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and
INTERNATIONAL CAPITAL MARKETS

Interim Assessment

December 1998

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Contents

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 October 19–November 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; that the average price of oil will be $13.39 a barrel in 1998 and $14.51 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 5.5 percent in 1998 and 5 percent in 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 in mid-December 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.

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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:

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Preface

This interim update of the IMF's latest regular reports on the *World Economic Outlook* (published in October 1998) and *International Capital Markets* (September 1998) provides a preliminary assessment of the unusual turbulence in international financial markets during much of the period August–November 1998, and its implications for the global economic outlook and for policy.

The analysis and projections contained in this report are integral elements of the IMF's surveillance of economic developments and policies in its member countries, developments in international financial markets, and the global economic system. 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. For its evaluation of developments in financial markets, the report also draws, in part, on informal discussions with commercial and investment banks, securities firms, stock and futures exchanges, and regulatory and monetary authorities.

The analysis in this report has been coordinated in the Research Department under the general direction of Michael Mussa, Economic Counsellor and Director of Research. The project has been directed by Flemming Larsen, Deputy Director of the Research Department, together with Charles Adams, Assistant Director for Capital Market Studies, Graham Hacche, Assistant Director for the World Economic Studies Division, Donald J. Mathieson, Chief of the Emerging Market Studies Division, and Garry J. Schinasi, Chief of the Capital Markets and Financial Studies Division.

Primary contributors to this report also include John H. Green, Andrew Tweedie, Mark De Broeck, Charles Kramer, Jorge Roldos, Ranil Salgado, and Harm Zebregs. Other contributors include Peter Breuer, Burkhard Drees, Subir Lall, Douglas Laxton, Joaquim Levy, Sandy MacKenzie, Alessandro Prati, Anthony Richards, and Cathy Wright. The Fiscal Analysis Division of the Fiscal Affairs Department computed the structural budget and fiscal impulse measures. Gretchen Gallik, Mandy Hemmati, Yutong Li, Advin Pagtakhan, Subramanian Sriram, Peter Tran, and Kenneth Wood provided research assistance. Allen Cobler, Nicholas Dopuch, Isabella Dymarskaia, Yasoma Liyanarachchi, Olga Plagie, and Irim Siddiqui processed the data and managed the computer systems. Susan Duff, Caroline Bagworth, Sheila Kinsella, Rosalind Oliver, Lisa Marie Scott-Hill, Ramanjeet Singh, and Adriana Vohden 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 report on December 16, 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.

I

Containing the Risks to the World Economy

Turbulence in world financial markets in recent months has raised questions about certain features of financial systems in the mature economies and has heightened uncertainty about global economic prospects. The crisis in Russia in mid-August, coming in the wake of the Asian crisis, led to a drying up of private financial flows to emerging markets, a broader increase in risk aversion among financial investors, and concerns about a global credit crunch. As a result, through early October fears escalated that the current economic slowdown might continue to widen and deepen in 1999. Partly in response, monetary policies have been eased throughout the industrial countries and in some emerging market economies. Together with several other positive developments, the easing of monetary conditions has helped to restore calm in financial markets. But while the danger of a global recession does seem to have diminished, the supply of funds to most emerging market economies is still sharply reduced, and conditions in financial markets remain fragile in several respects. It would therefore be premature to consider the difficulties to be over. The IMF staff's projections for world growth in 1999 have been revised further downward—but not substantially, and by much less than in the two preceding issues of the *World Economic Outlook*. The risks appear to remain predominantly on the downside, however.

* * *

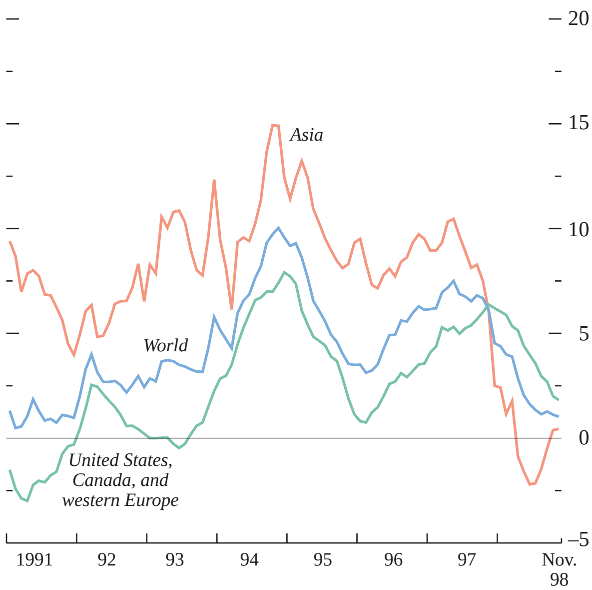
The purpose of this Interim Assessment is threefold. First, given recent concerns about the risks to the global economy, the report reassesses world economic prospects and the policies needed to contain the global financial crisis and to foster recovery, taking into account new information available since the October 1998 *World Economic Outlook* was finalized. Second, the report attempts to shed light on the apparent disproportionality between the extraordinarily high degree of turbulence seen recently in both emerging and mature financial markets and the seemingly more limited scale of the "triggering events," the most important of which were probably the Russian crisis and, subsequently, the near collapse of a highly leveraged hedge fund, Long-Term Capital Management (LTCM). Third, the report seeks to identify some of the most critical shortcomings in private and public risk management systems that need to be addressed to strengthen the resilience of capital markets in the face of future shocks.

The Crisis Intensifies up to Early October and Then Eases

Through the late spring and summer of 1998, developments indicated a further deepening and broadening of the global economic slowdown that was in train following the financial crisis that had erupted in southeast and east Asia in the second half of 1997. Among the countries at the center of the Asian crisis, the contractions in demand and output proved much more severe than generally expected in the early stages of the crisis. In Japan, a key export market for Asian crisis countries, recession deepened considerably, adding to concerns about the health of its banking system. During this period, pressures mounted on the Chinese renminbi and the Hong Kong dollar. Russia's and Ukraine's continued failures to tackle budgetary imbalances were other factors unsettling financial markets, and a number of emerging market countries in other regions experienced recurrent exchange market pressures amid concerns about the sustainability of fiscal or external imbalances. In North America and western Europe, growth appeared to be generally well sustained, indeed to be strengthening in some cases, but the impact of the Asian crisis was beginning to be felt, particularly in the industrial sector (Figure 1.1), and there were concerns that buoyant stock markets might undergo sharp corrections if the growth of activity and corporate profits began to slow. These problems and risks were highlighted in a draft of the October 1998 *World Economic Outlook*, prepared in early August 1998. That document revised down sharply projected world growth in 1998 from 3 to 2½ percent, and in 1999 from 3¾ to 3¼ percent, and cautioned that a significantly worse outcome was clearly possible. The potential for a broader and deeper economic downturn stemmed from a multitude of interrelated risks that made the economic situation unusually fragile. Viewed in isolation, any one of the risks, though serious, might not be sufficient to raise concerns about a sharper global slowdown. But the interrelated nature of these risks, with the scope for contagion and chain reactions this implied, warranted the attention of policymakers around the world.

Figure 1.1. World Industrial Production[1]
(Percent change from a year earlier; three-month centered moving average; manufacturing)

The slowdown in world industrial activity since mid-1997 has been most pronounced in Asia but has also been apparent in North America and Europe. There have been signs of recovery in some Asian countries in recent months.



Sources: WEFA, Inc.; OECD; and IMF, *International Financial Statistics.*

[1]Based on data for 32 advanced and emerging market economies representing about 75 percent of world output. The world total includes five emerging market countries (Argentina, Brazil, Chile, Hungary, and Mexico) that are not included in either of the two subtotals. Data through 1994 exclude Indonesia.

In the event, the effective devaluation and unilateral debt restructuring announced by Russia in mid-August triggered a series of sharp market corrections indicating a generalized increase in perceived risk or risk aversion. Yield premia for emerging market bonds rose sharply, almost across the board, to an average of 1,700 basis points in early September from below 600 basis points in most of 1997 and early 1998; equity prices fell sharply in both emerging and mature markets; and exchange market pressures intensified in many emerging market countries. As a by-product of these developments, many international investors and banks suffered substantial losses, especially on highly leveraged investment positions, which in turn gave rise to margin calls and a rush to raise liquidity that exacerbated the decline in the prices of many financial assets. The widespread flight to quality and liquidity gave rise to a severe tightening of credit conditions, not only for emerging market borrowers but also for non-prime corporate borrowers in some mature markets, especially the United States. These developments led the staff to revise down further their projections for world growth in 1998 and 1999 to 2 percent and 2½ percent, respectively, in the *World Economic Outlook* published in October 1998, in which staff warned (page 1) that:

> Chances of any significant improvement [in world growth] in 1999 have also diminished, and the risks of a deeper, wider, and more prolonged downturn have escalated.

