CHAPTER II

THE ONGOING RECOVERY IN EMERGING MARKET ECONOMIES

Financial and macroeconomic conditions in the emerging market economies have continued to improve since the middle of 1999. Equity prices have rallied, exchange rates have stabilized, and yield spreads in external debt markets have begun to ease. In Latin America, the recessions have been generally short-lived and, in Brazil, unexpectedly shallow. Growth in east Asia has picked up strongly in the course of 1999, especially in Korea. This overall improvement notwithstanding, conditions among emerging market regions and countries continue to differ, reflecting divergences in cyclical positions and in budgetary and external balances and the need for structural reform. In view of persistently high current account deficits and continued subdued net private capital flows, Latin American emerging market economies remain vulnerable to reversals in market sentiment and financing flows. In east Asia, however, the rapid pace of the recovery will require some moderation in stimulative fiscal and monetary policies, and additional progress in banking and corporate sector restructuring is needed to transform the recovery into robust and sustained growth.

The improvement in the economic and financial outlook for Latin America and east Asia owes much to the policy responses to the recent crises. In addition to sound macroeconomic policies, many countries have adopted strong structural reform measures, including actions to strengthen financial systems, improve fiscal and monetary policy frameworks, and, in particular in east Asia, promote corporate restructuring. The welcome focus on structural reform stands in contrast with earlier crisis episodes in emerging markets, when the emphasis was much more on macroeconomic policies to achieve short-term external adjustment. The current structural agenda is far from finished, however, and the pace of reform needs to be maintained, especially as ongoing rapid recoveries heighten the risk of complacency. Priorities include initiatives to assist further financial sector and corporate restructuring, as well as broader institutional, legal, and regulatory reforms aimed at strengthening the environment for market-based activities. Provided the reform momentum can be maintained, the east Asian and Latin American countries will be well placed to achieve sustained robust growth and to reduce the risk of new crises.

In addition to sound macroeconomic policies and structural reform measures, other factors are also expected to help lower the risk of renewed crises in the emerging market economies. International investors have generally become more cautious toward these economies, and are differentiating among countries based on credit quality. In spite of an easing in secondary market spreads and some pickup in flows since early 1999, conditions overall remain less generous and market access more limited than during 1996 and most of 1997, in the run-up to the east Asian crisis. The easing in spreads has generally been more pronounced for the east Asian emerging markets than for their Latin American counterparts, reflecting credit fundamentals. External positions in east Asia have improved considerably in the wake of the 1997–98 crisis and financing patterns in the region are shifting from debt to equity. In contrast, current account deficits and refinancing needs remain sizable in Latin America, although for a number of countries increases in oil and nonfuel commodity prices have helped ease the external vulnerabilities somewhat. Latin America would also be more affected by a sharper-than-expected slowdown in the United States. Nevertheless, ongoing reforms and more realistic assessments of risk have reduced the immediate probability of a sudden and generalized reversal in flows followed by extensive contagion of the type seen in

the east Asian crisis of 1997–98 and the more recent crises in Brazil and Russia.

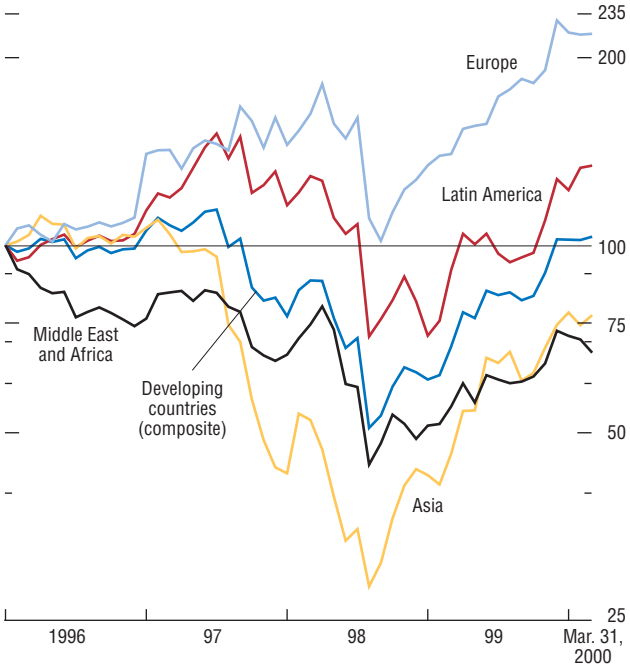
The chapter first discusses the substantial improvement in financial market conditions facing the emerging market countries and the diverging forces likely to influence these economies in the period ahead. It then assesses developments in global commodity markets, emphasizing both the impact of the pickup in world growth on commodity prices and the effects of the recent sharp increase in oil prices on the global economy. The last two sections analyze the improving economic outlook for Latin America and east Asia, comparing remaining vulnerabilities and identifying key policy challenges. Russia and other countries in transition have also been in crisis, but the economic situation in Russia remains complex and its recovery is tentative, as a wide range of financial and structural issues still need to be addressed. The performance of the countries of central and eastern Europe remains quite mixed, although most seem to be recovering from the effects of the Russian crisis. Many of these countries are also benefiting from their ongoing reorientation toward western Europe (see Chapter I). These and other developments in the transition countries will receive special attention in the forthcoming October 2000 *World Economic Outlook*.

