In Bulgaria, a particularly dramatic decline in inflation has been achieved since early 1997, with the currency board arrangement (introduced as part of the program supported by the IMF) playing a central role. By contrast, in *Romania,* not only did delays in the implementation of fiscal and structural reforms contribute to a drop in output last year but, together with a considerable loosening of monetary policy, they have led to a resurgence of inflation in early 1998.

Structural reforms remain a crucial part of the policy challenge in transition economies. In many cases, structural deficiencies underlie the macroeconomic imbalances that have contributed to financial market pressures and disrupted growth. Thus in Russia, weak revenue collection reflects not only poor tax administration and deficiencies in the enforcement of tax laws, but also lack of progress in the restructuring of government and poor expenditure management, which have contributed to the problem of arrears in government payments that undermine discipline in meeting payments obligations more generally. In several countries also, banking sector weaknesses have contributed to fiscal imbalances and excessive foreign borrowing and at times have significantly constrained monetary policy. In *Belarus,* the lack of progress with structural reform, combined with unsustainable policies to boost output through rapid credit expansion and an associated buildup of external arrears, led to a currency crisis in March 1998 and to increased risk that the projected growth of the economy will not materialize.

Apart from complicating stabilization policy, structural weaknesses slow trend growth. Empirical analysis has shown that the main reason that growth in Russia and the other 11 countries of the former Soviet Union (excluding the Baltic countries) lags behind the performance of most of the central and eastern European countries is the slower pace of market-oriented structural reform.[6] The countries lagging behind in growth have the most still to do to establish the legal and institutional frameworks needed for the effective functioning of a market economy. But in all transition countries there are areas where reforms have not gone far enough, both in transforming the role of the government and in establishing an environment conducive to private sector development. In most cases, high priorities include the strengthening of bank regulation and supervision; further privatization and enterprise reform; the minimization of monopoly power, including in public utilities; legal and institutional reforms to make it easier to exercise property rights and enforce contracts; improvements in tax systems and governance; and pension and health care reforms to lessen fiscal pressures as populations age. These reforms are needed not only to raise potential growth but also to reduce countries' vulnerability to disruptive shifts in investor sentiment as witnessed most recently in Asia.

[6]Stanley Fischer, Ratna Sahay, and Carlos A. Végh, "From Transition to Market: Evidence and Growth Prospect," in Salvatore Zecchini, ed., *Lessons from the Economic Transition: Central and Eastern Europe in the 1990s* (Dordrecht, Netherlands, and Boston, Massachusetts: Kluwer Academic, 1997).

Appendix: Countdown to EMU—Progress Toward Convergence and Challenges Remaining

On May 2, 1998, the Council of the European Union, meeting at the level of heads of state or government, will decide which countries are qualified to participate in EMU. Of the 15 EU member states, only four are not planning to participate at the outset: Denmark, Sweden, and the United Kingdom have indicated that they do not wish to participate at this point, and Greece is aiming to join by 2001.

In determining a country's eligibility, the Council will consider performance in relation to convergence criteria in the areas of inflation, public finances, interest rates, and exchange rates, which were specified in the Maastricht Treaty (Table 1 and note thereto). As input to the Council's decision, the European Commission and the European Monetary Institute published reports on March 25 assessing compliance with the convergence criteria. Based on these reports, the Commission recommended that the 11 countries planning to participate in EMU in 1999 be judged to have qualified.

As discussed in the October 1997 *World Economic Outlook,* there has been considerable progress in reducing inflation and fiscal imbalances since the signing of the treaty (Figure 3). Except in Greece—which nonetheless has made important progress—inflation in EU countries was below the Maastricht reference value in 1997, and general government deficits satisfied the 3 percent of GDP reference value (Table 1). Reflecting these developments and market sentiment that EMU would begin in January 1999, long-term interest rates for these countries satisfied the Maastricht reference value in 1997, and there have been no major tensions within the exchange rate mechanism (ERM) since spring 1995.