Developments since early October have been more reassuring, helping to restore a measure of calm to financial markets. This can be attributed in large part to a number of policy actions, including:

- Easing of interest rates by central banks in most industrial countries, including the United States, Canada, the United Kingdom, and the member countries of the prospective euro area.
- In Japan, new policy measures to address banking sector problems and announcements of further fiscal actions to stimulate demand. A significant strengthening of the yen, especially vis-à-vis the dollar—attributable partly to these policy actions by Japan, but also to the easing of interest rates in the United States and, perhaps most important, to technical factors related to the unwinding of short yen positions (as discussed in Chapter III)—has helped to improve financial market confidence in the rest of Asia, although it is likely to have a negative short-term impact on Japan's own economy.
- Commitments and actions by Brazil to address its chronic fiscal imbalances, and the large-scale support of the international community, agreed in mid-November, for a strong program to forestall a financial crisis that would potentially have severe contagion effects on other emerging market countries.

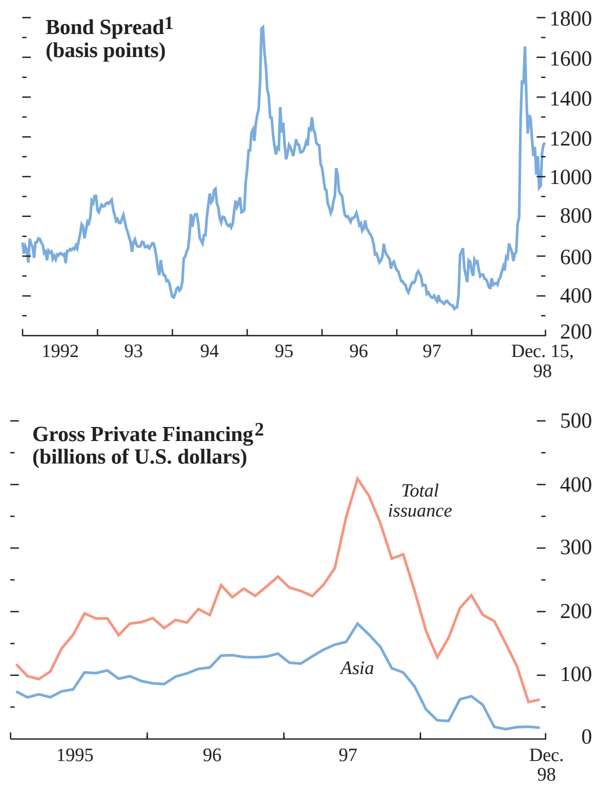
- Continued progress with stabilization and reform in the Asian crisis countries implementing policy programs supported by the IMF. With current account balances having moved into surplus and financial market confidence having begun to recover, the strengthening of exchange rates has allowed monetary policy to be eased, which in turn has helped to boost equity markets. With fiscal policies also having become expansionary, the easing of macroeconomic policies has significantly improved the prospects for recovery to begin in the course of 1999. This is not to deny that slow progress with reform in some areas—such as corporate debt workouts—threatens to retard growth in east Asia for some time.
- Progress toward implementation of the IMF quota increase and the New Arrangements to Borrow (NAB), which have improved the international community's ability to assist countries in the resolution of financial crises;[1] the Miyazawa initiative to provide assistance to the Asian crisis countries; and the proposal by Group of Seven (G-7) Finance Ministers and Central Bank Governors, in their end-October statement, to enhance financing facilities in the IMF and World Bank to help ward off destabilizing financial market contagion, along with their reaffirmed commitment to move forward with the agenda to strengthen the architecture of the international financial system.[2]

Also helpful has been the avoidance of protectionist and other market-closing measures in the large majority of countries, including those that have suffered competitiveness pressures and financial strains.

The positive impact of these policy actions on financial markets is particularly evident in the strong rebounds in global equity prices. With respect to emerging market countries, secondary market bond yield spreads have declined significantly, although they generally remain well above levels observed prior to the Russian crisis in August (Figure 1.2). Access for emerging market countries to external borrowing has also begun to ease, and there have been a number of new debt issues. There have as well been signs of greater

Figure 1.2. Financing Conditions for Emerging Markets

Bond yield spreads for emerging market countries have declined since mid-September, but gross capital flows have remained depressed.



Source: Bloomberg Financial Markets, LP.
[1]J.P. Morgan Emerging Market Bond Index (EMBI, Brady narrow) sovereign spread over the theoretical U.S. zero-coupon curve.
[2]Three-month moving averages; annualized.

[1]The increase in IMF quotas of 45 percent, from SDR 146 billion (about $206 billion) to SDR 212 billion (about $300 billion), will take effect when member countries having not less than 85 percent of the total of present quotas have consented to their quota increases. The timing of ratification is still difficult to predict because parliamentary approval is needed in many countries. The New Arrangements to Borrow (NAB), which took effect on November 17, 1998, doubles the amount previously available under the General Arrangements to Borrow to up to SDR 34 billion (about $48 billion). The NAB is a set of credit arrangements between the IMF and 25 members and institutions to provide supplementary resources to the IMF to forestall or cope with an impairment of the international monetary system or to deal with an exceptional situation that poses a threat to the stability of that system.

[2]See the October 1998 *World Economic Outlook,* Box 1.2.

differentiation in favor of countries with strong fundamentals and credible reform strategies. Nevertheless, gross new private financing flows have only recovered slightly so far, and considerable uncertainty persists about the willingness of international banks to maintain or extend credit lines to emerging markets. In mature markets, reduced supply of credit has been felt mainly by lower-rated borrowers in the United States, but the decline in new debt issues has been alleviated by the ability of such borrowers to draw on bank credit lines.

Overall, therefore, there is some evidence that conditions in capital markets have eased since early October. But there are still signs that perceived risks, or risk aversion, are considerably greater not only than during those periods of 1996–97 when spreads declined to unusually low levels, but also than has been normal in recent years.

Implications for the World Economic Outlook and Remaining Risks

The latest revisions to the staff's projections, incorporating information through November 1998, reflect the restoration of relative calm in international capital markets. In particular, the global growth projection for 1999 has been lowered only slightly further—to 2¼ percent—a much smaller revision than those seen in the last two issues of the *World Economic Outlook* (Table 1.1). For some countries, including Japan, Brazil, and Russia, the outlook has deteriorated more significantly. The growth projections for some of the Asian emerging market economies in crisis have also been lowered somewhat further, reflecting the judgment that the improved prospects for recovery may not materialize until well into 1999. An exception is Thailand, where GDP is now projected to rise steadily, though slowly, throughout 1999. Among the most encouraging aspects of the baseline scenario are the continued solid growth performance, despite modest downward revisions, of the United States and the future euro area, although, as noted below, there are downside risks in both cases. In addition, projected growth in China has been revised up, reflecting stronger-than-expected performance in the second half of 1998, partly in response to policy stimulus. Australia's economic performance has also exceeded expectations, notwithstanding its close trade ties with the crisis-afflicted countries.

The modest scale of the further downward revision to the world growth projections for 1999 may reasonably be viewed as indicating that the global economic situation and near-term prospects have begun to stabilize. At the same time, however, the balance of risks remains on the downside. Five such risks are of particular concern.

- Some emerging market countries will have difficulties remaining current on their external obligations if private financing does not recover from the very low levels of capital inflows observed since August. Indeed, private financial flows to emerging market countries in all regions may well fall short of the levels assumed in the projections. This would necessitate greater trade adjustments by emerging market countries through weaker domestic demand growth, currency depreciations, or both.
- Japan's economic outlook remains particularly uncertain, and questions remain about the adequacy and implementation of recent initiatives to turn the economy around. The Bank of Japan has stepped up efforts to boost credit and liquidity, and further expansionary tax measures are being considered. A clear risk is that confidence and demand would remain depressed if the restructuring and recapitalization of Japan's banking sector were either delayed or pushed through without the fundamental changes needed to convince markets that banking weakness was finally being dealt with.
- The uneven pattern of trade adjustments among the industrial countries could lead to destabilizing movements in exchange rates among the major currencies. While some further appreciation of the yen and the euro against the U.S. dollar seems necessary over the medium term to restore a more sustainable pattern of current account balances, rapid and large realignments could be problematic. Further appreciation of the yen in the short term would be particularly unhelpful from the viewpoint of relative cyclical conditions.
- The large trade adjustments resulting from the Asian crisis could also lead to a resurgence of protectionist pressures, with negative repercussions for world growth.
- The strong recovery of stock markets in some countries, especially the United States, following the recent period of market turmoil has again brought equity prices into a range that may not be sustainable, especially if future corporate earnings were to disappoint financial investors or if inflation and interest rates were to turn upward. The sharp deterioration in the private sector's saving-investment balance in the United States in recent years, and its current, unusually large, deficit po-

Table 1.1. Revisions to World Growth Projections

(Percent change in world real GDP)

World Economic Outlook Issued	1997	1998	1999	2000
October 1997	4.2	4.3	4.4	4.6
December 1997	4.1	3.5	4.1	4.4
May 1998	4.1	3.1	3.7	3.8
October 1998	4.1	2.0	2.5	3.7
December 1998	4.2	2.2	2.2	3.5

sition, may be attributed in part to positive wealth effects on consumer spending from the stock market boom. It underscores the potential for a stock market correction to lead to a rise in saving that, although desirable and necessary from a medium-term perspective, could in the short term markedly weaken demand, activity, and confidence.