Financial Conditions Facing Emerging Market Economies

Reflecting a further recovery in economic activity and rising investor confidence, domestic financial conditions in the emerging market economies generally continued to improve in the second half of 1999 and early 2000. This was, in particular, the case for *emerging equity markets*, which staged a sharp rally in the final months of 1999, as fears of higher U.S. interest rates and Y2K-related problems eased, information technology-related stocks surged in the United States, and economic prospects for both east Asia and Latin America continued to improve (Figure 2.1). Building on a strong performance in the first half of 1999, the rally resulted in eq-

Figure 2.1. Emerging Market Economies: Equity Prices
(U.S. dollar terms; logarithmic scale; January 1996 = 100)

Equity prices in all emerging market economies staged a strong rally during 1999.



Source: Standard and Poor's Emerging Markets Database.

uity price increases in U.S. dollar terms of more than 60 percent on average in 1999 as measured by the Standard & Poor's/International Finance Corporation (IFC) investable price index. This overall strengthening, however, masks a variety of country experiences in economic performance and policies.

In Asia, equity prices more than doubled in China and Korea last year and almost doubled in Indonesia. But markets in Thailand and, especially, the Philippines lagged behind the regional average because of concerns about the pace of bank restructuring (Thailand) and the overall course of economic policy (the Philippines). Indian equities finished the year with an 81 percent increase, in part driven by gains in the country's fast growing information technology sector. In Latin America, Brazil and Mexico recorded the strongest gains in 1999, in line with favorable economic developments. In Brazil, where the stock market soared in the last month of the year on the improving economic outlook, equity prices by year-end had strengthened by 67 percent since the beginning of the year, while the Mexican market rose even more. But markets in Colombia and Venezuela closed 1999 with losses, which were attributable mainly to deep recessions in the two countries.

Among other emerging market economies, stock exchanges in Russia and Turkey posted exceptionally strong rebounds in 1999, in part on the back of sharp year-end rallies. Improving economic prospects and a successful political transition lifted Russian equity prices by 65 percent in December, while the announcement of a macroeconomic stabilization program and positive news on European Union accession sent Turkish prices sharply up in the same month. The South African market also gained momentum in late 1999, amid falling interest rates, rising commodity prices, and a recovering economy.

The Czech, Hungarian, and Polish markets, which had lagged other markets in late 1999, registered strong gains in the first quarter of 2000 on the back of an improving growth and external outlook, capital inflows, and rallies in technology-related assets, while Russian equity prices strengthened further, reflecting higher oil prices and reduced political uncertainty. In Asia, equity markets in Indonesia, the Philippines, and Thailand weakened significantly during this period, in part because these markets offer fewer technology-related investments than competing regional exchanges. However, China reported price gains, as did Malaysia, where portfolio inflows picked up. In Latin America, the main markets other than those in Colombia and Venezuela posted moderate price increases. Overall, the composite S&P/IFC investable price index (measured in U.S. dollars) rose by 1 percent in the first quarter of 2000, in contrast to declines in many advanced economy equity markets during this period.

In *foreign exchange markets*, the currencies of the emerging market economies regained a measure of stability in the early fall of 1999 when mid-summer pressures related to uncertainties about U.S. interest rate movements abated (Figure 2.2). In emerging east Asia, the Indonesian and Thai currencies broadly returned to their June–July 1999 highs against the U.S. dollar in the fall of 1999, and the Korean won appreciated further to a post-crisis high of less than 1120 per U.S. dollar in March 2000. The Philippine peso came under some downward pressure in late February–March, reflecting concerns about policy slippages, in particular in the fiscal area. In Latin America, the Brazilian *real* strengthened to below 1.75 per U.S. dollar in March 2000, following some weakening in the early fall of 1999, as concerns of a pickup in inflation eased and capital inflows rose. Elsewhere on the continent, the Chilean and Colombian pesos, supported by strengthening recoveries and rising commodity export revenues, appreciated against the U.S. dollar in late 1999 and, in the case of the Chilean peso, early 2000. The Mexican peso also strengthened against the U.S. dollar in February–March 2000 on the back of higher oil prices and rising capital inflows. By contrast, Ecuador's currency lost more than half of its value against the U.S. dollar between September 1999 and early January 2000, reflecting the country's deepening economic and fi-

nancial crisis, but appeared to be stabilizing following the announcement of the government's intention to move toward dollarization.

