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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 July 27–August 24, 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 2.1); that the average price of oil will be $13.28 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 5.7 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 in mid-September 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:

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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, Donogh McDonald, Ramana Ramaswamy, Jahangir Aziz, Phillip Swagel, Ranil Salgado, and Cathy Wright. Other contributors include Anthony Boote, Philip Gerson, Sanjeev Gupta, Peter Heller, Kalpana Kochhar, Laura Kodres, Guy Meredith, Doris Ross, Blair Rourke, Christian Schiller, Steven Symansky, and Andrew Tweedie. The Fiscal Analysis Division of the Fiscal Affairs Department computed the structural budget and fiscal impulse measures. Gretchen Gallik, Mandy Hemmati, Yutong Li, and Anthony G. Turner 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, 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 September 9 and 11, 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

Policy Responses to the Current Crisis

International economic and financial conditions have deteriorated considerably in recent months as recessions have deepened in many Asian emerging market economies and Japan, and as Russia's financial crisis has raised the specter of default. Negative spillovers have been felt in world stock markets, emerging market interest spreads, acute pressures on several currencies, and further drops in already weak commodity prices. Among the industrial countries of North America and Europe, the effects of the crisis on activity have been small so far but are beginning to be felt, especially in the industrial sector (Figure 1.1). World growth of only 2 percent is now projected for 1998, a full percentage point less than expected in the May 1998 *World Economic Outlook* and well below trend growth. Chances of any significant improvement in 1999 have also diminished, and the risks of a deeper, wider, and more prolonged downturn have escalated.

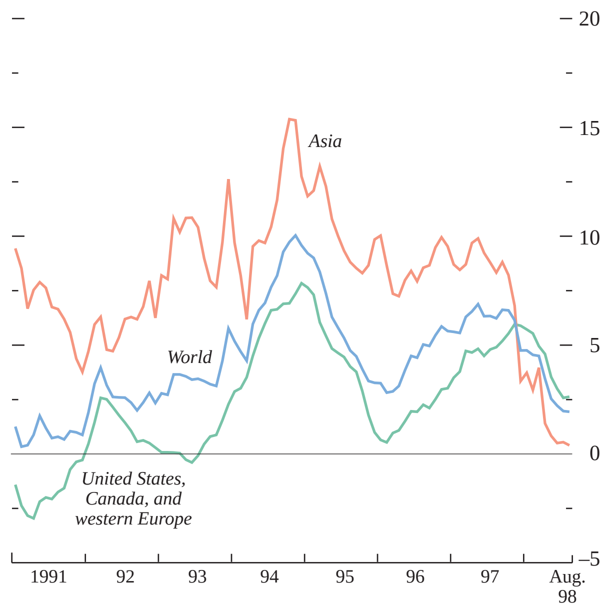
* * *

Among the countries at the center of the Asian crisis, Korea and Thailand have made encouraging advances toward restoring confidence and initiating recovery, although their turnarounds remain at risk, including from the external environment. The situation in Indonesia, however, remains very difficult. Malaysia has resorted to external payments controls in an effort to insulate its economy from the regional crisis. In Japan, despite substantial fiscal stimulus and new initiatives to deal with banking sector problems, only modest recovery is expected in 1999, and significant downside risks remain. Growth in China appears to be slowing, and both the renminbi and the Hong Kong dollar have been under considerable pressure.

With Russia's unilateral debt restructuring and the ensuing intensification of contagion, the current crisis has extended to most emerging market economies and to stock markets globally. A key problem is that financial markets tend, in the face of such a shock, to be characterized by panic and herd instinct, and, as in times of euphoria, to fail to discriminate between economies with strong and weak fundamentals. Except perhaps for central and eastern Europe, the recent upward spike in interest rate spreads indicates a sharp slowdown in capital flows to emerging market economies, including notably in Latin America. Policy responses can help to restore confidence, but even with such actions growth is likely to slow. As these

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

The worldwide slowdown in industrial activity has been most pronounced in the Asian region but is also being felt in North America and Europe.

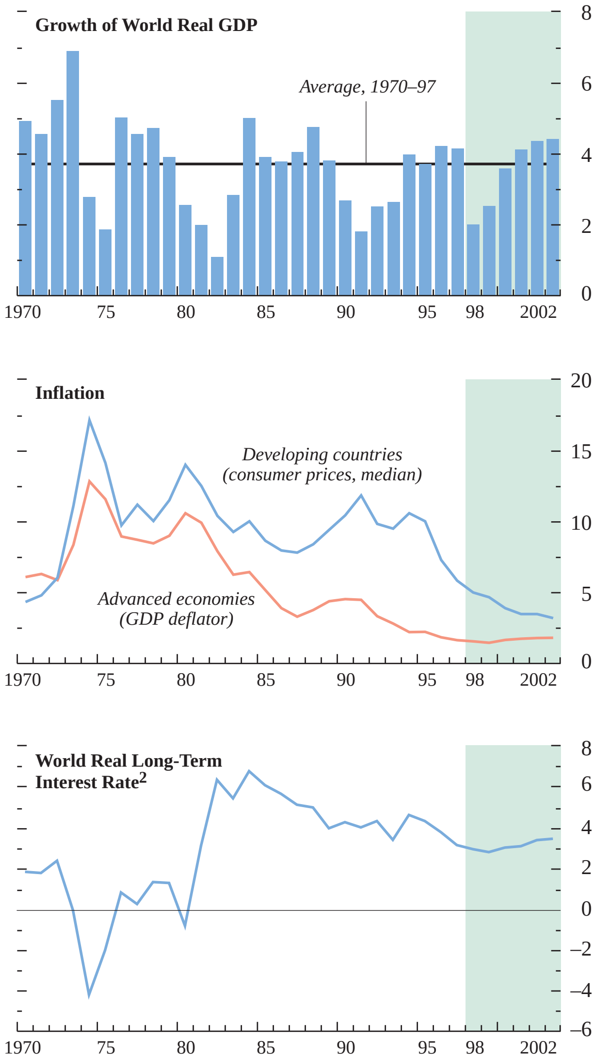


Sources: WEFA, Inc.; OECD; and IMF, *International Financial Statistics.*

[1]Based on data for 30 advanced and emerging market economies representing 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.

Figure 1.2. World Output and Inflation[1]
(Annual percent change)

The Asian crisis has resulted in the fourth global economic slowdown in a quarter century.



[1]Shaded areas indicate IMF staff projections. Aggregates are computed on the basis of purchasing-power-parity weights unless otherwise indicated.
[2]GDP-weighted average of ten-year (or nearest maturity) government bond yields less inflation rates for the United States, Japan, Germany, France, Italy, the United Kingdom, and Canada. Excluding Italy prior to 1972.

economies adjust to smaller capital inflows, their trade balances will improve significantly, and coming on top of the continuing trade adjustments by the Asian crisis countries, this implies another negative shock to be absorbed by the rest of the world, primarily the United States and the European Union (EU), and also many commodity-exporting developing countries.

Considerable uncertainty remains about the near-term outlook. The IMF's revised projections (summarized in Table 2.1) are based on the assumption that financial market confidence in the Asian crisis economies will gradually return during the remainder of 1998 and in 1999, as crucial reforms are implemented. This should allow financial market pressures in these countries to continue to abate and permit the recent easing of interest rates to be sustained, which will reinforce the boost to activity from strengthened external competitiveness. In this scenario, economic recovery in Asia should be well under way by the second half of 1999. A key assumption is that Japan implements the planned fiscal stimulus and undertakes banking sector restructuring measures that bolster confidence and set the stage for an economic turnaround. The scenario also assumes that emerging market interest spreads will gradually decline and that capital flows to Latin America, central and eastern Europe, the Middle East, and Africa will recover to levels that, although lower than in the recent past, will not provoke payments crises. For the future euro area, it is expected that the momentum of recovery will be reasonably well-sustained, and for the United States, it is projected that the economy will slow markedly in a "soft landing," without falling into recession. The resulting slowdown in world economic growth would be of the same order of magnitude as the three previous slowdowns in the past quarter century (Figure 1.2). One feature of this "baseline" scenario is that the global economy would gradually recover in the course of 1999, and return to trend growth in 2000. The risks to this projection, however, are predominantly on the downside.

Indeed, a significantly worse outcome is clearly possible. The potential for a broader and deeper economic downturn stems from a multitude of interrelated risks that make the current economic situation unusually fragile. Many of these risks are related to developments in international capital markets, including the danger of a prolonged retreat by international investors and banks from emerging markets, widespread financing difficulties, threats to international payments and associated disruptions to trade, and further declines in stock markets and other asset prices, with attendant losses of financial wealth and contraction of consumption and investment worldwide.

To deal with the worsening global economic situation and prospects, confidence-restoring policy adjustments are needed. In view of its pivotal role in the world economy, and especially in Asia, it is critical that Japan takes decisive action to resolve banking problems and ensure a self-sustaining recovery. The emerging Asian market economies in recession need to steadfastly address the weaknesses in policies and institutions that have been unmasked by the crisis, including the restructuring of their financial and corporate sectors. Russia needs to reestablish monetary discipline, achieve fiscal viability, restructure its banking system, and restore relations with external creditors. Other emerging market countries under stress need to forcefully address key problem areas and sources of vulnerability. The international community needs to support strong policy actions through multilateral and bilateral financial assistance. And for the United States and the future euro area, the time has come to consider a moderate easing of monetary policies to help counter the effects of the deteriorating external environment on domestic activity, and to help restore calm in global financial markets. In all countries, it is particularly important that the difficult external environment does not lead to defensive exchange rate and trade actions with negative international consequences, or to market-closing measures that would threaten countries' longer-term economic prospects.