In making its assessment, the Council will also look at prospects for inflation and public finances, and whether the gross debt of general government is falling at a satisfactory pace in those cases where it is in excess of the Maastricht reference value of 60 percent of GDP. There seems little question about the sustainability of inflation performance, with prices pro-

Table 1. European Union: Convergence Indicators

(In percent)

	Consumer Price Inflation				General Government Balance/GDP					Gross Government Debt/GDP[2]				Long-Term Interest Rates[3]
	1996	1997	1998	1999	1996	1997	1998	1998[1]	1999	1996	1997	1998	1999	Feb. 1997 to Jan. 1998
Germany	1.5	1.8	1.6	1.7	–3.4	–2.7	–2.7	–2.5	–2.5	60.4	61.3	62.5	62.7	5.6
France	2.0	1.2	1.4	1.8	–4.1	–3.0	–3.0	–3.0	–2.7	55.4	57.7	58.9	59.6	5.5
Italy	3.9	1.7	1.8	1.7	–6.7	–2.7	–2.5	–2.6	–2.5	124.0	121.6	118.8	116.5	6.7
United Kingdom[4]	2.9	2.8	2.9	2.6	–4.8	–1.6	–0.3	. . .	—	53.8	54.5	51.8	49.7	7.0
Spain	3.5	2.0	2.1	2.3	–4.4	–2.6	–2.2	–2.2	–2.0	69.9	68.3	66.6	65.3	6.3
Netherlands	2.1	2.2	2.0	2.2	–2.3	–1.4	–1.7	–1.7	–1.3	77.2	72.1	70.0	67.5	5.5
Belgium	2.1	1.6	1.7	1.8	–3.2	–2.1	–1.7	–1.8	–1.6	126.9	122.2	118.1	114.5	5.7
Sweden	0.8	0.9	2.0	2.0	–3.5	–0.4	1.3	—	2.0	76.7	76.6	71.3	67.2	6.5
Austria	1.9	1.3	1.4	1.5	–4.0	–2.5	–2.5	–2.5	–2.5	69.5	66.1	65.2	64.5	5.6
Denmark	2.1	2.2	2.6	2.7	–0.9	0.4	1.2	1.2	2.0	66.7	63.3	57.5	53.3	5.6
Finland	0.6	1.2	2.3	2.5	–3.1	–0.9	0.5	0.6	1.0	57.6	55.8	53.5	51.5	5.5
Greece	8.2	5.4	5.0	3.7	–7.6	–4.0	–2.4	–2.4	–2.0	111.6	108.7	107.4	103.1	9.8
Portugal	3.1	2.2	2.1	2.0	–3.3	–2.5	–2.5	–2.5	–1.9	66.0	63.4	62.4	61.6	6.2
Ireland	1.7	1.5	2.2	2.1	–0.4	0.9	0.5	0.5	0.3	72.7	66.3	60.8	56.0	6.7
Luxembourg	1.4	1.4	1.2	1.4	2.5	1.7	0.6	. . .	0.9	6.6	6.7	7.7	7.5	5.6
All EU[5]	2.5	1.9	2.0	2.0	–4.3	–2.3	–2.0	. . .	–1.7	73.6	73.0	71.8	70.6	6.1
Reference value[6]	**2.4**	**2.6**	**2.8**	**3.0**	**–3.0**	**–3.0**	**–3.0**	**. . .**	**–3.0**	**60.0**	**60.0**	**60.0**	**60.0**	**7.8**

Sources: Except where noted, national sources; and IMF staff projections.