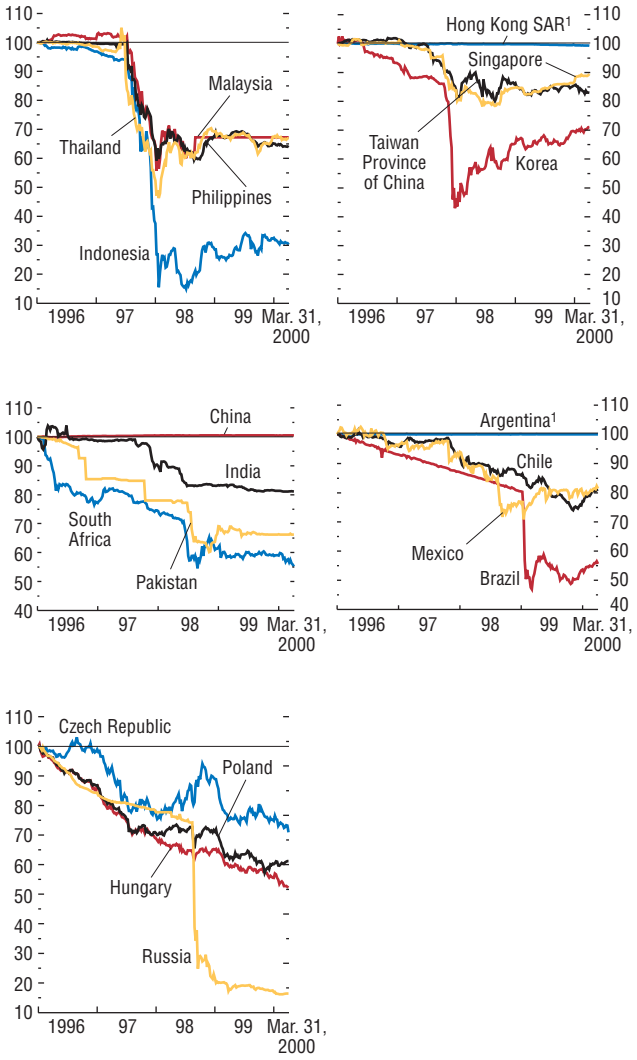
In central and eastern Europe, the Polish zloty weakened significantly in early November 1999 amid inflation fears and political uncertainty, but then rebounded following a tightening of the monetary policy stance and an easing of political uncertainties. In part reflecting the weakness of the euro, the zloty strengthened by around 15 percent against the euro between early November 1999 and the end of March 2000, as foreign inflows associated with privatization receipts and with portfolio investments in high yielding zloty assets surged. Several of the other currencies in the region, in particular the Czech and Slovak korunas, also faced upward pressure against the euro, and the Czech and Slovak authorities responded by intervening in the foreign exchange market. By contrast, the Russian ruble came under renewed downward pressure against the U.S. dollar in late 1999–early 2000, mainly because of a temporary easing of monetary conditions. The South African rand broadly stabilized at around 6.1 per U.S. dollar in the fall of 1999, but then weakened somewhat in early 2000.

With exchange rates stabilizing and inflation generally remaining under control, the monetary policy stances in most emerging market economies were eased considerably in the course of 1999, as reflected in *short-term interest rates* (Figure 2.3). In a number of cases, however, monetary policy has been put on hold since the early fall of 1999, either because of concerns about potential currency pressures or because further easing would have been inappropriate in view of strengthening recoveries and risks of overheating. The Bank of Korea held the overnight call rate steady at around 4¾ percent until early February 2000, when the rate was raised to 5 percent to narrow the spread between long- and short-term interest rates. Money market rates have stabilized in the 2 to 3 percent range in Malaysia and Thailand and at around 9 percent in the Philippines. In mid-November 1999, China reduced the required reserve ratio

Figure 2.2. Selected Emerging Market Economies: Bilateral U.S. Dollar Exchange Rates

(U.S. dollars per currency unit; January 5, 1996 = 100)

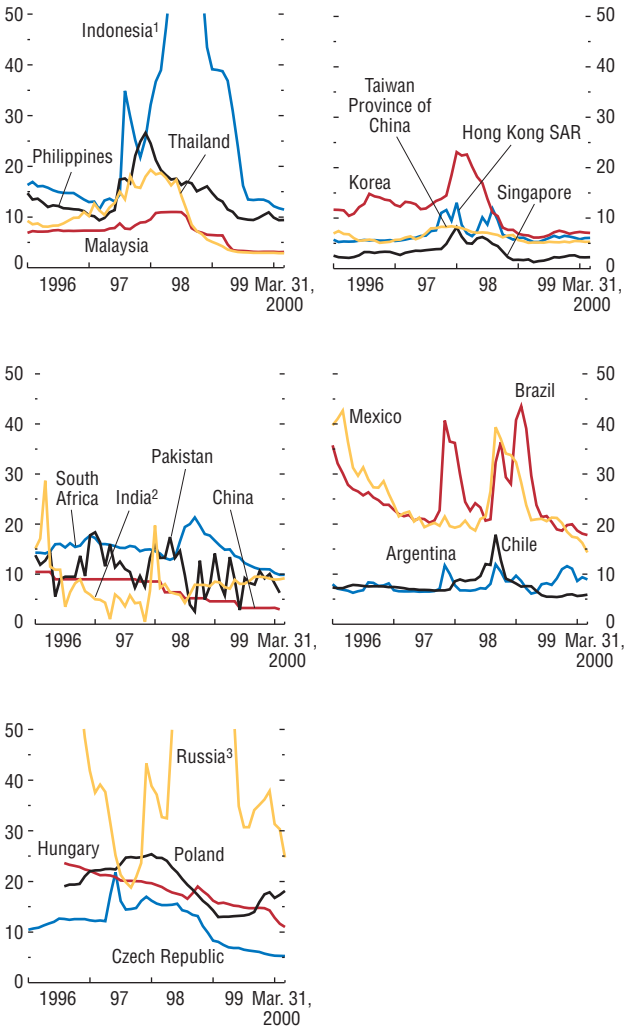
The currencies of most emerging market economies have been broadly stable against the U.S. dollar since the fall of 1999.