The current crisis has underscored the urgent need to improve the functioning of the international financial system so that countries can safely access international capital markets and investors can diversify their portfolios with a better understanding of the risks involved. This requires increased efforts to strengthen the robustness of financial institutions in both debtor and creditor countries, to enhance the transparency of the financial health of countries, corporations, and financial institutions, and to foster a realistic pricing of risks in the face of market volatility. It also requires more effective means to ensure that debtor countries face their responsibilities in dealing with the legitimate rights of creditors, that creditors participate constructively when debt workouts become necessary, and that debtors, creditors, and the international community find means to cooperate more effectively to avoid actual and quasi defaults in situations of stress.

Financial Market Developments and Risks

Following several waves of pressure in emerging markets since early 1997 emanating mainly from Asia, Russia became a new source of contagion during August. Negative sentiment in response to the devaluation of the ruble and Russia's debt restructuring quickly spread to other emerging market countries, with risk premia increasing sharply and exchange market pressures intensifying as investors fled to quality and unloaded assets to meet margin calls. Emerging market spreads, on average, have widened to levels not seen since early 1995 at the peak of the Mexican crisis. Short-term interest rates have also risen, partly as a policy response to counter exchange market pressure.

For some time after the recent panic has subsided, emerging market countries' external borrowing costs are likely to remain considerably higher than in most of 1996–98, and their access to international finance could be significantly reduced. Net private capital flows to emerging markets, which in the May 1998 *World Economic Outlook* were projected to be less than half their level in 1996 before recovering next year, are now expected to decline even more sharply in 1998, to their lowest level since 1990, and to remain weak in 1999. Latin America, which had continued securing relatively large inflows of private capital in the wake of the Asian crisis, appears to have been affected the most by the dramatic deterioration in market sentiment following the Russian crisis. A real risk is that the recent panic may fail to subside for some time, which could imply significant net outflows of foreign capital from many economies, as witnessed in the Asian crisis countries. Fears among market participants reflected in the large yield spreads seen recently could become self-fulfilling and result in prolonged disruption of international financial flows, with severely depressive effects on trade and activity. This risk can and must be contained.

Among the industrial countries, the global flight to quality has been reflected in further declines in long-term interest rates on public sector debt instruments, in many cases to levels not seen in more than 30 years. In contrast, stock market prices have declined, amid considerable volatility, as investors have marked down growth and profit expectations in the wake of the Russian crisis and fled to lower-risk assets. By mid-September, U.S. stock market prices had declined by about 15 percent from their peak in mid-July. In the major European countries, declines in stock prices from peaks at around the same time average somewhat more than 20 percent. To some extent, such corrections may be warranted in view of the earlier surge in equity prices, which may not have been fully justified by earnings prospects. However, just as equity prices may previously have overshot, the turmoil in financial market risks provoking an overreaction to recent events, with investors becoming unduly risk-averse. Significant further stock market corrections in the industrial countries might well spill over to the already depressed stock markets in Asia and other emerging markets. This could further undermine confidence and prospects for recovery.

The adjustment processes that have been triggered by the current crisis have produced a sharp widening of current account imbalances among the major industrial countries, which may also affect financial markets. The United States has so far absorbed much of the improvement in emerging Asia's trade balance, whereas Japan's external surplus has widened further owing to the weakness of both domestic activity and the yen, and the future euro area's external position has remained in large surplus. Although the adjustments to the most recent bout of turmoil may be allocated more evenly between the United States and the euro area, large imbalances are likely to persist. These imbalances are not sustainable over the medium term and give rise to concerns about prospective changes in the pattern of exchange rates among the major currencies, especially if the potential downward correction of the U.S. dollar and upward correction of the yen and the euro were to occur too abruptly. It is therefore important to ensure that domestic policies in the three large currency areas during the period ahead are consistent with the need to gradually reduce external imbalances over the next several years while minimizing the risk of excessive exchange rate volatility.

Asia: Setbacks, but Progress Toward Crisis Resolution

Since the May 1998 *World Economic Outlook* was finalized, significant setbacks in the resolution of the Asian crisis have overshadowed the progress that has been made in some countries in the implementation of corrective policies and the stabilization of exchange rates.

First among the *setbacks*, data that have appeared in recent months point to significantly larger contractions in activity in much of Asia than earlier envisaged. The proximate causes include larger-than-expected declines in consumption and investment owing to losses of confidence, the widespread deflation of asset values in the region, substantial corporate debt burdens, and large reversals of capital flows that have reduced access to financing and made many firms unviable. The declines in domestic demand, in turn, have exacerbated the compression of intraregional trade, which has added to the weakness of activity both in the countries at the center of the crisis and in their trading partners in the region. In addition to these feedback effects of the ongoing contraction, the unexpected severity of the crisis could also indicate that the underlying structural weaknesses in the crisis countries may be more serious than previously thought (see Chapter III).

The evidence of greater economic weakness in Japan has had a particularly large impact because of the importance of that economy—both in terms of size and regional trade and financial links—and also the role of the yen. Thus, associated with the renewed weakness of the yen in May and early June, in particular, were further downward pressure on other Asian currencies and further declines in stock markets. Exacerbating the weakness of confidence in Japan has been the lack of convincing progress in addressing the problems of the banking sector and slowness in responding to the unexpected weakness of private demand.

Also setting back the resolution of the Asian crisis in May and June were delays in the implementation of stabilization and reform policies in Indonesia, due in part to the political instability that led to a change of government in late May. Associated with Indonesia's political instability has been the largest currency depreciation, by far, among the Asian crisis economies.

The introduction by Malaysia in early September of exchange and capital controls may also turn out to be an important setback not only to that country's recovery and potentially to its future development, but also to other emerging market economies that have suffered from heightened investor fears of similar actions elsewhere.

Despite these setbacks, sight should not be lost of a number of significant *achievements* since the beginning of the year:

- The exchange rates of all the crisis economies have strengthened from their lows, which in most cases were reached in January. The Indonesian rupiah remains deeply depreciated, but it has recovered significantly from its low reached in June. It is encouraging as well that both China and Hong Kong Special Administrative Region (SAR) have successfully maintained their exchange rate policies.
- In Korea and Thailand, and also the Philippines, interest rates have declined markedly since January as currency pressures have eased.
- Korea and Thailand, in particular, have made significant progress in macroeconomic stabilization and have also begun to implement structural reforms, including in the key areas of the financial system and corporate debt restructuring. In Indonesia, the modified policy program in effect since late June has been implemented broadly as planned, with some positive results.
- Increases in inflation in the wake of currency depreciations have in most cases fallen significantly short of expectations, reflecting the flexibility of wages and prices in the Asian economies in the context of very weak demand conditions, firm monetary policies, and the weakness of commodity prices.
- Contributing to the strengthening of currencies have been rapid and large turnarounds in current account positions generated by substantial gains in price competitiveness, and the compression of demand and imports. In 1998, Indonesia, Korea, Malaysia, the Philippines, and Thailand are now projected to have current account surpluses amounting in total to $57 billion, which contrasts with aggregate deficits of $24 billion in 1997 and $54 billion in 1996.

The prospects for financial stabilization and economic recovery in Asia continue to depend crucially on policies, with the appropriate roles of fiscal policy, monetary policy, financial and corporate sector restructuring, and other structural reforms in helping generate recovery varying from case to case. In the countries at the center of the crisis, the international financial community is providing essential support, including private creditors through debt-restructuring agreements.

For strong growth to resume on a sustained basis in the crisis countries, fundamental economic, financial, and institutional reforms will clearly be required. There is a particular need to adopt stricter prudential rules and ensure their enforcement, to strengthen corporate governance, and to combat the relationship-based financial and business practices that appear to have played such a large role in the imprudent lending and borrowing that characterized the buildup to the crisis. If these challenges are met, the crisis countries should be able to achieve quite rapid rates of economic growth combining somewhat lower—and more sustainable—rates of capital accumulation in the future with stronger productivity growth as the region resumes the process of catching up with the mature industrial countries.

Japan, the second largest advanced economy in the world and the market for about one-sixth of the exports of the ASEAN-4 countries (Indonesia, Malaysia, the Philippines, and Thailand) and Korea, bears a particular responsibility to support recovery in Asia by ensuring a resumption of solid growth in domestic demand. Since early last year domestic spending has fallen significantly, owing in part to excessively ambitious fiscal consolidation in 1997, but perhaps more importantly to continuing strains in the financial system and their effects on both the availability of credit and business and consumer confidence (see Chapter IV). The authorities have taken measures in the fiscal, monetary, financial sector, and other structural areas in order to revive the economy, but there have been shortcomings in policy design and implementation.

In the *fiscal* area, the stimulus package announced in April includes measures estimated to be equivalent to 2½ percent of GDP, which should help to ensure a pickup in domestic demand and activity in late 1998. In August, the new government announced a further fiscal package, including tax reductions, which should provide a further moderate stimulus in 1999 as a whole. But on present plans, the stimulus would start to be withdrawn in the second half of next year, and further expansionary measures seem likely to be needed to provide continued support to activity until recovery is firmly in place. Given the downside risks, an early announcement of such measures would be desirable. Although the expansionary fiscal stance will add to the public debt burden, which remains a significant issue that will need to be addressed over the medium term, in view of the very low level of interest rates, it need have only modest effects on the cost of servicing this debt.

With regard to *monetary policy,* in a context of virtual price stability and very weak demand the authorities have continued to maintain easy monetary conditions, including through market operations in late 1997 and early 1998—in response to failures of several major financial institutions—that accelerated the expansion of base money. In early September, the Bank of Japan lowered its operating target for the overnight call rate to around 0.25 percent from its recent average of about 0.45 percent, while leaving the official discount rate unchanged at 0.5 percent. This action was appropriate, particularly in the context of further evidence of deteriorating economic conditions and a strengthening of the yen from very weak levels. The scope to lower interest rates further is now virtually nil, and excessive monetary expansion would risk exacerbating financial turbulence in the region by leading to renewed depreciation of the yen. Any further policy stimulus accordingly needs to come from the fiscal side.