Note: The table shows actual outcomes and IMF staff estimates related to the convergence criteria mentioned in the Maastricht Treaty, except for the exchange rate. The data and projections shown for consumer price inflation are based on national statistics rather than on the harmonized consumer price indices being constructed by Eurostat that are being used in applying the Maastricht criteria. As regards the general government deficit and debt, the data in this table are not in all cases based on the definition being used by the EU in the convergence assessments. The three relevant convergence criteria are (1) consumer price inflation must not exceed that of the three best-performing countries by more than 1½ percentage points; (2) interest rates on long-term government securities must not be more than 2 percentage points higher than those in the same three member states; and (3) the financial position must be sustainable. In particular, the general government deficit should be at or below the reference value of 3 percent of GDP. If not, it should have declined substantially and continuously and reached a level close to the reference value, or the excess over the reference value should be temporary and exceptional. The gross debt of general government should be at or below 60 percent of GDP or, if not, the debt ratio should be sufficiently diminishing and approaching the 60 percent value at a satisfactory pace. The exchange rate criterion is that the currency must have been held within the normal fluctuation margins of the ERM for two years without a realignment at the initiative of the member state in question.

[1]Official targets or intentions. The IMF staff's fiscal projections shown in the two preceding columns are in some cases based on different growth, inflation, or interest rate assumptions from those used by national authorities and do not take into account further consolidation measures that are planned by EU governments in accordance with their convergence programs but that have not yet been announced. See Box 4 for the IMF staff's fiscal assumptions.

[2]Debt data refer to end of year and relate to general government. For the United Kingdom, general government consolidated debt evaluated at the end of March.

[3]Ten-year government bond yields or nearest maturity, as reported in the convergence reports of the Commission and the EMI. For Greece, yields on ten-year bonds have been available only since June 1997, and yields on seven-year bonds are used prior to this.

[4]Retail price index excluding mortgage interest.

[5]Average weighted by GDP shares, based on the purchasing power parity (PPP) valuation of country GDPs for consumer price index, general government balances, and debt.

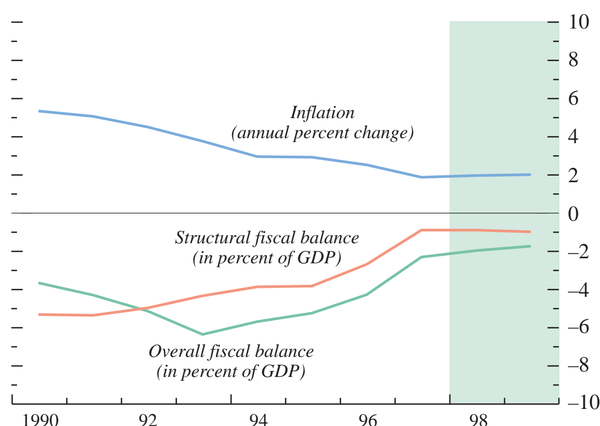
[6]The Maastrict Treaty is not specific about what methodology should be used to calculate reference values for inflation and the interest rate beyond noting that they should be based on the three lowest-inflation countries. For illustrative purposes, a simple average for the three countries is used in calculating the reference values.

jected to rise by 2 percent a year in 1998–99 in the EU as a whole and priority given to price stability in the statute of the European Central Bank (ECB). From 1998, fiscal deficits are expected to be below 3 percent of GDP in all countries, including Greece, which is projected to satisfy the deficit criterion for the first time this year. As regards government debt, particular attention has focused on how the Council will interpret the Maastricht criterion for countries with debt ratios that, while falling, are of the order of 100 percent or higher. With long-term interest rates now differing by ¼ of 1 percentage point or less among the countries aspiring to participate in EMU in 1999, the markets clearly expect that the recommendation of the Commission that all these countries be judged to have qualified will be endorsed by the Council.

The progress in nominal convergence has been sufficient to allow EMU to begin in 1999. The achievements on inflation in particular provide a propitious starting point for the single monetary policy. In most

Figure 3. European Union: Average Inflation and General Government Balance[1]

Since the signing of the Maastricht Treaty, considerable progress has been made by the countries of the European Union in reducing inflation and fiscal imbalances.



[1]Shaded area indicates IMF staff projections.

countries, however, additional fiscal and structural policy measures—as well as being desirable in their own right—are needed for the monetary union to work smoothly and effectively.