In addition, the baseline scenario does not incorporate the further decline of oil prices in recent weeks. If the continued weakness of oil and other commodity prices is sustained, financing constraints for many emerging market countries will tighten further.

As discussed in Chapter IV, the materialization of the above risks, even on a relatively moderate scale, could easily cut world growth by a further percentage point in 1999—and extend what would then effectively become a global recession at least into 2000. The outcome will depend crucially on policies.

Policy Requirements

Recent developments have raised a number of questions about policies relating to the prudential regulation and supervision of financial systems, and these are considered in the next section. This section focuses on policies in the macroeconomic and other structural areas.[3]

Although macroeconomic policy requirements vary among countries, depending on priorities and economic circumstances, there has appropriately been a widespread easing of monetary policies in recent months. In the Asian emerging market economies in crisis, this has been allowed by a strengthening of exchange rates in a context of severe economic weakness. In Japan, interest rates had already been lowered close to zero, but the yen's recent appreciation has provided room for more aggressive injections of liquidity. In North America and western Europe, monetary easing has been a response to the weakening of growth prospects, continuing subdued inflation, and concerns in the United States about strains in credit markets, as well as the need for convergence of short-term interest rates in the prospective euro area, which is now almost completed following the concerted reductions in early December. Discretionary fiscal easing also is appropriately being used in the Asian crisis economies and Japan to support demand. In the case of Japan, the need for medium-term fiscal consolidation, although an important concern, is outweighed by the need to counter the economy's extreme cyclical weakness. Thus, in a large part of the world economy, macroeconomic policies, or at least monetary policy, are usefully helping to support or stimulate aggregate demand and activity. There are two main exceptions to the scope for expansionary policies. First, in North America and western Europe, the need for medium-term budgetary consolidation—to reduce debt burdens and to allow for future demographic pressures—continues in most cases to make discretionary fiscal expansion inadvisable, as opposed to letting the automatic stabilizers operate. Second, some emerging market economies need relatively tight macroeconomic policies to address unsustainable fiscal or external imbalances, to adjust to adverse developments in financial and commodity markets, and to regain investors' confidence.

In the *Asian crisis countries*, following the large contractions of output in 1998, the main priorities are to end the decline of economic activity, limit the impact of the crisis on the welfare of the most vulnerable, and promote the resumption of sustainable growth, including by accelerating the restructuring of financial and corporate sectors—a key element of IMF-supported programs. In Korea, Thailand, and more recently Indonesia, the tightening of monetary policies that occurred in the wake of the crises has achieved considerable success in reestablishing financial stability, and the strengthening of exchange rates has allowed interest rates to be lowered significantly. In both Korea and Thailand, short-term market rates have fallen below precrisis levels of 5–8 percent, and although lending rates have been slower to decline owing to the burden of problem loans in the financial system, monetary conditions are now more supportive of recovery. In Indonesia, also, interest rates have begun to be lowered following the strengthening of the rupiah and the improvement of inflation prospects; assuming that program implementation remains on track, further gradual easing should be possible without undermining confidence. In each of these countries, the primary focus of monetary policy will need to continue to be the assurance of financial and exchange rate stability, with the authorities having to be prepared to resist significant downward currency pressure.

Fiscal policy, however, is available in each case to support domestic demand and promote recovery. In fact, in all three countries there is scope for fiscal policy to provide continuing support for activity, and this should help to secure a turnaround of activity in the course of 1999. The public finances in all three countries are sufficiently healthy to make significant fiscal stimulus feasible without adverse financial market repercussions, but medium-term sustainability must be safeguarded—for example, by concentrating on nonrecurrent spending, including infrastructure investment.

[3]Reflecting the concerns motivating this report and its interim nature, the policy challenges facing the emerging market countries most affected by international financial market developments, and the major industrial countries, are given most emphasis. In contrast, policy issues facing the smaller industrial countries and the developing and transition countries less closely connected to global financial markets are generally not revisited on this occasion. They will be considered in the next *World Economic Outlook*, which will appear in May 1999.

Macroeconomic policy requirements in Malaysia are similar to those in the three crisis countries worst hit. A stimulative budget was introduced in October, and there have been a number of efforts to promote private sector credit growth. Interest rates have fallen to levels similar to those in Korea and Thailand, but in the context of exchange and capital controls, introduced in September, that have damaged investor confidence. The Malaysian authorities have recently put together a more comprehensive strategy to restructure the banking sector, but the credibility of the reform efforts has been undermined by the weakening of loan classification and provisioning guidelines and by the imposition of minimum lending targets (see Annex). The Philippines is more constrained in its fiscal policy than the other four crisis countries, owing to its larger public debt, and the authorities in any event do not have to deal with such a large output decline as in the other four cases; but there too the government is contemplating a cautious easing of fiscal policy to support recovery. Market interest rates in the Philippines have come down substantially from their peaks of late 1997.

In China and Hong Kong SAR, the successful maintenance of the exchange rate regimes has helped to restore stability in Asian financial markets. In fact, currency pressures have eased considerably in recent months in both cases, partly owing to the weakening of the U.S. dollar relative to other major currencies. This has facilitated a lowering of interest rates in both economies. Fiscal policy is also providing helpful support to demand in both cases. In China, increased public investment has provided substantial support for activity in 1998, but nonstate investment and exports remain weak. It is unclear how slow or negative growth in other indicators of activity, such as electricity production and freight traffic, relate to the more buoyant data for GDP, especially given the limited information on the components of aggregate expenditure, including the absence of information on inventory accumulation. In fact, some observers consider that GDP growth in China has been overestimated by 1–2 percentage points a year for several years, and that the discrepancy may have increased somewhat in 1998 (see Chapter IV, Box 4.1). While fiscal stimulus is appropriate, its composition should be carefully tailored to ensure that unproductive spending is minimized and the quality of growth is not compromised. Interest rate policy will need to remain cautious in light of continuing outflows on the capital account of the balance of payments. In this context, it will be important for the recent intensification of capital controls to be implemented without adversely affecting legitimate trade and investment activities. The recent problems in the trust and investment corporations underscore the need for continued financial sector reform.

In Hong Kong SAR, the fiscal position has deteriorated significantly owing to the weakening of economic activity, with a deficit of about 3 percent of GDP projected for the current fiscal year. Although the flexibility of prices and wages is promoting rapid adjustment, the short-term prospect is one of continued economic weakness. It would therefore not be desirable to tighten fiscal policy in 1999, but it will be important to set the current and prospective fiscal shortfalls in the context of a medium-term framework to restore budget balance. The authorities' announced expansion of retraining and job placement schemes, and acceleration of labor-intensive projects, will help to contain the rise in unemployment, which has risen above 5 percent to its highest level in more than 17 years and seems likely to rise further until recovery is under way.

In *other emerging market countries,* the main priorities are orderly adjustment to adverse external developments, including weaker exports to Asia and lower commodity prices, as well as reduced capital flows; the reestablishment of investor confidence and, in several cases, financial stability; and the reduction of vulnerability to adverse shifts in investor confidence. In most cases, financial imbalances and external financing constraints require tight macroeconomic policies. Although these may increase the likelihood that activity will weaken in the short run, forceful measures to reduce financial imbalances are needed to reduce the risk of contagion, alleviate the need for monetary policy to defend exchange rates, and strengthen medium-term growth prospects.

In recent months, the main focus has been on Brazil, whose currency came under sustained pressure between July and October because of concerns about the fiscal situation and external competitiveness. Sharply higher domestic interest rates slowed the pace of capital outflows from mid-September, but a sustainable resolution of the difficulties, given the government's debt-service obligations, required action to reduce the fiscal deficit. Anticipation of such action, the implementation of some early measures, and expectations of large-scale financial support by the IMF and other multilateral and bilateral creditors led to a further easing of pressures in October and early November. Agreement on the policy program and financing package was announced on November 13 (Box 1.1). The determined and sustained implementation by Brazil, at all levels of government, of this front-loaded fiscal adjustment effort (including passage of measures recently delayed in Congress), accompanied by appropriately tight monetary policies and wide-ranging structural reforms, will make an essential contribution to sustaining the improvement in global financial market sentiment that has occurred over the past two months.