Resolution of the bad-loan problems that have afflicted the *financial sector* is the key to providing the basis for a lasting recovery. A number of important and welcome initiatives have been announced in recent months. However, questions remain about how problem loans will be dealt with and whether the necessary recapitalization and restructuring of the core banking system will be achieved quickly and decisively. The extent of bad loans should be promptly recognized and provisioned against, which will require that the self-assessment framework be rigorously enforced by the new Financial Supervision Agency. For this purpose, the independence and resources of this new agency need to be assured. Ways need to be found to ensure the appropriate incentives for vigorous efforts to resolve problem assets, including through debt work-outs and liquidation. Recently proposed legislation to set up a bridge bank facility and to provide the government with authority to nationalize troubled banks provides potentially valuable instruments for dealing with failing institutions in an orderly manner, and thus limiting further losses in asset values and the disruption of credit relations. However, care will be needed to ensure that public resources are used efficiently and the stockholders take appropriate responsibility for losses. Bad assets will need to be quickly identified, and new loans provided only on strictly commercial criteria. Private sector buyers for bridge banks and nationalized banks will need to be identified in a timely fashion. Public funds have been made available to bolster the deposit insurance system and to inject capital into solvent banks, but the limited use of these funds so far has not effectively promoted the restructuring that is needed. The recapitalization of the core banking system needs to be pursued urgently and aggressively by the government, with injections of public funds linked to strong restructuring plans.

Elsewhere on the *structural reform* front, deregulation initiatives already announced will promote the necessary restructuring of the Japanese economy, but a more ambitious approach is needed in a number of areas to meet the challenges of globalization and an aging population and to foster fresh economic dynamism. The "big bang" financial reforms will promote the longer-term restructuring of the financial sector, and are critical to restoring the long-term health of the economy. However, given the difficult economic environment, the process of financial liberalization will need to be managed carefully, and the supervision and regulatory structure will need to be strengthened to contain potential risks that would be expected to arise in a more deregulated financial system. Further deregulation in the real estate market and telecommunications, and reforms to labor market and bankruptcy laws, need to be pushed ahead, while more ambitious steps toward reducing nontariff barriers to trade would also help to raise productivity.

In both *Korea* and *Thailand*, the steadfast implementation of the policy programs supported by the IMF, World Bank, and other official financing needs to be sustained for the stabilization gains that have been achieved to be consolidated and translated into an early resumption of growth. Provided that programmed policies are fully implemented, there is scope for activity in both countries to begin to turn around in the course of 1999. Policy-determined interest rates have already come down significantly in both countries, to precrisis levels, but cautious monetary policies will still be needed to maintain exchange market stability and prevent inflation from picking up. Lending rates have been slower to recede, but are likely to fall in the period ahead, adding support to the recovery. Fiscal deficits have widened appropriately, in the face of the worsening recessions and to accommodate the need to strengthen social safety nets and finance financial restructuring.

In both countries, policies to strengthen the financial system, restructure the corporate sector, and deal decisively with the corporate debt problem are essential. Significant progress has been made, notably with the consolidation under way in Korea's banking sector and the comprehensive package announced in Thailand in August, which aims to further consolidate and recapitalize the financial sector and provides for the use of public funds—linked to banks' progress in corporate debt restructuring—in recapitalizing financial institutions. The resolution of Thailand's 56 closed finance companies has also been proceeding satisfactorily. But in both countries, the problems being addressed in these areas are complicated, and their resolution will take time.

Indonesia has begun to reestablish financial stability following the collapse of its currency, financial system, and distribution network in May and early June as the political situation worsened and investor confidence plummeted. The revised policy program introduced in late June with the support of the IMF projects a fiscal deficit in 1998/99 of 8½ percent of GDP, to be financed by foreign assistance. This reflects the depth of the economic crisis and the associated substantial increase in social safety net spending. The tasks ahead—including the rehabilitation of the financial system, restoration of confidence to foster the reversal of capital flight, restructuring of the corporate sector, and repair of the distribution system and market mechanisms more generally—are formidable, requiring bold action across a range of policy areas. With regard to corporate debt restructuring, the government's recent announcement of the "Jakarta initiative" is a promising step. The rice situation is of particular concern, and the government is now increasing imports, expanding open market sales, and greatly extending the targeted program of subsidized rice to poor families. The economic situation remains fragile, but assuming that the current program continues to be implemented as planned, output may be expected to bottom out during 1999.

Malaysia has been better positioned than the other crisis countries, because of its smaller short-term external debt burden. The authorities' response to the deteriorating situation has included a reversal of earlier fiscal tightening, combined with efforts to stimulate private sector credit. In addition, exchange and capital controls were introduced in early September to support a renewed peg of the ringgit to the U.S. dollar. These policies are having a negative effect on foreign investors' confidence. Whether they will improve near-term prospects for economic recovery remains to be seen, but in any event, they cannot be a substitute for strong reform and stabilization efforts. With a coherent strategy to deal with longer-term structural problems in the banking and corporate sectors still lacking, the fragility of the financial sector, faced with a sharp downturn in activity, continues to present a serious threat to the economy.

In the *Philippines* also, banking and corporate sectors have shown increasing signs of stress, and plans to reform the public finances and strengthen the banking system need to be firmly implemented to reduce the economy's vulnerability.

The stability of the renminbi and the Hong Kong dollar has provided important anchors for the region. Both currencies have been subject to significant strains, however. In *China*, growth is expected to slow significantly this year, because of the weakening of external demand, past overbuilding and excess inventory accumulation that will need to be worked off, and devastating floods; unemployment is becoming an increasing problem. Further cuts in interest rates in recent months and an expansionary fiscal package amounting to about 2½ percent of GDP will provide worthwhile support for activity in the period ahead, although it will be important for the package to be carefully tailored to ensure that the quality of growth is not compromised. The continuing strong balance of payments and foreign reserve position, in the context of a relatively closed capital account, should allow the maintenance of the current value of the renminbi. The slowing of growth has heightened the importance of accelerating structural reforms, especially in the financial and public enterprise sectors.

Hong Kong SAR has suffered a much more severe weakening of activity, reflecting the economy’s greater openness, the reversal of the previous sharp run-up in asset prices, and the increases in interest rates that have been required to maintain exchange rate stability. Fiscal policy has appropriately been eased. The authorities in mid-August began intervening in the stock market to counter speculative pressures. The intervention was, appropriately, halted by end-August, and measures were adopted to discourage speculation in the securities and futures markets. Also, in early September, technical measures were implemented to buffer the effects on interest rates of temporary market pressures and strengthen the currency board arrangements. The flexibility of domestic wages and prices and the strength of the banking system, together with a gradual return of confidence, should help to limit the contraction and facilitate recovery.

Singapore and *Taiwan Province of China* have been hit less hard by the regional turmoil, reflecting these economies’ strong macroeconomic positions and sound financial sectors. In Singapore, a fiscal stimulus package introduced in late June should help prevent contraction of the economy on a calendar-year basis.

Both *Australia* and, especially, *New Zealand* are experiencing slower growth as a result of the deterioration in the external environment and an associated weakening of confidence. Large external current account deficits—projected at 5 percent and 6½ percent of GDP respectively in 1998—underscore the need to maintain cautious fiscal policies. In Australia, the achievement of an underlying budget surplus in 1997/98—a year ahead of schedule—means that the projected rise in the current account deficit is taking place against the background of a significant improvement in public finances. Subdued inflationary pressures in both countries have enabled monetary policy to allow significant exchange rate depreciations, which will both support activity and facilitate external adjustment.

In *India*, the weakness of the exchange rate and equity markets in recent months has reflected not only the Asian crisis, but also concerns about the economic sanctions introduced following the nuclear tests in May and the limited fiscal adjustment and reforms contained in the budget in early June. To restore investor confidence, contain the risk of macroeconomic instability, and enhance growth prospects, action continues to be needed to rein in the public sector deficit and to implement a wide range of structural reforms. *Pakistan* is facing even greater challenges as a result of the economic sanctions and in view of its vulnerable external and domestic financial situation and unfinished structural reform agenda.

Russia’s Financial and Payments Crisis

In August, Russia replaced Asia as the epicenter of global financial market pressures. The emergency measures announced by the Russian authorities on August 17—including a de facto devaluation of the ruble unaccompanied by supporting macroeconomic policies, a unilateral restructuring of ruble-denominated public debt, and a 90-day moratorium on foreign credit repayments—gave rise to new fears in financial markets not only of macroeconomic instability in Russia, but also of default by other emerging market countries, and to further declines of confidence in the containment of what had hitherto been a mainly Asian crisis.

The immediate cause of the Russian crisis was the growing loss of financial market confidence in the country’s fiscal and international payments situation, leading to a loss of international reserves and an inability to roll over treasury bills as they matured. The financial market concerns had been reflected in substantial hikes in interest rates that had been needed to defend the ruble. The strengthened policies announced by the government in June and July, and the associated large package of financial assistance from the IMF, World Bank, and Japan, provided only temporary relief. This was mainly because markets remained concerned that the government’s promised actions would not be implemented, especially after the Duma rejected certain key measures. Also, problems in the banking sector were becoming severe as the continued fall in asset prices led to margin calls that could not be met.