Countries need fiscal policies that promise compliance with the Maastricht Treaty in periods of cyclical weakness, as agreed in the Stability and Growth Pact (SGP).[7] This is important both to allow a balanced policy mix for the euro area and to ensure that countries have sufficient leeway to deal with circumstances that might push their economic cycles out of phase with that of the euro area as a whole. Past experience with cyclical fluctuations in output and estimates of the cyclical sensitivity of fiscal positions are key inputs for assessing the amount of room that countries need to allow. The appropriate target for a country, however, will also depend on whether scope is required for discretionary fiscal measures, on the sensitivity of its fiscal position to interest rate changes, and, in a longer-term context, on the need to prepare for the fiscal impact of prospective demographic changes. Most countries, taking all considerations into account, need to aim for medium-term fiscal positions that are at least in balance, with moderate surpluses likely to be needed to the extent that they opt to prepare for demographic changes through increased fiscal saving rather than through reforming pension plans.

Of the countries planning to join EMU in 1999, Finland, Ireland, and Luxembourg are expected to have underlying fiscal positions of balance or surplus in 1998. For the other eight, structural fiscal deficits are projected in the range of about 1–2½ percent of GDP (Figure 4). These countries need to strengthen their fiscal positions if they are to comply with the medium-term requirements of the SGP. In this task, many are expected to receive considerable assistance from falling interest burdens over the next few years, owing especially to declining debt ratios and the pass-through of smaller interest premia. It is disappointing that, despite declining interest spending and a helpful cyclical recovery, the countries that need to reduce structural deficits are, in general, not projected to make progress on this in 1998–99. Of the four countries that do not plan to join the euro area at this stage, Denmark and Sweden have already achieved a structural budgetary surplus, and the United Kingdom is expected to get very close to structural balance by 1998.

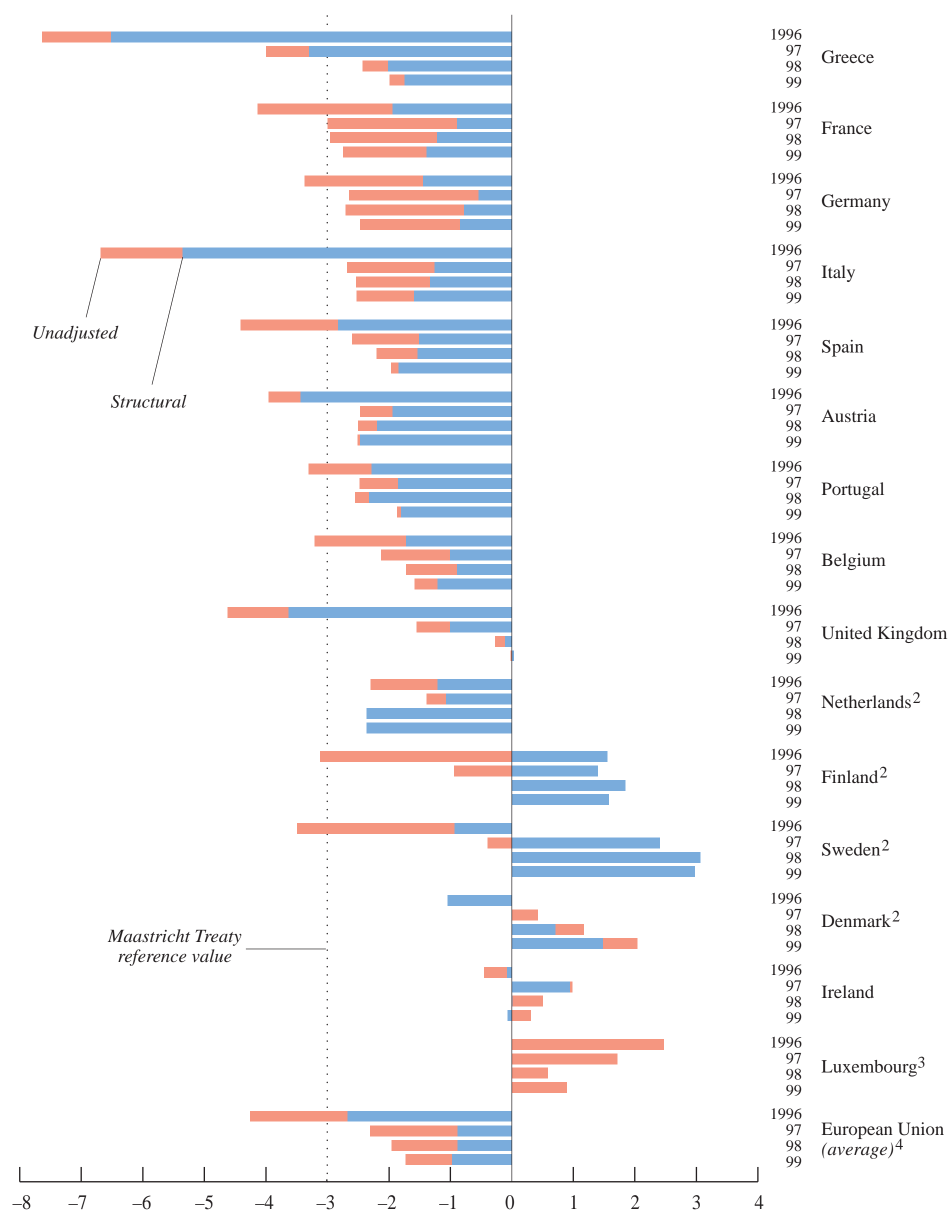
Economic performance in most EU countries has been hampered by excessive rigidities in product and labor markets. The October 1997 *World Economic*