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

Figure 2.3. Selected Emerging Market Economies: Short-Term Interest Rates
(Percent)

Short-term interest rates in emerging markets have generally eased in the wake of Brazil's currency crisis.



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

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

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

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

from 8 percent to 6 percent to boost liquidity and encourage bank lending.

In Latin America, after having lowered the benchmark SELIC rate to 19 percent at the end of September 1999, from a high of 45 percent in late March, the Brazilian central bank abstained from further interest rate reductions during a six-month period to keep inflation under control. At the end of March 2000, the SELIC rate was cut to 18½ percent in view of the *real's* tendency toward appreciation and reduced concerns of the inflationary effects of higher oil prices. Also reflecting inflation-related considerations, the Mexican central bank reduced its daily lending to commercial banks so as to increase money market rates in mid-January 2000. By contrast, the Colombian central bank used a move to a free-floating exchange rate in the early fall of 1999 to ease monetary policy in support of the recovery, lowering its repo rate gradually from 17 percent in mid-August 1999 to 12 percent in mid-January 2000. Monetary policy was tightened again somewhat in February 2000 as the Colombian peso tended to weaken.

Elsewhere among the emerging market economies, the South African Reserve Bank continued to bring its repurchase rate down gradually during the second half of 1999, until it reached 12 percent by the late fall. At that time, the Reserve Bank fixed the rate to help reduce Y2K-related concerns. In mid-January 2000, when the float of the repurchase rate was resumed, the repurchase rate dropped by an additional 25 basis points. In Turkey, the introduction of a new crawling peg exchange rate regime supported by stronger adjustment policies in early January 2000, allowed the central bank to substantially cut its overnight bid and offer rates (Box 2.1). In central and eastern Europe, interest rate hikes in Poland and reductions in the Czech Republic and, in particular, Hungary, reflected differences not only in the growth, inflation, and current account outlook, but also in exchange rate regimes and monetary policy frameworks.

The improved prospects for the emerging market economies have also led to a further narrow-

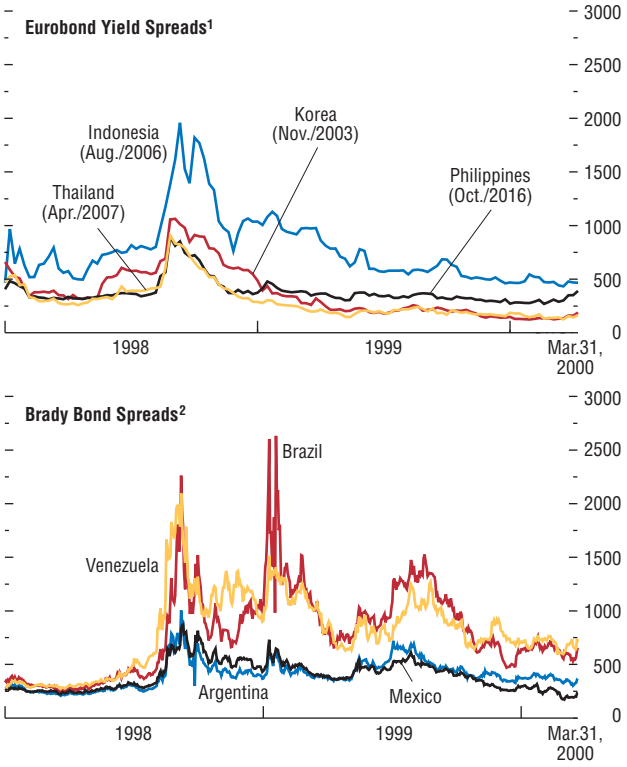
ing of *spreads on emerging market external debt* (Figure 2.4). Average spreads, as measured by the JP Morgan EMBI+ index, fell from around 1100 basis points at the end of September 1999 to a year-low of 824 basis points at the end of December, which was still well above levels observed before the Russian crisis, including those at the peak of the east Asian crisis in late 1997. During the first quarter of 2000, average spreads fluctuated in the 750 to 900 basis points range, broadly in line with movements in U.S. bond and equity markets. The overall narrowing in spreads during the fall of 1999 masks considerable regional differences, however, evidence of increasing investor differentiation among emerging markets. Spreads on bond issues by east Asian entities (except from Indonesia) were broadly stable at low levels during this period, after having eased in the first half of the year on the back of improvements in credit fundamentals. Spreads for Latin American countries, however, rose in mid-1999, reflecting concerns about U.S. interest rate movements and domestic fiscal policies, before easing again to year-lows by the end of 1999. They remain above spreads for the major east Asian borrowers, in line with Latin America's relatively high external vulnerability and uncertainties about the prospects for fiscal consolidation.