Many other countries in Latin America have appropriately adjusted macroeconomic policies to promote adjustment to adverse external developments and to strengthen the confidence of investors. In Argentina, domestic demand growth has slowed considerably. Fiscal policy has been tightened significantly in the past year, but even though the fiscal deficit is now quite small, continued consolidation may be needed, especially given the widening of the external current account deficit over the past two years. There is also scope for accelerating structural reforms that would strengthen external competitiveness by improving productivity and reduce unemployment by enhancing labor market flexibility. Chile has suffered a particularly marked deterioration in its external accounts over the past year, and its current account deficit in 1998 now seems likely to be about 6¾ percent of GDP. Currency pressures have been met by cuts in public spending and a tightening of credit conditions, as well as by adjustments of both the width and the rate of crawl of the exchange rate band, and the suspension of restrictions on capital inflows. The current account deficit is now declining, but a stronger fiscal position may be required to sustain a smaller current account deficit and ease the burden on credit policy. In Mexico, the authorities have appropriately cut government spending in the face of lower oil prices, and as a result are expected to come close to achieving their fiscal objective for 1998 of a deficit equivalent to 1¼ percent of GDP. They have also tightened monetary policy significantly to contain inflation in the face of the depreciation of the peso. Gains in international competitiveness and the slowing of domestic demand growth are expected to reduce the current account deficit significantly next year. Nevertheless, recent adverse developments have reemphasized the need for a strong fiscal reform effort to increase non-oil revenues, reduce the vulnerability of the budget to fluctuations in petroleum prices, and contain the growth of current spending. Problems in the banking sector also remain to be resolved. Venezuela and Ecuador also have been suffering from the weakness of oil prices, and their fiscal deficits have widened despite substantial spending cuts; further measures seem likely to be needed to secure financial stability. Also in Latin America, significant macroeconomic policy adjustments have been announced in Colombia to address large imbalances that have emerged as a result of past policy slippages as well as adverse external developments. In central America, economic recovery from the devastation caused by Hurricane Mitch in late October is being supported by emergency financial assistance from the IMF, World Bank, and other multilateral and bilateral sources.

In Asia, India has been experiencing a slowing of growth in the industrial sector, accompanied by higher inflation that reflects agricultural supply difficulties, rapid monetary growth, and the depreciation of the rupee since late 1997. The current account position has weakened, but international reserves remain comfortable, boosted by capital inflows from nonresident Indians. The first priority for macroeconomic policy is to take decisive steps toward medium-term fiscal consolidation, in order to reduce the public sector deficit substantially from its recent level of close to 10 percent of GDP. It will also be important to avoid a premature easing of monetary policy: in fact, further tightening may be warranted if inflation does not slow. Aside from these macroeconomic policy requirements, a wide range of structural reforms are needed to boost confidence and reinvigorate growth.

The external financial crisis in Pakistan, which has been reflected in a sharp decline in international reserves and the accumulation of large external payments arrears, is being addressed by a policy package entailing substantial fiscal adjustment as well as broadly based structural reforms and the gradual removal of the temporary exchange restrictions imposed at the onset of the crisis, and by debt relief from official and private creditors.

Among emerging market countries in the Middle East and Europe region, Turkey suffered the worst contagion from the Russian crisis in August, reflecting its close trade links with Russia and its difficult fiscal position. While the country's international reserves have stabilized since September, domestic interest rates have remained high, partly owing to Turkey's reduced access to international capital markets and domestic political uncertainties. The budgetary situation has remained on its adjustment track, but substantial further progress in fiscal consolidation and structural reforms will be important to achieve the targeted reduction of inflation and to maintain investor confidence in the face of the heavy debt-service obligations falling due in the period ahead. In Israel, monetary policy has been tightened sharply in recent months in the face of downward pressure on the shekel and a pickup in inflation following earlier depreciation.

Many other countries in the Middle East are having to adjust to the weakness of world oil prices, with declines in export revenues resulting in acute budgetary and external pressures in many of the region's oil producers, including some of the wealthiest countries such as Saudi Arabia. At the same time, current conditions in global financial markets provide limited scope to offset export shortfalls through expanded foreign borrowing. Consequently, gross official reserves have been drawn down in a number of countries—including Algeria, Iran, Oman, and Yemen—to finance sizable current account deficits. Given prospects for continued weakness in the oil market in the period ahead, an immediate policy challenge is the adoption of measures to restore macroeconomic equilibrium and promote growth of non-oil activities, particularly in the oil producers of the Gulf region. Efforts to restrain public spending, broaden the revenue base, and press ahead with structural reform will all be important. Progress to date in these areas has been limited, and further delays would risk financial instability, with potential spillover effects on the non-oil economies in the Middle East, some of which—in particular, Jordan, and, to a lesser extent, Egypt—are already experienc-

Box 1.1. Brazil's Financial Assistance Package and Adjustment Program

The terms of a $41 billion IMF-led financial assistance package for Brazil, in support of the program of adjustment and structural reform described below, were released on November 13, 1998. Of the total amount, $18.1 billion (SDR 13,025 million) would be provided by the IMF in the form of a three-year Stand-By Arrangement, about $4 billion each from the World Bank and the Inter-American Development Bank, and $14.5 billion from 20 governments channeled through, or provided in collaboration with, the Bank for International Settlements (BIS). The U.S. government is the largest bilateral contributor, with a credit line of $5 billion. There is no explicit contribution from the private sector, since the Brazilian authorities believed it would be most effective to seek the voluntary participation of international banks in a rollover of credit lines once the financial package had been arranged. Initial contacts by the authorities with private banks suggest that banks will hold open their trade and interbank credit lines. The bilateral financing is not guaranteed by any collateral—something that distinguishes the package from the one arranged for Mexico in 1995, where U.S. repayment was guaranteed by oil revenues.

The financial package is significantly front-loaded, with about $37 billion available, if needed, in the first 13 months, and carries relatively high interest rates and short repayment schedules. In the case of IMF funds, 30 percent will be available under the credit tranches, at a floating interest rate, currently 4.25 percent, and a repayment period of five years. The remainder, 70 percent, will be available under the Supplemental Reserve Facility (first used in the case of assistance to Korea at end-December 1997), with a repayment period of two and a half years and an interest rate of 300 basic points above that applying to the credit tranches. In the case of the funds channeled through the BIS, a repayment period of two years will apply upon drawdown, with a 470 basis point spread over the London interbank offered rate (LIBOR). The first tranche of $5.3 billion from the IMF became available after the approval of the package by the IMF's Executive Board on December 2. The second tranche will become available from February 1999, or even earlier depending on circumstances.

* * *

Background

In the four years between the introduction of the *Real Plan* and September 1998, Brazil managed to wrench inflation down from rates in excess of 2,700 percent a year to under 3 percent. It was also able to advance the implementation of its structural reform agenda, and to achieve annual growth of GDP of about 4 percent. In the structural area, its privatization program was particularly successful, but it also made progress in resolving the problems of the state banks and in other aspects of financial reform, deregulation, and the opening up of the economy.

Notwithstanding the *Real Plan*'s great success in reducing inflation, it has not been successful in reducing the public sector deficit. After a strong initial fiscal adjustment when the *Plan* was introduced, the fiscal stance was loosened. The public sector borrowing requirement (PSBR) reached 6.3 percent in 1997 and is projected to approach 8 percent in 1998. In addition to the impact of declining inflation on real expenditure, which had been held down by the lack of rapid and full indexation of nominal expenditure, the weakness of the public finances reflected some basic structural problems: an excessively generous pension system, inflexibility of civil service employment rules, the lack of a hard budget constraint on subnational governments, and a distorted system of indirect taxation. The increase in the PSBR was reflected in the deterioration in the external current account, which is projected to reach a deficit of 4 percent of GDP in 1998.

The fiscal and external deficits made Brazil vulnerable to changes in investor sentiment and the attendant capital outflows. It successfully responded to a bout of capital outflows in the wake of the Asian crisis in the fall of 1997, mainly because of the timely response of monetary policy and the announcement of a strong fiscal policy package. However, disappointment with slippages in fiscal adjustment in 1998 and the continued growth of the public debt contributed to the sentiment that Brazil remained vulnerable. The crisis in Russia led quickly to pressures on emerging markets, and particularly Brazil's external capital account, as described in the text. Liquidation of Brazilian Brady bonds to cover losses on Russian securities and, more generally, the buildup of short positions in Brazilian offshore debt instruments resulted in arbitrage by resident investors seeking the higher return on "Brazil risk" offered by Brady bonds. Nonresident holdings of Brazilian debt and equity instruments were also significantly reduced, and capital outflows by residents took place in other forms. Overall, most of the outflows were by nonresidents.

The government reacted initially by announcing a number of measures to increase the attractiveness of capital inflows; it then announced measures to tighten the

ing a drag from weaker export growth and workers' remittances.