Although external developments, including the Asian crisis and associated weakness of energy prices, contributed to Russia’s difficulties, domestic policy shortcomings were more important. In particular, the failure over many years to bring the fiscal situation under control led to levels of public debt and debt-service payments that increasingly appeared unsustainable. The fiscal problems, in turn, originated in failure to reform the tax system, inadequate tax collection that formed part of a culture of nonpayment, lack of spending discipline in important areas, and slow progress in structural reform, including in enterprise restructuring and the legal framework, which adversely affected the economy’s performance more broadly.

In the wake of the crisis, the need for effective stabilization and reform remains, but the emergency measures taken, including the effective default on ruble debt, and the ensuing political uncertainties and relaxation of monetary policy, have heightened the challenges involved. In particular, the fiscal situation has been further worsened by the loss of access to financial markets, the devaluation, the likely disruptions to the economic system and contraction in economic activity, and the increased prospective costs of bank restructuring; and the risk of a reemergence of rapid inflation has damaged confidence and calls for a renewed effort to establish macroeconomic stability. To resolve the crisis and to put Russia on a path toward economic recovery and sustainable growth, the new government will need the will and parliamentary support to strengthen tax collection, tighten credit policy, restructure the banking system, restore relations with external creditors, and pursue badly needed reforms in many areas. The strength of the program adopted will be key to determining the availability of external financial support, the timing of the turnaround in economic activity, and the momentum of recovery.

Other Emerging Market Countries: Reducing Vulnerabilities

Many developing and transition countries have felt in their own financial markets the waves of pressure that have emanated first from Asia and then from Russia over the past year, with currencies weakening and equity markets declining sharply. The general decline in private capital flows to emerging markets, higher yield spreads, weaker exports to Asia, deteriorations in competitiveness as a result of depreciations abroad, and commodity price declines have all formed part of the transmission mechanism. In many cases, macroeconomic policies have been tightened to preserve financial market confidence, with effects on growth that are generally negative in the short term, but with longer-term benefits. Countries with strong economic fundamentals—including many that have turned their economies around in recent years through policies of adjustment and reform—have shown the most resilience to spillovers from crisis countries. Nevertheless, discrimination in their favor by private investors has sometimes appeared to be lacking.

Until the Russian crisis broke out in August, most of the developing countries in the Western Hemisphere had weathered the turmoil in financial markets reasonably well thanks to the strengthening of economic policies in the region during the past decade and also through a broad range of measures, including increases in interest rates, to help defend exchange rates, and a tightening of fiscal policies. As a result, capital inflows had been sustained at relatively high levels, and growth prospects had deteriorated only moderately. Venezuela, Chile, and to some extent Mexico were more seriously affected than others, partly as a result of weakening prices of export commodities. With the Russian crisis, however, financial market pressures intensified in most of the region, apparently reflecting increased fear of devaluation and default. To help alleviate these concerns, individual countries have needed to take appropriate measures to strengthen and safeguard macroeconomic stability, maintain the credibility of their exchange rate policies, and continue their structural reform efforts.

The country whose growth has been worst hit by developments over the past year is *Venezuela,* owing in part to its dependence on oil. With macroeconomic policies having been loosened in 1997, the tightening of policies that is in train this year is important for the achievement of macroeconomic stability. Venezuela also has a pending agenda of structural reforms that are needed to put the economy on a sustainable recovery path and to promote economic diversification. The Asian crisis has also had a significant impact on *Chile*'s balance of payments, reflecting the importance to it of the Asian market, which accounts for about one-third of its exports, and also its dependence on primary commodity exports. Chile's strong macroeconomic and structural fundamentals will help it to cope with the needed adjustment. Private demand growth is slowing down, and in late September the authorities announced measures to restrain the growth of public expenditure in 1999 to 1 percentage point below projected GDP growth. Given present uncertainties about external and domestic economic conditions, it will be important to monitor developments closely and to assess on a continuous basis whether further policy action is needed. In early September, a reserve requirement that has discouraged short-term capital inflows was removed to promote stronger inflows, and the trading band for the peso was widened.

Brazil weathered the Asian crisis with the assistance of tighter fiscal and monetary policies implemented in late 1997. In fact, by late June, interest rates had been allowed to decline to pre-October 1997 levels. The intensification of pressures in August led to a renewed tightening of policies in early September, but this failed to fully restore confidence and reverse the capital outflows; additional spending cuts were announced in mid-September. With the fiscal deficit still running at 7 percent of GDP and a significant current account deficit, efforts to rein in spending and to improve the finances of state governments still need to be strengthened to restore and maintain investor confidence. Financial pressures in *Argentina* and *Mexico* have also intensified since the eruption of the Russian crisis. In Argentina, confidence in the currency board arrangement has been maintained, and there are no indications of capital flight. Nonetheless, a relatively heavy debt-service burden for 1999 and a still large current account deficit point to a difficult financing situation if the external turbulence were to continue for an extended period, and highlight the importance of continued fiscal restraint and structural reforms. Likewise in Mexico, continued capital market uncertainty points to the need to maintain tight credit conditions, while a widening current account deficit points to the importance of continued fiscal restraint and structural reforms.

In Africa, the limited access of most countries to international financial markets has in turn limited the impact of the past year's market turbulence: the crisis in emerging markets has affected Africa mainly through commodity prices and trade. Growth in Africa is now projected to be little higher than 3½ percent in 1998, but such an outcome would still exceed the growth performance of most of the past 20 years. This can be attributed to substantial improvements in economic policies in many countries, which are being supported by several important initiatives to ease the debt burdens of the poorest countries (Box 1.1). Although some African countries will be net gainers from recent commodity price declines—benefiting more from cheaper oil imports than they lose from lower export prices—the region as a whole, and about one-third of the countries, are expected to be net losers.

In *South Africa,* the authorities faced the challenge of reestablishing financial stability in the face of heavy downward pressure on the exchange rate in May and June. After an initial rise in interest rates, the authorities intervened heavily in the foreign exchange markets, particularly the forward market, leading to a weakening of the net reserve position. Subsequently, they allowed the rand to adjust, but have since pursued a tight monetary policy. This, together with cautious fiscal policies, will need to be maintained to avoid a rise in inflation and to maintain confidence. Accelerated implementation of structural reforms would not only help to restore confidence and dampen inflationary pressures, but also would enhance competitiveness and improve the medium-term outlook. Oil price declines have placed particular pressure on *Nigeria*'s external and fiscal situation, and growth performance has continued to be hampered by governance problems and widespread economic distortions. Broadly based reforms will be needed for Nigeria to achieve higher growth on a sustainable basis.

In the Middle East, the sharp deterioration in fiscal and external current account positions in the oil-exporting countries has forced governments to compress public sector outlays and contributed to marked decelerations in growth. It will be important not to allow these adverse developments to delay the implementation of structural reforms that are essential for enhancing medium-term growth prospects. In *Saudi Arabia,* revenue and expenditure measures that have been announced to contain the deterioration in the fiscal position will need to be implemented forcefully. In *Egypt,* the downturns in oil export earnings and workers' remittances from within the region have been exacerbated by a weakening of tourism earnings and the current account has shifted into deficit. The external capital account has also weakened. To reduce Egypt's vulnerability to adverse external developments, it will be important to maintain progress with structural reforms and to make further headway with fiscal consolidation; monetary policy will also need to be responsive to adverse shifts in sentiment.

In *Turkey,* a strengthened commitment to reduce fiscal imbalances and a more active use of monetary policy have improved inflation prospects and helped to contain the effects of the turmoil in global financial markets. But the crisis in Russia, a major trading partner, will adversely affect Turkey's external position. Sustained macroeconomic discipline, measures to strengthen the banking system, and increased commitment to reforms, notably of the tax and social security systems, will be needed to safeguard financial stability.

The transition countries have felt the repercussions of the crisis in emerging markets unevenly. The new round of turbulence set off by the events in Russia in August have had a particularly large impact on Ukraine and other economies with close trade and financial linkages to Russia. Most countries of central and eastern Europe have weathered the crisis better, reflecting their considerable progress in stabilization and economic reform, which had enabled them to lower inflation and resume growth following years of large output declines. The most significant achievements in this regard have been in Poland, the Czech Republic, Hungary, Croatia, Slovenia, and the Baltic countries. Several of the central Asian and transcaucasian countries have also seen a resumption of growth and most other transition countries have registered significant progress in some areas. In the wake of the Russian crisis, sharp declines in equity prices have been recorded throughout central and eastern Europe, and exchange market pressures have also been evident.

For all of the transition countries, the turmoil in emerging markets has brought new challenges and has underscored the risks of setbacks in the transformation process. In most cases, the transition countries have only recently gained access to international financial markets, but such access expanded rapidly in 1997. Capital inflows into transition countries remained substantial in the first half of 1998, and sustained recovery in western Europe should provide a favorable external environment, but increased volatility of capital flows and higher risk premia in the wake of the Asian and Russian crises have highlighted the vulnerability of these economies to sudden shifts in attitudes of foreign investors.

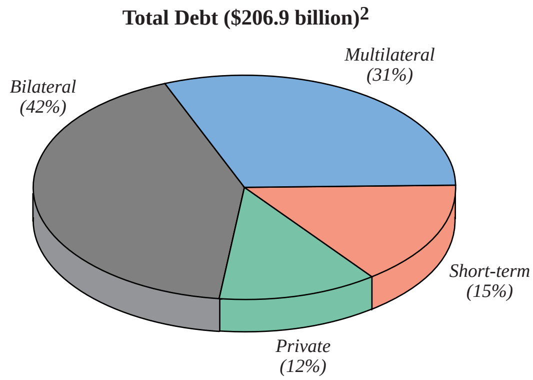
In eastern Europe, such difficulties were manifested in the *Czech Republic* in May 1997 when internal political difficulties and a large and widening current account deficit led to an abrupt reassessment of the country's fundamentals. Policies were subsequently tightened to reduce fiscal and external imbalances, causing financial market confidence to recover. More recently, the Czech koruna has been subject to upward pressure. But growth slowed sharply in the Czech

Box 1.1. Review of Debt-Reduction Efforts for Low-Income Countries and Status of the HIPC Initiative

For many years, support from the international community to low-income countries has included debt relief from commercial/private and official bilateral creditors, as well as highly concessional development finance from both bilateral and multilateral creditors, including in the context of arrangements with the IMF under the Enhanced Structural Adjustment Facility (ESAF).