The improvement in secondary market conditions in emerging debt markets reflects a number of factors. In the early fall of 1999, investors grew more confident that the emerging market economies would avoid major Y2K-related problems and they began to anticipate a rally in emerging debt markets in early 2000. Investor pre-positioning for this expected rally brought it forward to November–December 1999. The rally was also supported by relatively small inflows of new money into the market and by some country-specific developments, in particular a sharp fall in spreads on Russia's external debt owing to the country's improved economic outlook and expectations of a restructuring agreement on Soviet-era debt held by London Club (commercial bank) creditors.

Average secondary market spreads do not appear to have been affected strongly by the fail-

Figure 2.4. Selected Emerging Market Economies: Eurobond Yield Spreads and Brady Bond Spreads
(Basis points)

External debt spreads for Latin American countries generally remain above those for their east Asian counterparts.



Sources: Bloomberg Financial Markets, LP; Reuters; and Salomon Brothers.
[1]Spreads are calculated relative to a U.S. treasury bond of comparable maturity.
[2]Stripped yields are adjusted to exclude both the value of collateral held as security against repayment of the bond and the value of coupon payments. Spreads are calculated relative to a U.S. treasury bond of comparable maturity.

Box 2.1. Turkey's IMF-Supported Disinflation Program

Macroeconomic instability—characterized by chronic inflation, wide swings in output, volatile interest rates, and persistent fiscal imbalances—has been the norm for the Turkish economy during the last two decades. The country launched at least five disinflation programs during the 1990s, but these were ineffective in lowering the inflation rate, which averaged over 80 percent over the period (see the first table). As a result, Turkey has been a striking exception to the disinflation trends observed worldwide since the 1970s.

The ultimate cause of chronic high inflation in Turkey has been the existence of deep structural weaknesses in public sector finances. Opaque indirect agricultural support policies, other nontransparent fiscal and nonfiscal activities by budgetary and nonbudgetary funds and state enterprises, and credit subsidies through state banks have contributed to substantial primary deficits.[1] These deficits have persisted since the 1970s and have been consistently monetized to alleviate the government's budget constraint (see the second table). As the inflation tax base eroded, however, the same level of money creation extracted lower amounts of seigniorage and provided further upward pressure on prices. Inflation was also sustained by a strong expectational component, which impeded the success of the disinflation programs of the 1990s. In particular, in the programs implemented in 1994–95 and 1998, the fiscal primary position strengthened significantly, and inflation performance also improved, but nominal interest rates failed to come down as envisaged. This was partly because financial markets remained worried about the sustainability of the situation, especially in the light of the crises in Asia and many other emerging market countries in 1997–98. The end result was sizable increases in real interest rates from already very high levels, thus undermining the authorities' resolve to continue disinflation.

The new disinflation program supported by the Stand-By Arrangement approved by the IMF Board on December 22, 1999 was designed to address upfront the issue of the credibility of

[1]For a more detailed analysis, see Rakia Moalla-Fetini, "Inflation as a Fiscal Problem," IMF Staff Country Report No. 00/14 (Washington: International Monetary Fund, February 2000), pp. 7–27. (This document is also available online at *www.imf.org*).

Disinflation Attempts

(percent change)

Disinflation Program (starting date)	Monetary Framework	Inflation Before the Beginning of the Program[1]	Inflation Target for the First Year of the Program[1]	CPI Inflation after Six Months[2]	T-Bill Rates Six Months After the Beginning of the Program	
					In nominal terms	In real terms[3]
Jan. 1990	Base money targeting	66.8	54.0	61.3	50.4	–2.3
Jan. 1992	Base money targeting	70.9	42.0	56.1	97.7	39.2
May 1994	Nonbinding crawling exchange rate floor	115.9	45.4[4]	71.9	113.2	47.0
Jan. 1995	"Enhanced" crawling floor[5]	125.1	40.0	100.4	103.2	44.5
Jan. 1998	Inflation targeting	90.4	50.0	46.8	92.2	28.0

[1]GDP deflator (annual average) for 1990; CPI (Dec./Dec.) for 1992; CPI (June/June) for 1994; CPI (Dec./Dec.) for 1995; WPI (Dec./Dec.) for 1998.

[2]CPI inflation in the first six months of the program, seasonally adjusted and annualized.

[3]Deflated with the inflation target.

[4]Inflation target for the period May 1994–April 1995, derived from the annual targets for 1994 and 1995 under the Stand-By Arrangement program.

[5]In addition to the announcement of quarterly exchange rate floors, the authorities were committed, in case of slack under the floor, to avoid a rate of depreciation significantly different from the targeted inflation rate. This commitment, however, was expected to guide interest rate policy, with no specific commitment on intervention policy.