Among developing countries in Africa, financial markets in South Africa have stabilized in recent months following the period of severe downward pressure on the rand in midyear, but activity has slowed sharply. The authorities' tight monetary policy appears to have been the main factor contributing to a partial recovery of the exchange rate, which has led to rebounds in bond and equity markets. Financial market stabilization has allowed monetary policy to be eased somewhat since October. A durable strengthening of economic growth continues to require structural reform in a number of areas.

fiscal stance, as well as an increase in interest rates. With the outflow of capital continuing unabated, it hiked interest rates by 20 percentage points, raising the overnight rate to over 40 percent. This stemmed but did not stop net capital outflows, and the government began to prepare the policy package described below and to intensify its dialogue with the IMF and other members of the international community to seek their support.

Policy Program

On the macroeconomic front, the program is focused on a set of fiscal measures announced by the Brazilian government in late October, aimed at increasing primary surpluses of the public sector sufficiently (given the assumption that interest rates will decline gradually, from 40 percent in early November to 20 percent by mid-1999 in terms of the overnight rate) to arrest in 2000 the rise in the ratio of public debt to GDP. Thus the program sets a target surplus of 2.6 percent of GDP for the primary balance of the consolidated public sector in 1999, followed by surpluses of 2.8 percent of GDP in 2000 and 3.0 percent in 2001. Contributions to the fiscal adjustment effort are expected from all levels of government, and a series of expenditure-saving and revenue-raising measures have been announced, some of which have already been enacted (see below). In terms of domestic public debt management, the government will aim at securing a progressive lengthening of the maturity of the debt and, as interest rates decline, at increasing the share of fixed-rate securities in total debt. Monetary policy will continue to be conducted to support the exchange rate regime, a crawling peg whereby the *real* depreciates against the U.S. dollar at a rate of about 7½ percent a year. Reliance on the *real* as the nominal anchor is seen as the key to low inflation. The improvement in the fiscal position is to take place despite a projected decline in real GDP of 1 percent in 1999, reflecting the high interest rates expected to prevail through early 1999, the fiscal contraction itself, and slower export market growth. Economic recovery is projected to begin in the latter part of 1999, with growth of 3 percent projected for 2000, helped by improvements in international competitiveness implied by the crawling exchange rate peg and the projected low rate of inflation and continued robust productivity gains. In addition to the structural reforms of the public sector described below, the government also intends to advance financial sector and labor market reforms and to avoid reversals of the trade liberalization program.

Fiscal Policy

Most of the program's fiscal adjustment is to occur at the federal government level, with about two-thirds resulting from revenue measures. In addition to an increase in the tax on financial transactions, these include increases in the payroll taxes paid by civil servants to finance their pension plan, which is unusually generous.[1] The program's expenditure cuts are intended to spare sensitive social expenditure programs. Adjustment at the state and municipal levels is based on the increased control the government has over the states' financing sources, on the discipline imposed by the fiscal adjustment agreements most states have signed with the federal government, and on the impact of a law imposing a ceiling on the civil service wage bill in relation to revenue. Tariff increases will raise the operating surpluses of those enterprises remaining in the public sector, and privatization-related investment will fall.

Public sector structural reforms will make a growing contribution to the fiscal adjustment over time. The recently passed constitutional amendment to social security will achieve expenditure economies by increasing the effective retirement age of participants in the private sector pension scheme. The administrative reform, whose implementing legislation is now being passed, will reduce excess staffing in the civil service at all levels of government.

The social security reform that congress recently approved will be bolstered by a more fundamental reform that the government is now preparing, based on the principle that what a participant, or his or her employer, contributes must bear a reasonable relationship to the pension he or she can expect to receive. Administrative reforms of public sector pension plans at the state and local levels are also planned. The government has also been working for some time on a reform of the country's indirect tax system, under which the value-added taxes administered by the states, whose bases have been eroded and whose rate structure has been affected by excessive tax competition, will be replaced by a VAT with a common base and rate structure. Its revenues will be shared between the different levels of government, and it will probably be administered by the states.

[1]This payroll tax increase was voted down by the congress in early December. It is to be resubmitted to the new congress in February 1999, and the government has announced that measures will be taken to compensate for any revenue loss resulting from the delay.

Among the countries in transition, Russia continues to lack macroeconomic policies that would help to restore the confidence of investors and establish the preconditions for sustainable growth. The central areas of concern remain the large underlying fiscal imbalance, which has widened further since the August crisis, and the distortions arising from the associated arrears and broader culture of nonpayment in the economy. Russia urgently needs a fiscal policy by which the bulk of expenditures would be financed by tax revenues, without resort to arrears, and whose financing would allow inflation to be reasonably well contained, without price controls. To reduce the deficit to the levels required, measures need to be taken as early as possible to enhance government revenues—particularly through improvements in tax administration and an end to ad hoc negotiated tax deductions—and to cut government spending. The authorities' current budget plans fail to meet these requirements. Macroeconomic stabilization will also require a monetary policy that avoids substantial central bank financing of the banking system as well as the government. The reestablishment of stability-oriented macroeconomic policies will have to be accompanied by actions to address severe difficulties in the banking system (discussed in the Annex), the normalization of relations with creditors, and a return to the unfinished task of structural reform, which needs to be accelerated on many fronts. Strong spillovers from the Russian crisis have been felt in Ukraine, although continued lags in progress there with macroeconomic stabilization and structural reform have been a greater source of difficulty. Particularly important now is the satisfactory resolution of uncertainties regarding the implementation of the 1999 budget and the elimination of fiscal overruns.

In central and eastern Europe, Hungary and Poland have weathered the financial market turmoil of recent months reasonably well: the progress in recent years with fiscal consolidation has helped to maintain confidence in their foreign exchange markets. With inflation having been reduced significantly in both cases, the continued improvement of external financial market conditions should allow domestic interest rates to be lowered gradually further. In the Czech Republic, output is estimated to have fallen by 1½ percent in 1998 following a tightening of policies that was needed to reduce fiscal and external imbalances. Since July, the strength of the koruna has allowed reductions in interest rates amounting cumulatively to 4½ percentage points, which should help to ease banking sector difficulties and, along with a slightly expansionary budget, help to support the economy in 1999.

Among the industrial countries, *Japan* stands out as the economy with the weakest growth performance in the 1990s, and as the only economy in recession, having suffered four successive quarters of output decline since late 1997. The main objective for policy continues to be to end the recession and reignite growth. A key element among the policies needed to achieve this objective is the resolution of the problems in the banking system, and in this area significant steps have recently been taken (Box 1.2). The critical challenge for the authorities is still to catalyze a quick and forceful recapitalization and restructuring that will restore the financial health and profitability of the banking system, including a full and transparent accounting of banks' financial positions to restore investor confidence. But macroeconomic policies also have a major role to play in stimulating domestic demand—a role that is facilitated by the absence of inflation and the large external current account surplus. In addition, further progress with deregulation and broader structural reform is essential for the economy to regain its dynamism and meet the needs of its aging population.

The scope to reduce interest rates further has been very limited since the Bank of Japan lowered its operating target for the overnight call rate to around 0.25 percent in early September. But the marked appreciation of the yen that occurred in early October effectively tightened monetary conditions and, at the same time, provided additional room for monetary easing since it substantially reduced the risk that faster monetary expansion would add to destabilizing exchange rate pressures in the region. Thus the Bank of Japan has recently broadened the scope of its operations in the private debt market to boost liquidity growth and support private sector credit creation. These operations can continue to play a useful role in helping to moderate deflationary pressures.

With regard to fiscal policy, increases in public works contracts since September indicate that the April stimulus package has begun to take effect. The further package of measures introduced in mid-November—the third supplementary budget to be introduced since the beginning of the current fiscal year, on April 1—promises significant additional stimulus in 1999. As a result, the fiscal tightening of 1997 will have been more than fully reversed. The "headline figures" referring to the size of the package—including estimates that it is equivalent to 5 percent of GDP—overstate its additional stimulative effect, partly because some of the measures replace temporary ones implemented earlier. The stimulus to be provided by fiscal policy in the next fiscal year (beginning April 1999)—measured as the change in the structural general government deficit from the current fiscal year—is tentatively estimated by IMF staff at about 1 percent of GDP; this estimate will need to be reviewed in the light of the budget and tax policy decisions to be made in coming weeks. The general government deficit (excluding social security) would then rise to almost 10 percent of GDP. While Japan clearly faces a difficult challenge of fiscal consolidation in the medium term, in the short term the paramount need is to ensure a resumption of growth. The expansionary fiscal stance need have only modest effects on debt-servicing costs in view of the continuing very low level of interest rates; although the recent downgrading of Japan's sovereign debt by a credit-rating agency has contributed to a recent upturn in government bond yields, they remain only a little over 1 percent.[4]

For the *other industrial countries*, although there have been widespread downward revisions to growth projections for 1999, the outlook in most cases is still fairly good. Continuing low inflation—close to zero in

[4]For analysis of Japan's economic crisis and policy options, see the October 1998 *World Economic Outlook*, Chapter IV; and IMF, *Japan—Selected Issues*, IMF Staff Country Reports, No. 98/113 (Washington: October 1998).