As of the end of 1996, the external debt of the heavily indebted poor countries (HIPCs)[1] amounted to some $210 billion, equivalent to about 1½ times their combined GNP, or $167 billion in net present value (NPV) terms *(see first table)*.[2] The bulk of this was to official bilateral (44 percent) and multilateral (30 percent) creditors *(see figure)*. These amounts reflect debt relief already granted by bilateral creditors in the framework of the Paris Club. Since the late 1980s, such debt relief has been on increasingly concessional terms. In addition, a number of bilateral creditors have forgiven large amounts of claims, particularly aid loans. Multilateral creditors agreed in 1996 to provide debt relief in the context of the HIPC Initiative.[3] New financing to HIPCs is provided largely by multilateral and bilateral creditors, typically in the form of grants or highly concessional loans aimed at achieving economic adjustment and sustainable development. HIPCs' debt to commercial/private creditors is much more limited (12 percent of total external debt at end-1996); most of it has been restructured or bought back at very steep discounts with IDA support, and these creditors typically do not provide new financing. To date, all but 4 of the 40 HIPCs have rescheduled debt with Paris Club official bilateral creditors. This has involved 169 rescheduling agreements, covering debt of some $54 billion, including amounts rescheduled repeatedly. These creditors have provided increasingly concessional reschedulings under Toronto terms (October 1988–June 1991) with up to 33 percent NPV reduction, under London terms (December 1991–December 1994) with 50 percent NPV reduction, and under Naples terms (since January 1995) with 67 percent NPV reduction on eligible nonconcessional debt.[4]

HIPC External Indebtedness, 1996[1]
(Percent of total)



Sources: World Bank, *Global Development Finance* (Washington); and IMF staff calculations.
[1]HIPCs, excluding Nigeria.
[2] Including short-term debt.

[1]The group of 40 HIPC countries shown in the table was established for analytical purposes in the work leading up to the HIPC Initiative. Nigeria was originally also included, but it is excluded here because it does not have IDA-only status with the World Bank (that is, the ability to borrow only on concessional terms, from the World Bank Group's International Development Association)—one of the prerequisites for HIPC eligibility.

[2]The face value of the external debt stock is not a good measure of a country's debt burden if a significant part of the external debt is contracted on concessional terms—for example, with an interest rate below the prevailing market rate. The net present value (NPV) of debt is a measure that takes into account the degree of concessionality. It is defined as the sum of all future debt-service obligations (interest and principal) on existing debt, discounted at the market interest rate. Whenever the interest rate on a loan is lower than the market rate, the resulting NPV of debt is smaller than its face value, with the difference reflecting the grant element.

[3]The Initiative aims to provide special assistance to reduce the external debt of HIPCs to sustainable levels. It entails coordinated action by all creditors. To obtain assistance under the HIPC Initiative, a country must be eligible for concessional assistance from the IMF and the World Bank, face an unsustainable debt burden even after the full application of traditional debt-relief mechanisms, and establish a track record of reform and sound policies through IMF- and World Bank-supported programs. Stages in the decision-making process include the *decision point*, after a track record of three years, when the Executive Boards of the IMF and the World Bank formally decide on a country's eligibility and commit assistance under the Initiative in parallel with a country's other creditors. At the *completion point*, typically three years later, the two Boards decide if a country has met the conditions for assistance, allowing that assistance to be implemented and disbursed. The conditionality is linked both to macroeconomic variables as well as social aspects. Creditors are free to deliver this assistance according to their own modalities; some creditors may provide interim assistance during the second stage. See Anthony R. Boote and Kamau Thugge, *Debt Relief for Low-Income Countries: The HIPC Initiative*, Pamphlet Series, No. 51 (Washington: IMF, 1997).

[4]Naples terms also provide for a 50 percent NPV reduction for countries with per capita GDP above $500 and overall indebtedness in NPV terms of less than 350 percent of exports. Only three countries—Cameroon, Guinea, and Honduras—have received 50 percent NPV reduction under Naples treatment; all others have received 67 percent NPV reduction. In the context of concessional Paris Club reschedulings, concessional debt (official development assistance) is deferred over long periods—with a maturity of 40 years under Naples/Lyon terms, including a grace period of 16 years, and an interest rate no higher than the original concessional interest rate.

Past Debt Restructurings for HIPCs, 1976–July 1998[1]

	Total External Debt (end-1996;[2] billions of U.S. dollars)	Paris Club Reschedulings					Commercial Bank Debt- and Debt-Service-Reduction (DDSR) Operations			
		Number								
		Total	Concessional	Year	Amounts consolidated (millions of U.S. dollars)[3]	NPV reduction in last rescheduling (percent)[4]	Number	Year of agreement in principle	Amounts restructured (millions of U.S. dollars)[5]	Effective net present value reduction (in percent)[6]
Angola	10.6	1	—	1989	446	—	—	. . .	. . .	. . .
Benin	1.6	4	4	1989–96	579	67	—	. . .	. . .	. . .
Bolivia	5.2	6	4	1986–95	2,379	67	2	1987, 1993	643	91
Burkina Faso	1.3	3	3	1991–96	171	67	—	. . .	. . .	. . .
Burundi	1.1	—	. . .	. . .	. . .	. . .	—	. . .	. . .	. . .
Cameroon	9.5	5	3	1989–97	5,273	50	[7]	. . .	. . .	. . .
Central African Rep.	0.9	6	3	1981–94	163	50	[7]	. . .	. . .	. . .
Chad	1.0	3	3	1989–96	60	67	—	. . .	. . .	. . .
Congo, Dem. Rep. of	12.8	10	1	1976–89	6,555	33	—	. . .	. . .	. . .
Congo, Rep. of	5.2	4	1	1986–96	4,741	67	[7]	. . .	. . .	. . .
Côte d’Ivoire	19.7	8	2	1984–98	6,355	80	1	1996	6,658	77
Equatorial Guinea	0.3	4	3	1985–94	131	50	—	. . .	. . .	. . .
Ethiopia	10.1	2	2	1992–97	625	67	1	1996	284	93
Ghana	6.2	1	—	1996	93	. . .	—	. . .	. . .	. . .
Guinea	3.2	5	4	1986–97	801	50	[7]	. . .	. . .	. . .
Guinea-Bissau	0.9	3	2	1987–95	241	67	—	. . .	. . .	. . .
Guyana	1.6	4	3	1989–96	1,150	67	1	1992	93	89
Honduras	4.5	3	2	1990–96	572	50	[7]	. . .	. . .	. . .
Kenya	6.9	1	—	1994	535	. . .	—	. . .	. . .	. . .
Lao People’s Dem. Rep.	2.3	—	. . .	. . .	. . .	. . .	—	. . .	. . .	. . .
Liberia	2.1	4	—	1980–84	94	. . .	—	. . .	. . .	. . .
Madagascar	4.2	8	3	1981–97	2,316	67	—	. . .	. . .	. . .
Mali	3.0	4	4	1988–96	160	67	—	. . .	. . .	. . .
Mauritania	2.4	6	3	1985–95	521	67	1	1996	89	93
Mozambique	5.8	5	3	1984–96	2,467	80	1	1991	198	93
Myanmar	5.2	—	. . .	. . .	. . .	. . .	—	. . .	. . .	. . .
Nicaragua	5.9	3	3	1991–98	1,625	67	1	1995	1,819	95
Niger	1.6	9	4	1983–96	623	67	1	1991	207	91
Rwanda	1.0	1	1	1998	64	67	—	. . .	. . .	. . .
São Tomé and Príncipe	0.3	—	. . .	. . .	. . .	. . .	1	1994	10	90
Senegal	3.7	12	6	1981–98	1,684	67	1	1996	112	87
Sierra Leone	1.2	7	3	1977–96	432	67	1	1995	286	89
Somalia	2.6	2	—	1985–87	280	. . .	—	. . .	. . .	. . .
Sudan	17.0	4	—	1979–84	1,457	. . .	—	. . .	. . .	. . .
Tanzania	7.4	5	4	1986–97	3,921	67	[7]	. . .	. . .	. . .
Togo	1.5	10	4	1979–95	1,486	67	1	1997	74	92
Uganda	3.7	7	4	1981–98	606	80	1	1993	177	87
Vietnam	20.0	1	1	1993	791	50	1	1996	808	50
Yemen, Rep. of	6.4	2	2	1996–97	1,557	67	[7]	. . .	. . .	. . .
Zambia	7.1	6	3	1983–96	3,445	67	1	1994	408	94
All HIPCs	206.9	169	88		54,399		16		11,866	95

Source: (World Bank) *Global Development Finance*, 1998 (Washington); Paris Club; IMF and World Bank staff estimates for DDSR operations.

[1]Forty heavily indebted poor countries (HIPCs), excluding Nigeria because it is not IDA-only (International Development Association).

[2]From World Bank (Washington), *Global Development Finance, 1998*. For some countries, debt to Russia is covered only partially; an adjustment has been made for Vietnam.

[3]Includes each rescheduling, and thus double-counts debt covered repeatedly.

[4]On eligible debt only.

[5]Including eligible principal and accrued interest.

[6]Effective NPV reduction of overall operation.

[7]DDSR operation under discussion.