Selected Macroeconomic Indicators

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Real sector (percent change)										
Real GDP	9.2	0.8	5.0	7.7	–4.7	8.1	6.9	7.6	3.1	–4.3
CPI (period average)	60.3	66.0	70.1	66.1	106.3	93.7	82.3	85.7	84.6	64.9
WPI (period average)	52.3	55.3	62.1	58.4	120.7	88.5	77.9	81.8	71.8	53.1
Monetary and exchange rate sector (percent change)										
Broad money	52.2	81.7	77.4	63.4	144.7	103.4	117.1	87.9	96.4	85.7
Bank claims on central government	36.5	74.9	60.2	78.8	123.6	83.9	240.2	105.7	186.7	124.1
Interbank money market rate (percent)	51.9	72.8	65.4	62.8	137.2	72.5	76.4	70.4	74.8	73.4
Exchange rate	23.0	59.9	64.7	59.9	170.1	54.0	77.4	86.6	72.0	60.6
Public sector (percent of GDP)										
Public sector balance	–7.6	–11.3	–12.4	–13.1	–10.2	–6.4	–13.2	–13.1	–15.9	–24.2
of which:										
Primary balance	–3.6	–6.2	–7.0	–5.6	–0.2	2.7	–1.2	–2.1	0.5	–2.7
Net debt of the public sector	28.8	35.2	35.7	35.1	44.7	41.3	46.5	42.9	44.5	58.0
External sector (percent of GDP)										
Current account deficit	–1.7	0.2	–0.6	–3.5	2.8	–0.5	–1.4	–1.4	0.9	–0.5
External debt	32.6	33.0	34.8	36.9	50.1	42.4	45.3	47.0	51.2	56.2

the disinflation effort. To this end, the program rests on three pillars: a large front-loaded fiscal adjustment; a strong exchange rate commitment underwritten by a no sterilization monetary policy rule and income policies; and a wide range of upfront structural reform measures. This is expected both to stabilize the fiscal situation and to bring CPI inflation down from 65 percent at the end of 1999 to 25 percent by the end of 2000, and to single digits by the end of 2002.

The front-loaded fiscal adjustment is necessary as fiscal weakness is at the root of the inflationary process. A shift in the primary position of the fiscal sector to long-term fiscal sustainability is to be undertaken in the first year of the program. In particular, the primary balance of the public sector is expected to improve from a deficit of 2.7 percent of GNP in 1999 to a surplus of 2.2 percent of GNP in 2000. The achievement of these fiscal goals will be facilitated by the tax package that was approved by Parliament in late November 1999 (the package includes important adjustments in a wide range of both indirect and direct taxes), as well as by additional revenue-boosting and expenditure-cutting measures that were included in the 2000 budget prior to its approval in late 1999. As the disinflation will bring about a temporary rise in the burden of interest payments relative to GDP, reflecting high ex post real interest rates while inflation falls, the improvement in the overall balance of the public sector will be more limited. Sizable privatization receipts will be used to keep the public debt-to-GDP ratio at its 1999 level this year.

The nominal anchor—absent in earlier programs—will be provided by a forward-looking commitment on the exchange rate. A nominal exchange rate anchor was chosen because of the high visibility and strong effect on prices that the exchange rate has in Turkey, the difficulty in finding suitable alternatives (money demand appears unstable), and the need to facilitate a rapid decline in interest rates. The exchange rate commitment (a preannounced exchange rate path with a devaluation rate of 20 percent) is supported by strong fiscal adjustment and consistent income policies in the government sector (civil servant and minimum wages will rise only in line with targeted inflation). In addition, the conduct of monetary policy will be guided by a rule, whereby base money will only be created by changes in the net foreign assets of the central bank (apart from short-term fluc-

Box 2.1 *(concluded)*

tuations). Finally, to avoid being locked in this rigid monetary framework beyond the disinflation stage, a preannounced exit strategy has also been incorporated. A gradual shift into a more flexible exchange rate regime (with widening symmetric bands around the preannounced exchange path) will be introduced in mid-2001.

A comprehensive and front-loaded structural reform agenda, which is expected to be supported by the World Bank, will underpin the program. The agenda includes privatization, a restructuring and strengthening of the banking sector, an overhaul of financial support to agriculture, and pension reform. In addition, fiscal management and transparency will be strengthened, and tax policy and administration improved. The structural reform effort is also expected to generate efficiency gains; limit contingent claims on the government; and, through increased privatization receipts, stabilize the level of public debt.

A breakthrough pension reform was implemented in mid-summer 1999, which will allow for a gradual but significant strengthening of the pension system. Additional changes in administration, coverage, compliance, and the legal framework (including legislative changes allowing for the creation of private pension funds) are expected to deepen these reforms in the coming years. In the agricultural area, the long-term goal is to replace existing indirect support policies with a direct income support system. In the interim, the government has taken several steps to contain the cost of the existing system, most notably by phasing out credit subsidies and support to industrial crops. As regards fiscal management and transparency, changes will be implemented to strengthen budget preparation, execution, and control, most notably through the implementation of an integrated financial system based on a single account and a general ledger. Fiscal transparency will be enhanced by broadening the effective coverage of the budget and by limiting the operations of quasi-fiscal entities. The tax system will be improved to provide for a broad revenue base with low and predictable tax rates.