[7]Box 3 of the October 1997 *World Economic Outlook* (pp. 58–69) discussed the SGP. While the present box focuses on the euro area, it should be noted that the SGP also applies to EU countries outside the euro area, although without the threat of financial sanctions.

Figure 4. European Union: General Government Budget Positions[1]

(In percent of GDP)

In 1997, general government budget deficits satisfied the 3 percent Maastricht Treaty reference value in all countries except Greece.



[1]The detailed assumptions underlying the fiscal projections are set out in Box 4. The ordering of countries is based on the unadjusted budget positions for 1997; where the differences between budget positions are not significant, the ordering is alphabetical.

[2]The unadjusted budget positions are not shown separately for Denmark (1996), Finland (1998–99), the Netherlands (1998–99), and Sweden (1998–99) because the bars for the unadjusted balances lie completely within those for the structural balances.

[3]Structural budget positions are unavailable.

[4]Excludes Luxembourg.

Outlook emphasized that increased flexibility in labor markets, in particular, is critical for a stable and successful euro-area economy. Moreover, the broad consensus in favor of policies directed at price stability could be challenged if sufficient progress is not made in reducing structural unemployment; and, without such support, even an independent central bank could find it difficult to sustain such policies for long.

Apart from issues related to EMU, many members of the EU cannot afford the high social and economic costs of delaying structural reform. Given the short-term demands of the Maastricht criteria, governments have focused on macroeconomic rather than structural policies. From a broader perspective, however, policies in these two areas need to be mutually reinforcing. A decline in unemployment can facilitate fiscal consolidation, while the durability of fiscal consolidation in the face of persistent high unemployment will inevitably be open to question. At the same time, a satisfactory fiscal position is a prerequisite for the tax cuts needed in most EU member countries to strengthen incentives to work and invest.[8] Thus, fiscal consolidation will generally need to focus on spending, while measures to tackle unemployment should be broadly based, emphasizing deregulation and reform of social benefits as well as tax reduction.

Most EU countries, the major continental countries in particular, have been reluctant or unable to implement the broad labor market reforms that are needed. Moreover, the current projection of no decline in the structural deficit for the prospective euro area in 1998–99 raises doubts about the will of countries to push fiscal consolidation further. It is essential for confidence in the overall policy strategy that the commitment of governments to progress in both these areas be demonstrated. The significant contribution that falling interest spending is expected to make to fiscal consolidation should allow authorities to devote considerable attention to issues of structural reform.

[8]In addition, continued integration of national markets in the EU is likely over time to increase pressure for tax cuts in those countries with relatively high tax rates.