Box 1.1 *(concluded)*

In the context of the HIPC Initiative, Paris Club creditors agreed in 1996 to provide up to 80 percent NPV reduction under Lyon terms. As shown in the first table, most countries that have rescheduled since the inception of concessional terms have obtained the most favorable terms available at the time, except for Ghana and Kenya; in these two cases the reschedulings were, at the authorities' request, limited to arrears only on nonconcessional terms.

In the context of Naples terms, Paris Club creditors have provided stock-of-debt operations to seven HIPCs (Benin, Bolivia, Burkina Faso, Guyana, Mali, Senegal, and Uganda). Creditors have topped up the level of concessionality from a 67 percent NPV reduction to 80 percent for Uganda after it reached its completion point under the HIPC Initiative in April 1998. Creditors have indicated a willingness to top up the stock treatments for Bolivia, Burkina Faso, Guyana, and Mali when they reach their completion points under the Initiative. Such action was not required for Benin and Senegal, since their external debts are sustainable without assistance under the Initiative.[5] All stock operations provided for a comprehensive treatment of debt, including the topping-up of amounts previously rescheduled on less concessional terms. Generally, stock treatments provide a means for low-income countries to exit from the rescheduling cycle, as most middle-income countries have done by now.

Regarding debt to private commercial creditors, to date, 15 HIPCs have completed market-related restructurings of their debt to commercial banks, covering claims of $11.9 billion, of which $6.7 billion were claims on Côte d'Ivoire. In 13 cases, the country's commercial debt was virtually extinguished, and in the cases of Côte d'Ivoire and Vietnam it was reduced by three-fourths and one-half, respectively. The total cost of these operations has amounted to some $0.6 billion. All operations have been funded in large part from the IDA Debt Reduction Facility and bilateral donors, with the IMF contributing in the case of Côte d'Ivoire. Three other HIPCs—Guinea, Tanzania, and Yemen—are advanced in their negotiations with commercial banks, involving debt of $0.7 billion. Guyana is negotiating a settlement with non-bank private creditors, following the successful completion of a buyback operation with commercial bank creditors in 1992. Discussions have also been initiated by several other HIPCs, including Cameroon, Central African Republic, Republic of Congo, and Honduras, involving eligible debt of about $1.5 billion.

To date, assistance under the HIPC Initiative has been committed by the international financial community to six countries (Bolivia, Burkina Faso, Côte d'Ivoire, Guyana, Mozambique, and Uganda) for nominal debt relief of $5.6 billion, or a reduction of close to $3 billion in NPV terms, compared with total debt of these six countries—after traditional debt-relief mechanisms—of $17.4 billion in NPV terms *(see second table)*. In total, ten countries have been considered under the HIPC Initiative: two were found to have a sustainable external debt, and eight to require HIPC assistance, of which six

[5]Debt sustainability under the Initiative is generally defined by ratios for the NPV of public and publicly guaranteed external debt and debt service in relation to exports of goods and services in or below the ranges of 200–250 percent and 20–25 percent, respectively. Specific sustainability targets in these ranges are set for each country in light of country-specific vulnerability factors, such as the concentration and variability of exports, or fiscal indicators of the burden of debt service. For very open economies (exports of at least 40 percent of GDP) with a very heavy fiscal debt burden, despite strong efforts to generate revenue (fiscal revenue of at least 20 percent of GDP), the target can be set below an NPV of 200 percent of exports; for such countries, debt sustainability would be defined as meeting a maximum NPV of debt of 280 percent of fiscal revenue.

Republic in 1997–98, in contrast to the general strengthening of activity in central and eastern Europe.

Intense financial pressures have been felt in Ukraine for similar reasons as in Russia—persistent fiscal imbalances, significant short-term liabilities to foreign investors, and delays in the implementation of structural reforms. In response to spillovers from the Russian crisis, the authorities have announced a widening of the trading band for the hryvnia and an arrangement to swap part of the short-term domestic debt for longer maturities.

The United States, Canada, and the United Kingdom: Striking a Balance in Monetary Policy

The impressive economic expansion in the *United States,* now in its seventh year, has been underpinned by fiscal consolidation and the emergence of budgetary surpluses that have put the government debt-to-GDP ratio on a sharply declining path; a monetary policy that has successfully supported the expansion while helping to maintain low inflation; and flexible product and labor markets that have permitted rapid employment growth and a decline in the unemployment rate to its lowest level in decades, with little sign of increased inflationary pressure. The strength of the U.S. expansion, and especially of domestic demand, has facilitated adjustment in countries afflicted by the Asian financial crisis, albeit at the expense of a sharp deterioration of the U.S. external position that is not sustainable in the long run. Looking ahead, the U.S. economy is projected to experience a slowdown in 1998–99, partly on account of the deterioration in the external environment, with output growth in 1999 as a whole weakening slightly below potential, but the timing and degree of the slowdown remain uncertain.

How Much Relief Will the HIPC Initiative Provide?

Country	Decision Point	Completion Point	Total Debt Relief, Nominal (millions of U.S. dollars)	Assistance (NPV at completion point) Percent reduction in debt	All creditors (millions of U.S. dollars)	IMF (millions of U.S. dollars)
			Completion point reached			
Uganda	Apr. 1997	Apr. 1998	650	20 percent	347	69
			Decision point reached and assistance committed by IMF and World Bank			
Bolivia	Sept. 1997	Sept. 1998	600	13 percent	448	29
Burkina Faso	Sept. 1997	Apr. 2000	200	14 percent	115	10
Côte d'Ivoire	Mar. 1998	Mar. 2001	800	6 percent	345	23
Guyana	Dec. 1997	Early 1999	500	25 percent	253	35
Mozambique	Apr. 1998	June 1999	2,900	57 percent	1,442	105
Total provided/committed			5,650		2,950	271
			Preliminary discussions held (timing and assistance subject to change)			
Guinea-Bissau	End-1998	End-2001	. . .	. . .	300	8
Mali	Mid-1998	End-1999	. . .	. . .	128	14
			Debt judged to be sustainable			
Benin	July 1997	. . .	. . .	. . .	. . .	. . .
Senegal	Apr. 1998	. . .	. . .	. . .	. . .	. . .

have already reached their decision points, while two have been considered on a preliminary basis. The relief from traditional mechanisms is limited for Uganda, since its debt is largely to multilateral creditors. In contrast, most of Mozambique's debt is to bilateral creditors, including a large share to Russia,[6] and thus the relief provided by Paris Club reschedulings is substantial. Also, since Mozambique's overall indebtedness was higher than Uganda's, the need for HIPC assistance was larger.

[6]Russia, which inherited the external claims of the former U.S.S.R., is a major bilateral creditor for many developing countries. Most of its claims have not been serviced in recent years. It joined the Paris Club as a creditor in September 1997 and, in this context, has committed to provide substantial debt relief to rescheduling countries.

The effects of the current crisis are increasingly being felt by the United States and will influence the conduct of monetary policy during the period ahead. The crisis has contributed to a significant decline in net external demand, which is projected to deepen, and to a reversal since mid-July of most of the earlier gains this year in equity prices, which may be expected to slow domestic demand, especially given the low level to which personal saving has recently fallen. But at the same time, the flight to quality by investors that has been associated with the crisis has contributed to further declines in long-term interest rates, which will tend to strengthen domestic demand; and labor markets remain tight, with wage growth on an upward trend. Most measures of inflation have remained surprisingly subdued, partly reflecting the influence of a number of special factors that cannot be expected to continue indefinitely—including the appreciation of the U.S. dollar since 1995, declines in commodity prices, and a moderation of the rise in health care costs. Some of these forces are likely to reverse at some point; indeed the dollar has weakened against a number of major currencies since mid-August. But it seems increasingly likely that domestic demand and activity will slow sufficiently to keep inflation in check. Moreover, there are significant risks of a more pronounced weakening of domestic growth than projected, in the event of continuing global financial instability. At the present time, therefore, the balance of policy considerations has shifted away from favoring a near-term monetary tightening, and the projections in this report assume that the Federal Reserve will continue to maintain short-term interest rates at the level set early last year through 1999. However, the global financial crisis, with its attendant adverse effects on the U.S. economy, may soon justify a move to ease monetary policy on both domestic and international grounds.

Canada experienced solid growth for almost two years before the recent slowing associated largely with the Asian crisis. Official interest rates were raised by a full percentage point in late August in the face of continuing downward pressure on the exchange rate following significant depreciation over several months. At present, it is not clear that this action will have a significant adverse effect on economic growth. While both short- and long-term interest rates rose initially, they have come back down, and although short-term market rates are somewhat higher than before the tightening, long-term government bond yields are actually lower. Given the apparent softness of the economy, low inflation, and heightened uncertainty in world financial markets, consideration might be given to an easing of monetary policy in the period ahead.

In the *United Kingdom,* where the Bank of England raised the official interest rate by ¼ of 1 percentage point to 7½ percent in June, growth moderated to a little below potential in the first half of the year, and there have been increasing signs of growth weakening further. Although unemployment has fallen further to an 18-year low, earnings growth appears to have moderated, and inflation edged down to its 2½ percent target in August. Significant fiscal consolidation, together with the tightening of monetary conditions since early 1997, has restrained the forward momentum of domestic demand, and this should help to contain inflation risks in the period ahead. The possibility of a sharper slowdown than needed to meet the inflation target, which has been enhanced by the turbulence in financial markets and the external environment, warrants readiness for an early move toward monetary easing.