Far-reaching reforms are also envisaged to address long-standing weaknesses of the banking sector. Legislation increasing the independence of supervisors and streamlining bank resolution procedures has already been passed, and a fully independent Banking Regulation and Supervision Agency has been established. Further changes in the regulatory framework—including the implementation of internationally accepted prudential regulations—are due to be implemented early in 2000. The program also includes measures to deal with the problems of the operations of state banks by increasing transparency and hardening the budget constraints facing their management. Finally, some commercial banks were taken over for restructuring by the deposit insurance fund at the inception of the program.

The privatization effort is another key area of reform. The government intends to sell large stakes in the telecommunications operator Turk Telecom and major state enterprises and to transfer operating rights for electricity distribution and power plants. This privatization program is expected to lead to significant efficiency gains in key sectors of the economy, and to also generate sizable budgetary proceeds, which will help achieve the program's fiscal goals. Total receipts from these operations are expected to reach about $7½ billion (about 3½ percent of GNP) during the course of 2000. The attainment of this target has been facilitated by major revisions in the legislation regarding privatization, including a constitutional amendment to allow for international arbitration, a law changing the role of the State Council, a new energy law, and a new telecommunications law.

Initial indications of the positive impact of the program are encouraging, including favorable developments in the fiscal area. Interest rates have fallen from over 90 percent in November 1999 to about 40 percent in January 2000, and sentiment on the part of foreign and domestic investors has been bullish, as reflected in strong gains in equity prices and successful international bond issues.

ures of certain emerging market economies to fully meet external payment obligations. In October 1999, Ecuador became the first country to default on Brady bonds after a swap offer had been rejected by investors. The country subsequently also defaulted on its other external debt, including a Eurobond loan. In mid-November 1999, Pakistan's government announced an offer to exchange three outstanding Eurobonds for a new six-year instrument with a three-year grace period, which was accepted by an overwhelming majority of the bondholders. In early February 2000, Ukraine announced an offer to exchange its outstanding external debt for new seven-year euro- and U.S. dollar-denominated Eurobonds so as to relieve its heavy debt burden in 2000 and 2001; the offer was accepted by bondholders owning more than 95 percent of the outstanding debt. Finally, in mid-February 2000, Russia reached an agreement with its London Club creditors on the rescheduling of Soviet-era debt. The agreement, which involves an exchange of outstanding debt for Eurobonds, reduces significantly the net present value of the debt and lengthens its maturity profile. The lack of contagion from these events to the other markets was a result of investors largely anticipating these difficulties and increasingly differentiating between countries.

The overall improvement in secondary market conditions since the fall of 1999 has not translated into a commensurate narrowing in average spreads for new issues at launch. The improvement was driven in part by lower secondary market spreads for some countries, including Russia, that still have to regain access to the primary market. In early 2000, major U.S. dollar-denominated issues by Argentina, Brazil, and Turkey were priced in the range of 500 to 600 basis points above Treasuries, and a Eurobond from Mexico carried a premium of 315 basis points; these terms showed only a moderate improvement when compared with primary market conditions prevailing in early 1999. Conditions improved, however, in February–March and these four countries—as well as South Africa and Venezuela—issued bonds at yield spreads that were significantly tighter than those they had faced in the late 1990s. Conditions were also more favorable for issues by a range of central and eastern European sovereigns, as they benefited from improved prospects for integration with the European Union.

Gross private financing flows (not including foreign direct investment flows) to emerging market economies remained subdued in the second half of 1999, as broader investor interest in instruments issued by these economies continued to be rather weak (Table 2.1). Bond issues rose in the final quarter of the year, but this pickup mainly reflected exchanges of Brady bonds for Eurobonds that generated only small amounts of net inflows. At around $173 billion for 1999 as a whole, gross private financing flows were only moderately above the low level recorded in 1998 and significantly below the 1996–97 average. The share of syndicated loan commitments continued to decline in 1999, largely because of ongoing changes in risk management practices at major banks. Equity issues, however, gained in importance, with activity by east Asian entities well above pre-crisis levels, as companies in the region reduced their traditional dependence on bank credit. Bond issues were broadly stable at 1998 levels in 1999 as a whole, with, however, a shift in regional composition toward east Asia. Bond issues, however, picked up considerably in the first quarter of 2000 as a number of major sovereigns came to the market, while activity in the syndicated loan and equity markets declined from end-1999 levels.