Box 1.2. Recent Developments in the Japanese Financial System

This box describes Japan's new bank laws, the nationalization of Long-Term Credit Bank (LTCB)—a first test case for those laws—and the measures taken by the Bank of Japan (BOJ) in response to the breakdown of the bank credit channel in Japan.[1] It also briefly discusses the withdrawal of Japanese banks from several foreign markets, and the implementation of Big Bang financial reforms in the current environment.

The Legislative Package

The key provisions in the bank laws approved by the Japanese parliament in October are the following:

- The funds available to the banking sector were raised to ¥60 trillion, with ¥25 trillion targeted to the recapitalization of "viable banks,"[2] and ¥18 trillion mainly targeted to failure resolution schemes including public bridge banks and the nationalization of failed banks; ¥17 trillion continued to be reserved for guaranteeing deposits at failed banks.
- The creation of a new high-level body (the Financial Revitalization Commission, FRC) within the Prime Minister's Office. This body will be responsible for drafting and implementing the regulations necessary for bridge banks and carrying out the nationalization of failed banks. It will also oversee the recapitalization of banks, and centralize all financial supervisory activities (the Financial Supervisory Agency will be put under the FRC).
- Existing agencies (the Resolution and Collection Bank, RCB, and the Resolution and Collection Organization) will be consolidated into an asset management corporation shaped along the lines of the former Resolution Trust Corporation (RTC) in the United States. That agency will be in charge of receiving and disposing of bad assets from banks.

By early December there were indications that most of the major banks would apply for relatively small injections, in the range of ¥100–700 billion, with the bulk of the resources being used for accelerating the provisioning of bad loans, in face of (among other factors) the worsening of the economy (debts of firms filing for bankruptcy grew by 53 percent year-on-year in October, totaling more than $100 billion in the first ten months of 1998).

The passage of the new laws reduced the risk of a collapse of the Japanese banking system and provided some institutional and financial mechanisms that could help to accelerate the restructuring and consolidation of the banking system. They could lead to a quid-pro-quo between banks and the government, in which heavy provisioning by banks would be cushioned by injections of public funds and buttressed by major changes in management structures. Steps in that direction could also be supported by the provisions in the new laws that allow banks to receive funds in order to facilitate "realignments" (consolidation) in the sector. Prospects for success are still far from certain, however. The Japanese framework does not yet have explicit mechanisms that would force weak but viable financial institutions to access available public monies and undergo a fundamental restructuring.[3] Thus, a more effective balance still needs to emerge within this evolving framework between establishing clear incentives for the largest banks to accept recapitalization funds, and conditions that would help to facilitate the badly needed restructuring and consolidation that is required in the Japanese financial system.

Nationalization of LTCB

LTCB filed for temporary nationalization on October 23, about four months after its market valuation had dropped markedly, on rumors that the bank was facing difficulties in raising funds.[4] The original plan of merging LTCB with the smaller Sumitomo Trust Bank was ultimately abandoned, in part because of the reticence of the latter in taking over LTCB substandard loans. In September, after one of the main affiliates of LTCB with more than ¥1.5 trillion in debts (including ¥256 billion to LTCB itself and ¥150 billion to Sumitomo Trust) failed, little doubt about the bank's insolvency remained. At the time of the filing for nationalization, the bank declared a negative net worth of ¥350 billion (1.5 percent of total liabilities), including unrealized losses on securities holdings. An audit by supervisors indicated that LTCB's prob-

(Box continues on next page.)

[1]The challenges facing the Japanese banking system were extensively analyzed in the September 1998 *International Capital Markets* report; this box updates that analysis for the period since July 1998.

[2]The new legislation allows "well-capitalized" banks (that is, banks with a BIS capital ratio above 8 percent) to apply for public funds if they are participating in a bank consolidation (including by absorbing a failed bank) or if the capital injection can help to alleviate the credit crunch. More generally, funds to banks deemed solvent are to be injected through the purchase of debt instruments and stocks (typically preferred stock, or common stock in the case of severely undercapitalized banks).

[3]As part of their applications for public funds, well-capitalized banks are required only to announce plans that include cuts in the number of employees, compensation, and the number of directors; the sale of unessential facilities; and reduction of dividends.

[4]Until 1996 the price of LTCB's stock hovered around ¥900. By April 1998, it had fallen to ¥300, dropping to ¥37 in June and ¥3 at the time of the nationalization of the bank.

some cases, after allowing for measurement biases—provides scope for further monetary easing if warranted to support demand and output growth, and also to help stabilize financial markets. But the current economic conjuncture does not call for fiscal policies to be diverted from the important medium-term objective of reducing imbalances and debt burdens. Fiscal policies can, nevertheless, help to moderate the slowing of growth, and counter downside risks, through the operation of the automatic stabilizers.

Box 1.2 *(concluded)*

Japan: Derivatives Positions of Selected Japanese Banks

(Fiscal year 1997, March 1998)

	Notional		Credit Equivalent[1]	
	Trillions of yen	Billions of U.S. dollars[2]	Trillions of yen	Billions of U.S. dollars[2]
LTCB	51	425	. . .	. . .
IBJ	220	1,833	3.4	28.3
BTM[3]	250	2,083	. . .	. . .
DKB	166	1,383	1.7	14.2
Sumitomo	182	1,517	3.8	31.7
Sanwa	165	1,375	2.3	19.2
Fuji	337	2,808	2.2	18.3
Sakura	107	892	1.8	15.0
Total	1,418	12,317	15.2	126.7

Source: Banks' annual reports.
[1]Using BIS weights.
[2]Using the ¥120/US$ exchange rate.
[3]End of FY1996.

lem assets accounted, net of provisions, for ¥4.6 trillion, or 19 percent of the bank's total assets.

The new management appointed by the government has indicated that the bank should be privatized within a year but has not announced any major plan to break up the bank to facilitate its sale. Since the takeover, the BOJ has provided LTCB with ¥5 trillion to keep credit flowing to bank clients and to smooth the unwinding of LTCB's off-balance-sheet positions (*see table*). The table indicates that Japanese banks in general have large positions in derivatives instruments; interest rate swaps account for most of their notional value.[5]

Reaction of the BOJ to the Breakdown of Monetary Transmission Channels

Since late 1997, the BOJ has followed an accommodative monetary policy stance. Throughout 1998 it has purchased commercial bills and high-quality commercial paper on a repurchase basis in large volumes.[6] On September 9, the Bank lowered the target call interest rate to 0.25 percent. Despite these measures, and reflecting the breakdown of the monetary and credit transmission mechanisms, bank lending dropped by 3.3 percent in the 12 months to October 1998. The authorities anticipated severe liquidity problems ahead of the end of the calendar year, manifested in the growing funding difficulties of Japanese banks, especially abroad.[7] By late October, it became evident that the liquidity injected into the Japanese financial system was being used to finance Japanese banks' activities abroad—including through interest swaps of yen payments for dollar cash flows. Yen funds became so abundant that for a brief period in early November some foreign banks were ready to lend yen at negative interest rates, and the yield on treasury bills fell below zero (*see figure*, upper panel).

In those circumstances, the monetary authorities opted for opening new channels to finance the corporate sector. On November 13, 1998, the BOJ announced that it would enlarge the scope for repurchasing commercial paper and establish a new lending facility for refinancing half of the new bank lending in the fourth quarter of 1998. The bank also indicated that it would consider the purchase of bills issued by financial institutions and collateralized by corporate bonds and loans on deeds.

Withdrawal of Japanese Banks from International Markets

In October and November 1998, several Japanese banks indicated their intention to withdraw at least partially from overseas activities, which signaled a change in the pace and nature of a process of retrenching from international finance that had been apparent since the mid-1990s.[8] In particular, the announcement by some major

[5]Disclosure rules in Japan require banks to state the notional and market value of their derivatives positions every half-year. Recently, Fuji Bank also retained a foreign auditing company to evaluate its portfolio and risk management practices, after rumors about large losses in that portfolio depressed the bank's market valuation. The audit indicated that those practices were in line with international standards, and that Fuji's derivatives portfolio had not sustained extraordinary losses. (To improve transparency, Fuji Bank has also disclosed the results of the self-assessment of its loans.)