Euro Area: Prospects and Policy Challenges

With strengthening growth across the future euro area, improving labor market conditions, and a high degree of convergence of inflation rates close to price stability, domestic conditions are auspicious for the euro's start in 1999. Despite some adverse effects from the Asian crisis, there are encouraging signs that the economic recovery has been gaining in breadth and strength and that domestic demand in the major EU countries is beginning to replace net exports as the principal engine of growth. This is particularly the case in France and, albeit to a lesser extent, Germany. In contrast, the Italian upswing still appears to be somewhat tentative. In many of the other European countries, activity remains quite strong, including in Belgium, Denmark, Finland, Greece, Ireland, the Netherlands, Portugal, and Spain. The strengthening of domestic demand in the prospective euro area is particularly welcome at a time when two large trading partners, the United States and the United Kingdom, are likely to begin to experience cyclical slowdowns, when much of Asia has entered a recession that may last into next year, and when growth in many other emerging countries is likely to slow sharply after the recent escalation of the global financial crisis. In view of the risks emanating from the external environment, it is important that policies in the euro area be tuned to maintain robust growth of domestic demand.

The introduction of a common currency and adoption of a common monetary policy by 11 member countries of the EU—eventually perhaps the entire EU—will have far-reaching implications for Europe and the world economy. While monetary union carries many benefits, it also poses new challenges and merits reflection on the role of economic policies in safeguarding macroeconomic stability and securing high levels of employment. The responsibility for monetary policy will be transferred to the European System of Central Banks (ESCB), whose mandate is to safeguard price stability in the euro area as a whole. This implies that individual countries will sometimes find themselves with levels of interest rates that appear too easy or too restrictive, depending on a country's cyclical position relative to that of the area as a whole. It could be argued that this is not much different from the monetary regime prevailing among the countries participating in the exchange rate mechanism (ERM) of the European Monetary System (EMS), where interest rates have been largely set according to the needs in Germany, the anchor country. However, occasional currency realignments and significant interest rate differentials (partly reflecting risks related to possible currency movements and differences in fiscal positions) have meant that monetary conditions (broadly defined to include the effects of exchange rate changes) have often varied considerably within the ERM—although not always in ways that have been helpful from a cyclical perspective. Moreover, while a common monetary policy and continued economic and financial integration may eventually tend to reduce cyclical divergences across member countries, differences in economic structures will mean that asymmetric shocks and differences in economic responses to monetary policy will continue to limit the extent to which a common monetary policy can suit all members.

Current divergences in cyclical conditions and thus in policy requirements across the euro area raise an immediate issue, which has become more acute as a result of the crisis in emerging markets. The euro area as a whole is close to price stability, and there is little near-term danger of a pickup in inflation—the overall margin of slack as measured by the shortfall of actual from potential GDP is estimated by the IMF staff at some 2–3 percent of GDP for 1997, which would on current projections be absorbed only gradually over the next several years. This suggests that it would be appropriate for the ESCB initially to adopt a monetary stance similar to that prevailing in Germany at present, with the remaining convergence of short-term interest rates occurring close to the lower end of prevailing interest rates across the euro area. This would imply some further decline in the average level of interest rates in the euro area. Moreover, the absence of price pressures in the area as a whole provides room for some additional easing of core interest rates if warranted by the deteriorating external environment.

For some countries that are much more advanced in the upswing, however, such an easing of monetary policy in the area as a whole will exacerbate the risk of overheating in goods and asset markets and tend to accelerate wage growth, which would undermine competitiveness and future employment growth. This situation is a familiar one in the United States, where individual states or regions may experience cyclical conditions that diverge from those of the U.S. economy as a whole. However, the consequences are potentially more serious in Europe because of relatively rigid labor markets, low regional labor mobility, and limited scope for fiscal transfers among the member states.

In addressing this issue, two key requirements need to be met: fiscal policy (at the national level) needs to shift from being pro- to being countercyclical, and labor and product markets need to become more flexible. For fiscal policy, there is at present a fortunate compatibility between short-term and medium-term requirements. The key challenge for the medium term, for all member countries, is to ensure continued progress toward securing budgetary positions that would enable the authorities to allow, at a minimum, a full play of automatic stabilizers while complying with the requirements of the Stability and Growth Pact (SGP). Additional consolidation would be necessary to prepare countries for the aging of populations and associated pressures on pension and health outlays. Thus, countries facing the danger of overheating at the present time will benefit doubly from additional efforts to secure stronger budgetary positions, because such efforts are consistent with both short-term and longer-run policy requirements.

It is in the area of labor markets that the euro area faces its greatest policy challenge. High labor costs and entitlement systems that hamper incentives for job search have depressed employment creation. The flexibility of European labor markets needs to be enhanced through structural reform measures across a wide front to safeguard the key principles and objectives of European welfare systems and at the same time lessen distortions and strengthen incentives to work and create jobs. This would facilitate adjustment to adverse economic disturbances and lessen the magnitude and duration of divergent economic trends across the area. And even in the absence of disturbances, greater labor market flexibility is needed to promote job creation, reduce structural unemployment, enhance budgetary performance, and strengthen the area's resilience to inflationary pressures. Unfortunately, despite progress in some areas, labor market reform efforts have remained inadequate in most of Europe.

In the absence of deeper and more comprehensive reforms, emerging wage pressures could choke off the recovery prematurely by leading to a need to tighten monetary policy more quickly than would be the case if labor markets were more flexible. Moreover, without reforms, there is a serious risk that structural unemployment will continue to rise in some countries or regions, even as cyclical unemployment may be falling, thus compromising efforts to contain longer-term fiscal imbalances. A tendency for unemployment to continue to rise secularly along the trend of the past two to three decades would risk eventually increasing pressures for an undue relaxation of monetary policy. And down the road it could ultimately erode public support for the monetary union, which might unjustly be regarded as the cause of rising unemployment. With activity strengthening across Europe, the time is more than ripe for bold reforms to address the Achilles' heel of the Economic and Monetary Union (EMU) project.

Systemic Considerations

The seriousness of the Asian and Russian crises and the intensity of contagion effects on other emerging market countries have underscored the vulnerability of emerging market countries to disruptive shifts in investor sentiment.[1] A key lesson from this experience is the need to address promptly any signs of weaknesses in policies and institutions that may ultimately provoke sharp revisions in investor perceptions of a country's prospects. Countries also need to limit the potential damage from shifts in investor sentiment by fostering the development of robust financial systems.

It would be wrong, however, to attribute financial crises exclusively to policy shortcomings in the crisis countries. Financial crises of the type experienced in Asia and Russia also illustrate the difficulties that emerging market countries can experience when they suddenly become the target for very large capital inflows. History is replete with episodes in which developing countries have experienced large-scale capital inflows in situations when rates of return in the industrial countries were relatively unattractive, for example during periods of cyclical economic weakness, or when developing countries have appeared to offer particularly promising investment opportunities.

[1]See also Charles Adams and others, *International Capital Markets—Developments, Prospects, and Policy Issues* (Washington: IMF, September 1998).

Box 1.2. Strengthening the Architecture of the International Monetary System Through International Standards and Principles of Good Practice

Ongoing efforts to improve the resiliency of the international monetary system to financial crises seek to reduce the risk of disruptive shifts in market sentiment, limit damaging contagion and spillover effects when such shifts in sentiment do occur, and strengthen the process and procedures of crisis resolution. In this work, particular emphasis is being given to the development and implementation of international standards and principles of good practice. Although these standards or principles are in various stages of development and dissemination, their ultimate goal is to (1) strengthen effective financial market supervision and regulation; (2) improve the institutional infrastructure; (3) enhance transparency, market discipline, and corporate governance; and (4) enhance risk management by financial institutions. Besides encouraging the implementation of international standards, the Fund also aims to avoid crises and limit their contagious effect by continuing to strengthen its surveillance efforts and provide support for its adjustment policies through technical assistance missions and other means.

Financial Market Supervision and Regulation

• *Banking Supervision.* The Basle Committee has developed the *Core Principles for Effective Banking Supervision*, which are intended to serve as a basic reference and minimum standards for bank supervisory and other public authorities.[1] Consistent with these principles, the IMF has developed a framework for financial sector surveillance, which is helping to analyze financial sector vulnerabilities.[2] Promulgation of these standards or guiding principles is being conducted through a number of channels, including the Basle Committee's Liaison Group and the Institute for Financial Stability, recently created by the Bank for International Settlements (BIS), and the IMF's bilateral and multilateral surveillance activities.

• *Securities Regulation.* The International Organization of Securities Commissions (IOSCO) is working to establish universal principles for securities market regulation, and a draft will be considered for membership endorsement in September 1998. IOSCO is also working on improving disclosure requirements and has proposed a disclosure standard for international cross-border offerings, which will also be considered by the IOSCO membership in September 1998.[3]

• *Insurance Supervision and Financial Conglomerates*. In September 1997, the International Association of Insurance Supervisors (IAIS) released *Principles, Standards, and Guidance Papers* for insurance supervisors dealing with internationally active insurance companies.[4] Separately, the Joint Forum on Financial Conglomerates, a group of supervisors covering banks, securities firms, and insurance companies, released a set of consultative documents aimed at enhancing the supervision of financial conglomerates.[5]

Institutional Infrastructure

• *Bankruptcy*. Domestic bankruptcy systems vary considerably across countries, and regional and multilateral initiatives to harmonize domestic bankruptcy laws have not been successful. This reflects, in part, differences in legal traditions and practices. In contrast, some success has been achieved in promoting harmonization in the treatment of cross-border bankruptcy problems, notably under the auspices of the United Nations Commission on International Trade Law (UNCITRAL) (a model law on Cross-Border Insolvency),[6] the International Bar Association (a Cross-Border Insolvency Concordat), and the European Union (a still unratified Convention on Insolvency Procedures). While harmonizing bankruptcy laws across national jurisdictions has been difficult, somewhat more progress has been made in modernizing national bankruptcy laws under the aegis of IMF programs.