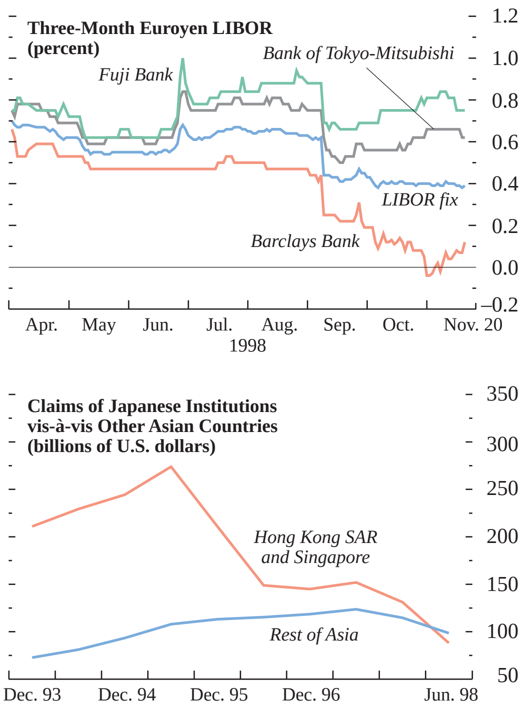
[6]The BOJ holds about one-third of the stock of commercial papers, which has grown by about 40 percent since mid-1997. After a big surge in late 1997, the issuance of corporate bonds by Japanese firms became increasingly difficult in the course of 1998 as the credit rating of Japan and Japanese companies worsened. Strong companies have issued securities backed by receivables and raised credit lines abroad, but the scope of these forms of financing is limited.

[7]Large Japanese banks were also facing funding problems domestically, with regional banks preferring to invest their cash surpluses in government paper rather than in the interbank market.

[8]The withdrawal of Japanese banks from international activities has in part been driven by the Japanese prudential regulations, which allow banks without overseas activities to maintain a ratio of capital to risk-weighted assets of just 4 percent (instead of the 8 percent BIS ratio). In early 1998, Fuji Bank sold part of

The United States and the United Kingdom are close to cyclical peaks, and in both cases signs of slowing growth have been evident, albeit less so in the United States. Although unemployment is low in both countries, wage growth has risen only moderately, and price inflation has remained relatively subdued. In both cases, a slowdown of growth from the above-potential pace of recent years is desirable to avoid inflationary pressures and a hard landing later on. The authorities therefore need to steer a balanced course between avoiding over-

Japan: Selected Claims of Banks and Interbank Offered Rates



Sources: Bank for International Settlements; and Bloomberg Financial Markets, LP.

banks of plans to close a large number of foreign branches and sharply contract their lending to non-Japanese borrowers was accompanied by statements from the head of the FRC, prodding banks to reduce their needs for foreign currencies. Because of the size of Japanese banks and the clustering in time of the decisions to review the scope of their foreign business, the strengthening of the yen in October could be linked to their retrenchment (see Chapter III, Box 3.1).

A temporary reduction in the flow of private capital from Japan to emerging markets might be expected from that withdrawal. Nevertheless, the impact even on Asia may be limited, because net flows from Japanese banks have already fallen substantially in recent years (see lower panel of figure), with official capital flows playing a greater role since the beginning of the Asian crisis. In view of the overcapacity of the Japanese banking system, the closure of foreign branches might represent a first step toward a "realignment" among top Japanese banks. On balance, the overall effect of the withdrawal (especially on mature capital markets) will depend largely on whether the Big Bang financial reform will provide room for foreign banks to intermediate a significantly larger share of Japanese saving and facilitate the recycling of these funds.

Preparations for Big Bang

Although still at an early stage, Japanese financial institutions are starting to respond to Big Bang.[9] Tie-ups of Japanese institutions with foreign partners have become an almost daily occurrence, and several alliances among major Japanese banks have been announced to develop specific businesses. Major banks are also positioning themselves to benefit from the switch to a real-time gross settlement payment system by the end of 2000, which will open new business opportunities to institutions with the capacity to act as clearing banks. Some alliances have involved the shift of profitable businesses (for example, asset management) from old de facto publicly insured institutions into newly created institutions. The issue of the distribution of risks in a changing environment is not, however, restricted to banks. For instance, the legislative requirement that the securities sector establish an industry-sponsored insurance scheme has resulted in the creation of two such schemes: one for domestic houses and one for foreign houses that were concerned about the potential liabilities of participating in a single industry-wide scheme.

its holdings in the U.S. institution, Heller Financial, and Sumitomo sold its California bank, Zions Bancorp. Among the banks that have recently announced a major overseas retrenchment are the small city bank Daiwa (which had already been battered by its expulsion from the United States in 1995 and carries large unrealized losses in its securities holdings), Fuji Bank, and the relatively strong and large Sanwa and Sumitomo Banks. Some trust banks, including Mitsubishi Trust, followed suit. On its part, Nomura Securities is also retrenching, after suffering large losses in its U.S. unit.

[9]See the September 1998 *International Capital Markets* report for the implementation schedule of the reforms, which has so far been adhered to. In December 1998, the sale of mutual funds at commercial banks was further liberalized, as planned.

stimulating demand—which would exacerbate future risks to the economy—and preventing the likely near-term slowdowns from turning into recessions.

In the United States, a widening external deficit (partly reflecting the Asian recession), slowing private investment growth, significant recent inventory accumulation, and the likelihood of an upturn in private saving from its exceptionally low recent levels point to overall growth falling somewhat below its potential rate next year. Activity will be supported in the period ahead by the cuts in interest rates by the Federal Reserve Board since end-September, amounting to 75 basis points, and by the depreciation of the dollar to which the cuts have contributed. With financial markets having stabilized and recovered in large measure since early October, it would now seem appropriate for the Federal Reserve to pause before taking further action, while being prepared both to ease again if U.S. growth prospects deteriorate significantly, and to tighten if inflationary pressures increase. The Federal Reserve's recent easing actions have been facilitated by the fiscal consolidation achieved in recent years, and the budget surpluses in prospect should be allowed to accumulate to help address the social security and health care financing shortfalls that are projected to arise in the next decade as a result of population aging. While it would be appropriate to let the automatic stabilizers operate, discretionary fiscal easing would not be warranted unless the slowdown were to become much more severe than seems likely at present.

Significantly slower growth is projected for the United Kingdom in 1999 than for the United States, reflecting the more severe tightening of monetary conditions that was needed in the economic upswing to hold prospective inflation to its target. With forecast inflation having fallen below the target amid the deterioration of global economic conditions, the Bank of England appropriately reversed the direction of monetary policy in early October, cutting its key interest rate between then and early December by a total of 1¼ percentage points. Monetary policy is still relatively tight, however, and there is significant scope for rates to be cut further as growth weakens and inflation concerns recede.

Growth in the Canadian economy has slowed significantly since early this year, largely reflecting the impact of the Asian crisis on commodity markets. A significant depreciation of the Canadian dollar has eased monetary conditions in spite of a hike in official interest rates in August that was mostly reversed in October and November. Particularly given the low rate of inflation—recently in the lower half of the 1–3 percent target range for core consumer price inflation, on a 12-month basis—further interest rate reductions will be warranted if the growth outlook worsens. The strong fiscal position, meanwhile, should be maintained to reduce the government's debt burden further.

In the euro area, the transition to a single common currency at the start of 1999 is proceeding smoothly. European Economic and Monetary Union (EMU) is a major achievement. The euro area will rival the United States in terms of trade and output, and the role of the euro in financial transactions eventually may match that of the U.S. dollar. The impact of euro area policies on the world economy will therefore be as important as that of U.S. policies in fostering an environment conducive to sustainable growth worldwide and in helping to restore global economic and financial stability in times of turbulence such as those experienced recently.[5]

The convergence over recent months of short-term interest rates in the euro area toward the level prevailing in Germany, France, and the other core countries, and the welcome reduction of interest rates in the core countries in early December from 3.3 percent to 3.0 percent (in terms of central banks' operating rates) has lowered average short-term rates in the area by about 50 basis points since midyear. This decline in short-term rates has been timely in view of the weakening of external conditions and the need to ensure that domestic demand growth remains sufficient to sustain slack-absorbing recoveries. Given the subdued prospects for inflation, the considerable amount of slack, and the more severe implications of downside—relative to upside—risks, scope remains for additional interest rate reductions should growth prospects weaken further.

As discussed in the October 1998 *World Economic Outlook*, structural fiscal positions in most euro-area countries still fall short of the medium-term requirements set out in the Stability and Growth Pact. In some cases, including Germany and the Netherlands, structural deficits widened in 1998. However, the medium-term shortfall for the area as a whole is not large (1 percent of GDP), and some of the needed improvement can be expected to come from declining debt-service payments. Nevertheless, any move to support demand in the euro area other than through allowing the automatic stabilizers to operate could weaken confidence in the policy framework for EMU and limit the European Central Bank's room for maneuver. In this context, increases in public investment—which would be welcome, not least because such spending has borne a disproportionate share of recent fiscal adjustment—would need to be compensated by other budgetary adjustments. Countries need to focus their fiscal efforts on structural reforms—aimed at lowering the growth rate of spending and creating room for tax cuts—as part of a broader strategy of reforms to reduce structural rigidities and strengthen employment performance. In particular, labor market reforms remain crucial to bring unemployment down on a sustainable basis.

Systemic Issues Arising from Recent Financial Market Turbulence

The recent turbulence in global financial markets was unusual for a period characterized by relatively strong macroeconomic policies and conditions in many of the advanced economies. The volatility re-

[5]For a detailed discussion of the external implications of EMU, as well as the policy challenges facing the euro area, see the October 1998 *World Economic Outlook*, Chapter V.

flected a sudden heightened perception of, and aversion to, risk following Russia's effective debt default in August and an associated flight to quality. Emerging markets were particularly seriously affected as interest rate spreads on their external debt increased significantly and new private external financing virtually ground to a halt. But the repercussions were not limited to these countries, as the global flight to quality led to sharp increases in spreads on financial assets in some of the deepest capital markets in the world, especially in the United States, and to sharp volatility in the dollar-yen exchange rate.

Subsequent actions by the Federal Reserve and other central banks to lower short-term interest rates have helped to alleviate fears of a deepening global credit crunch, as has the international support package for Brazil. However, the process of deleveraging and portfolio rebalancing in response to heightened risk aversion may not have run its course, and the situation remains fragile, especially in the emerging markets but also in some of the mature markets. Moreover, following their correction in the late summer, equity markets in a number of advanced economies have risen to levels close to previous peaks, even as the short-term macroeconomic outlook has weakened and uncertainty has further increased.

The global economy's close brush with a widespread credit crunch has raised a number of important questions about international capital market dynamics and the measures needed to improve financial sector resilience and reduce the risk of systemic problems, including:

- Why did Russia's effective debt default in August trigger a massive global reassessment and repricing of emerging market risk?
- Why did the accompanying turbulence generate severe strains, sharp increases in credit and liquidity spreads, and extreme price movements in some of the world's deepest financial markets, including the U.S. market for government securities and the dollar-yen foreign exchange market, especially in the wake of the near-collapse of LTCM?
- What measures can be taken to strengthen international capital markets and reduce the risk of systemic problems?

The recent turbulence in global financial markets followed several years of sharp spread compression across a wide range of debt instruments and record capital flows to the emerging markets. Even though the Asian crisis briefly punctuated this process, the effects were felt mainly in the region, and many of the mature markets benefited from a flight to quality from Asian markets. In the event, the Russian default in August served as a trigger for a very broad-based reassessment and repricing of risk. This not only severely curtailed emerging markets' access to external financing but also led to a sharp widening of interest rate spreads in key mature markets and severe short-term liquidity problems.

The severe reaction to the Russian default was partly due to the sizes of the losses on Russian exposures and positions, but these were not in aggregate large enough to account fully for the ensuing turbulence. More important was the role of Russia's default as a defining event that challenged widely held views about the default risks associated with *all* emerging market investments, and the willingness and ability of the international community to provide assistance to countries in difficulty. That Russia had been "permitted" to default was seen by some market participants as calling into question the readiness of the international community to provide support to other countries in difficulty. The general ensuing reevaluation of emerging market risk may subsequently have been compounded by Malaysia's decision to impose capital controls, which heightened the risk that countries in a similar economic predicament might also impose controls. This has so far not proved to be the case, and many emerging markets have reiterated their commitment to open capital markets.

A second issue concerns the sources of the vulnerabilities that led to the Russian default producing severe liquidity problems in some of the deepest capital markets in the world, and prompting action by a major central bank to facilitate the private rescue of a hedge fund (LTCM). The drying up of liquidity resulted mainly from many investors attempting at the same time to rapidly unwind highly leveraged positions, built up either to arbitrage mature market credit spreads or to exploit perceived differences in funding costs between major currencies, most notably the dollar-yen carry trade.[6] Modern risk management techniques and extensive marking to market encouraged a very rapid rebalancing and cutting of positions judged to have become more risky. The positions that were unwound had been part of a large number of "plays" encouraged by—and themselves contributing to—a sharp narrowing of spreads on many mature market fixed-income instruments in the period leading up to the Asian crisis in the second half of 1997.

In response to the global flight to quality, spreads between credits of "low" and "high" quality in several mature markets widened dramatically, especially in the United States, resulting in margin calls, reassessments of counterpart risk, and further deleveraging. Several hedge funds, including LTCM, that had large positions on yields spreads were reported to have had difficulty meeting margin calls in the period after the Russian default, and to be seeking additional liquidity. Hedge funds, however, were not the only participants

[6]For further discussion, see IMF, *International Capital Markets: Developments, Prospects, and Key Policy Issues* (Washington: September 1998).

in these trades and may not have been the most significant. While comprehensive data are not available, the proprietary trading desks of many of the large internationally active commercial and investment banks appear also to have taken highly leveraged positions on a variety of credit spreads. In these circumstances, the system was vulnerable to a sudden sharp increase in risk aversion, since it would trigger attempts by many financial institutions to close out their positions and reduce leverage. Against this background, the Federal Reserve made the decision in late September to facilitate a private rescue of the troubled LTCM hedge fund to avoid an even more disorderly unwinding of positions and further financial market turbulence.

Finally, the turbulence raises a number of important questions about financial market transparency, the internal risk management and control procedures of some of the largest internationally active financial institutions, and the adequacy of prudential supervision and systemic financial market surveillance. The key issue is how very large leveraged positions could be built up across a large number of financial institutions to the point where systemic risk was raised to extraordinary levels. Providing answers to these questions and limiting future vulnerabilities is critical.

- *Lack of Transparency*. The failure of market participants and financial supervisors to see warning signs of impending vulnerabilities appears to have been related to a general lack of transparency about the sizes of the positions built up. The lack of transparency reflected a number of factors including the opaque nature of the over-the-counter markets in which much of the off-balance-sheet trading takes place, the difficulties in assessing complex positions in layers of highly structured off-balance-sheet financial instruments, and the desire of the institutions involved to maintain secrecy to exploit profit opportunities. There are unlikely to be easy solutions to improving transparency in over-the-counter markets, but the recent turbulence suggests a need to strengthen position reporting to at least allow for the better monitoring by authorities of overall exposures.
- *Financial Firms' Risk Management Models Displayed Weaknesses*. Internal risk management models are intended to identify and limit the market risks assumed by financial institutions. At least in hindsight, the models used by some of the major financial institutions did not provide adequate safeguards. The recent episode of turbulence suggests at least three problems. First, insufficient attention was paid to low-probability events, perhaps as a result of inadequate stress testing and the belief that financial markets would continue their long rally. Second, the models typically assumed that market liquidity would be present to allow a rapid unwinding of positions without significantly affecting prices. This assumption was called into question where many institutions held similar positions. Finally, inadequate attention was paid to the interplay between credit and market risk, such as occurs in periods of extreme stress. Improvements in risk modeling are required but will need always to be complemented by sound judgment and strong overall risk management procedures—in order to limit excessive risk taking.
- *Inadequate Market Surveillance and Prudential Supervision by Authorities*. Although weaknesses in private risk management were evident in the period leading up to the turbulence, market surveillance and prudential supervision also paid insufficient attention to the buildup of highly leveraged positions across many institutions. Central banks and supervisory authorities therefore need to give consideration to ways by which they can monitor more adequately the degree of market-wide and cross-market leverage and deal with "excessive" leverage, through higher margin-type requirements, stricter capital requirements on the off-balance-sheet activities of financial institutions, or both. These efforts need to be accompanied by a reexamination of the adequacy of current controls on the largely unregulated hedge fund industry, including the scope either for more direct controls or for encouraging stronger bank oversight of their positions vis-à-vis the funds. Given that proprietary trading desks of the major banks are increasingly engaged in activities similar to those of many hedge funds, the focus will need to be on ensuring appropriate oversight and control of these highly leveraged activities so as to contain risks to individual institutions as well as systemic risk.

The issues raised by the most recent financial market turbulence are complex, including the adequacy of private and public risk management in some of the most sophisticated financial institutions in the world, the growing linkages between emerging and mature financial markets, and the role of leverage in magnifying the system's vulnerability to shocks. Against this background, current bilateral and multilateral initiatives to consider the adequacy of current prudential controls over financial institutions—especially the highly leveraged activities—and to revisit the treatment of credit and market risk under the Basle capital adequacy ratios are critically important. These will need also to be complemented by stepped-up efforts to improve the transparency of financial institutions' off-balance-sheet activities with a view to lessening the risks of the kind of large buildup of highly leveraged positions that contributed to the severity of the recent problems in mature financial markets.