• *Payment Systems.* Payment system reforms have focused on widespread adoption of real-time gross settlement (RTGS) systems and the use of delivery versus payment (DVP) schemes for securities settlement.[7] These reforms are ongoing, with a large number of countries adopting such systems. As noted by the Committee on Payment and Settlement Systems (CPSS), foreign exchange settlement risk, given that transaction lags settle in different time zones, raises significant concerns, including the effects on safety and soundness of banks, the adequacy of market liquidity, market efficiency, and overall financial stability. The CPSS has set out a strategy for reducing foreign exchange settlement risks, and several private sector initiatives are under way, including a potential new derivatives contract, the contract for differences, and a global settlement bank, using the Continuously Linked Settlement (CLS) system. These initiatives

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[1]Basle Committee on Banking Supervision, *Core Principles for Effective Banking Supervision: Consultative Paper* (Basle, Switzerland: Basle Committee, 1997). Available via the Internet: http://www.bis.org/publ/index.htm.

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

[3]International Organization of Securities Commissions (IOSCO), "Objectives and Principles Securities Regulation," and "International Disclosure Standards for Cross-Border Offerings and Initial Listings by Foreign Issuers" (Montreal, Canada: IOSCO, General Secretariat, 1998).

[4]IAIS (Basle, Switzerland: IAIS Secretariat, September 1997).

[5]Joint Forum on Financial Conglomerates (Basle Committee, IOSCO, and IAIS), *Supervision of Financial Conglomerates* (Montreal, Canada: IOSCO General Secretariat, February 1998).

[6]United Nations Commission on International Trade Law, "UNCITRAL Model Law on Cross-Border Insolvency" (New York: United Nations, 1997).

[7]For a survey of recent payment system initiatives, see Omotunde E. G. Johnson, *Payment Systems, Monetary Policy, and the Role of the Central Bank* (Washington: IMF, 1998).

would lower settlement risks by reducing the amounts at risk and the time lags involved in settlements. The CPSS continues to encourage other payment system reforms to reduce systemic concerns.

Transparency, Market Discipline, and Corporate Governance

• *Data Dissemination.* The IMF has established the Special Data Dissemination Standard (SDDS) to guide its market-borrowing members on the provision of economic and financial data to the public. The IMF maintains a Dissemination Standards Bulletin Board on the Internet, which posts information on the statistical practices to subscribers of the SDDS (46 countries at present). "Hyperlinks" to country data sites on the Internet have been established for 17 subscribers. The General Data Dissemination System (GDDS), the other tier of the dissemination standards, was established by the IMF in December 1997.[8] Its focus is on improvements in data quality across the spectrum of IMF membership. Both the IMF and the Eurocurrency Standing Committee are reviewing current data collection and dissemination efforts with a view to enhancing them. In particular, the BIS is set to collect information about over-the-counter derivatives on a six-month basis for a subset of derivatives dealers. The BIS is also enhancing its recording and dissemination of the maturity, sectoral, and geographical distribution of international bank lending. More generally, the Group of 22 (also known as the Willard Group), comprising the Group of 7 plus selected other mature and emerging economies, has established a working party to report on transparency and accountability.

• *Fiscal Transparency*. The IMF has developed a Code of Good Practices on Fiscal Transparency to guide members in enhancing the accountability and credibility of fiscal policy as a key component of good governance.[9] Fund members will be encouraged to implement the Code on a voluntary basis, with no formal subscription process currently envisaged. The desirability of a similar code with respect to financial and monetary policies is also being considered by the IMF.

• *Auditing and Accounting*. The International Accounting Standards Committee (IASC) has published a series of *International Accounting Standards (IAS)* that aim to achieve uniformity in the accounting principles used by business and other organizations for financial reporting across the world.[10] International standards of auditing have been established by the International Federation of Accountants (IFAC), through its International Auditing Practices Committee (IAPC). IOSCO is working with both IASC and IFAC/IAPC to ensure relevant and comprehensive approaches to the respective standards and their harmonization with securities market regulation.

• *Corporate Governance.* The OECD, the Basle Committee, the World Bank, and the European Bank for Reconstruction and Development (EBRD) are involved in the development of principles and good practices in the area of corporate governance. An informal, business sector advisory group associated with the OECD issued a report in April 1998 entitled *Corporate Governance: Improving Competitiveness and Access to Capital in Global Markets*.[11] In response, the OECD ministers have requested that the organization formulate a set of standards and guidelines for corporate governance. It is anticipated that these standards and guidelines will be available in May 1999. In April 1990, the Financial Action Task Force and the Basle Committee adopted recommendations designed to prevent the use of banks for money laundering. The OECD's *Convention on Combating Bribery of Foreign Public Officials in International Business Transactions* was signed in December 1997 and entered into force in 1998. The Convention sets a standard for national laws and requires that countries signing the Convention must implement laws that make bribery a criminal offence and impose strong penalties on both the company and the individuals who are found to bribe foreign officials. It is hoped the enforcement of the Convention will lead companies to put better internal controls in place.

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Other initiatives to strengthen international financial architecture include work to better understand the role of structural factors in contributing to financial crises (OECD); the development of indicators of vulnerabilities and an understanding of factors that may trigger financial crises (IMF; see the May 1998 *World Economic Outlook*, Chapter IV, pp. 88–97),[12] and proposals to potentially involve the private sector in crisis prevention and resolution (IMF). Group of 22 working parties are developing evaluations and recommendations on a broad range of issues that complement other efforts.

[8]Access and more information can be found at this Internet address: http://dsbb.imf.org.

[9]See Interim Committee of the Board of Governors of the International Monetary Fund, "Code of Good Practice on Fiscal Transparency: Declaration on Principles," *IMF Survey,* Vol. 27 (April 28, 1998), pp. 122–24; also available via the Internet as IMF Press Release No. 98/14 (April 16, 1998): http://www.imf.org/external/np/sec/pr/1998/pr9814.htm#12.

[10]International Accounting Standards Committee (IASC), *International Accounting Standards* (London, 1998).

[11]Ira M. Millstein, "Corporate Governance: Improving Competitiveness and Access to Capital in Global Markets—A Report to the OECD" (Paris: OECD, Business Sector Advisory Group on Corporate Governance, 1998).

[12]For an example of recent work in these areas, see "Financial Crises: Characteristics and Indicators of Vulnerability," in the May 1998 *World Economic Outlook,* pp. 74–97.

Such reallocations of financial resources are clearly desirable for reasons of economic efficiency. They may also help to sustain global economic expansion when large countries or regions experience cyclical downturns. At the same time, complications often arise for two reasons. First, because of the magnitude of the resulting capital inflows relative to the absorptive capacity of the recipient countries, the inflows may contribute to surges in property and stock market prices as well as appreciating real exchange rates—asset price bubbles that often prove unsustainable. Second, when cyclical conditions normalize in creditor countries, or when perception of countries' fundamentals change, investors and banks may no longer find the higher returns in emerging market countries worth the risk. Bouts of excessive optimism among international investors followed by episodes of excessive pessimism can also be a problem, as illustrated by the inadequate yield spreads on emerging market debt instruments immediately prior to the Mexican and Asian crises, and by the excessive jumps in risk premia in the wake of these crises, even for countries with relatively sound policy records. Indeed, such cycles go back hundreds of years. Through these channels, and in conjunction with weak financial systems in many emerging market countries and other weaknesses in policies and institutions, fluctuations in the global economic and financial environment may therefore contribute to the proneness of emerging market countries to crises.

How can individual countries best protect themselves against such destabilizing influences? Among creditor countries, it is apparent that investors, banks, and financial regulators need to recognize the inherently fragile and volatile nature of capital flows by better pricing risks—for example, by attributing appropriate risk weighting to cross-border assets. This should not be a contentious issue in principle, although it may be difficult to reach a consensus on the precise risk weights to apply to different types of assets and for different countries.

For recipients of capital flows, views differ more fundamentally about the appropriate course of action. In light of the apparent association of external financial liberalization and subsequent financial crises, some commentators have questioned whether policymakers should turn the clock back on capital account liberalization, especially the liberalization of flows other than foreign direct investment. However, to turn the clock back would be to forgo the benefits of countries' rapidly growing ability to attract foreign saving to help realize their potential, as well as the broader welfare gains from international portfolio diversification and risk sharing. Indeed, among the industrial countries, the benefits of liberalized capital movements are widely and correctly perceived to outweigh the costs.

For many emerging market countries, a more relevant issue is whether capital account liberalization sometimes may be premature in the context of countries' overall progress toward macroeconomic stability and structural reform, including the development of robust financial systems. Indeed, there is clearly scope for strengthening efforts to ensure that capital account liberalization is well sequenced and prudent. *Well-sequenced* external financial liberalization means that structural reforms in other areas are often needed prior to, or along with, capital account liberalization to reduce the risk that resource misallocations stemming from distortions elsewhere in the economy are exacerbated when capital controls are removed. *Prudent* liberalization means the need to take into account the possibility that information asymmetries or market failures may lead to undesirable surges and excessive volatility of capital inflows, especially short-term flows. Just as domestic financial deregulation needs to be accompanied by the adoption of prudential rules, so does international financial deregulation require the adoption of prudential measures that provide adequate safeguards against excessive short-term currency exposure by banks, nonfinancial corporations, and government entities.[2]

These concerns figure prominently in current discussions about the conditions that need to be in place for an orderly liberalization of the capital account of the balance of payments and, more generally, about strengthening the architecture of the international monetary system (Box 1.2; see preceding pages).

[2]For further discussion, see Barry Eichengreen and others, *Capital Account Liberalization: Theoretical and Practical Aspects*, Occasional Paper 172 (Washington: IMF, October 1998).