As a result of continued subdued levels of gross flows and substantial net repayments to banks, in particular in Asia but also in the Western Hemisphere, *net private capital flows* to emerging market economies in 1999 rose modestly to $80½ billion from a decade low of $75 billion in 1998 (Table 2.2). This small increase is accounted for by a decline in net outflows from Asia that more than offset a reduction in net inflows to the Western Hemisphere, where net repayments to foreign creditors rose and portfolio investment fell around the time of the Brazilian crisis. Net flows are projected to again decline to

Table 2.1. Gross Private Financing to Emerging Market Economies

(Billions of U.S. dollars)

				1999				2000			
	1997	1998	1999	Q1	Q2	Q3	Q4	Q1	Jan.	Feb.	Mar.
Total	**292.5**	**149.8**	**173.1**	**32.6**	**52.0**	**34.7**	**52.8**	**52.7**	**17.8**	**19.4**	**15.5**
Asia	128.6	35.0	62.7	11.9	17.1	17.4	16.4	20.5	2.6	12.5	5.4
Europe	37.7	35.9	26.0	3.2	7.9	5.1	9.8	7.6	2.7	1.7	3.2
Middle East and Africa	30.9	13.1	20.0	4.4	6.0	2.4	7.2	7.1	4.8	0.6	1.7
Western Hemisphere	95.3	66.1	64.4	13.2	22.0	9.8	19.4	17.5	7.6	4.6	5.3
Bond issues	**133.2**	**80.2**	**87.0**	**21.8**	**27.5**	**15.9**	**21.8**	**29.5**	**10.3**	**7.1**	**12.1**
Asia	45.5	12.4	24.1	7.0	6.3	6.2	4.7	6.8	1.5	1.4	3.9
Western Hemisphere	59.0	40.2	42.2	10.8	14.1	6.9	10.5	14.7	6.1	4.3	4.4
Other regions	28.7	27.6	20.6	4.1	7.1	2.9	6.5	8.0	2.7	1.4	3.9
Other fixed income	**10.0**	**0.5**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Asia	9.8	0.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Western Hemisphere	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other regions	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Loan commitments	**123.2**	**60.0**	**63.0**	**8.4**	**18.9**	**12.6**	**23.0**	**18.1**	**5.3**	**11.1**	**1.7**
Asia	58.9	17.7	20.3	3.5	5.1	5.9	5.8	10.8	0.3	10.2	0.3
Western Hemisphere	30.9	25.7	21.4	2.2	7.9	2.7	8.5	1.4	0.2	0.3	0.9
Other regions	33.4	16.6	21.2	2.7	5.9	4.0	8.6	5.9	4.8	0.6	0.5
Equity issues	**26.2**	**9.4**	**23.2**	**2.4**	**6.6**	**6.1**	**8.0**	**5.1**	**2.2**	**1.2**	**1.6**
Asia	14.4	4.5	18.3	1.4	5.7	5.3	5.8	2.9	0.9	0.9	1.2
Western Hemisphere	5.4	0.2	0.8	0.2	0.0	0.3	0.3	1.3	1.3	0.0	0.0
Other regions	6.4	4.8	4.1	0.8	0.9	0.5	1.9	0.8	0.0	0.3	0.5

Source: Capital Data Loanware and Bondware.

$71 billion in 2000, but to pick up considerably next year. With net direct investment expected to be broadly stable, the recovery will probably stem mainly from higher bond issuance and, in particular, from lower net reimbursement of bank loans. On a regional basis, the Western Hemisphere is projected to remain the main destination for funds, in line with the region's sizable current account deficits, which, as discussed later, increase its vulnerability to external financial shocks. The five east Asian economies most affected by the 1997–98 crisis are expected to see further, and increasing, net outflows in the form of reimbursement of bank loans and reserve accumulation in 2000, but positive net flows are projected to increase in the other emerging market economies of Asia this year. Flows to Africa are projected to remain modest this year and next.

Pronounced adjustments in the external accounts of the emerging market economies of the Western Hemisphere and Russia and continued sizable external surpluses in emerging Asia swung the combined current account balance position of the emerging markets economies into a $14 billion surplus in 1999, compared with a $51 billion deficit in 1998. The surplus is projected to widen moderately this year, as more robust growth and associated stronger import demand in the emerging market economies will be more than offset by the net beneficial impact of higher commodity prices elsewhere. The surplus of the east Asian countries is expected to narrow further and the deficits of the emerging market economies of the Western Hemisphere are projected to begin to widen again. But the combined current account positions of the countries in the Africa, Middle East, and Europe regions are projected to improve significantly in 2000, reflecting the net impact of higher commodity prices. Mainly owing to a further narrowing of east Asia's surplus and a widening of the deficit in the Western Hemisphere, and also to a renewed weakening of the current account position of the oil exporting countries, the overall current account position of the emerging market economies as a group is expected to swing into deficit again in 2001. The projected imbal-

Table 2.2. Emerging Market Economies: Net Capital Flows[1]
(Billions of U.S. dollars)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Total										
Net private capital flows[2]	112.6	172.1	136.3	226.9	215.9	147.6	75.1	80.5	70.9	127.8
Net direct investment	35.4	59.4	84.0	92.6	113.2	138.6	143.3	149.8	153.0	144.6
Net portfolio investment	56.1	84.4	109.6	36.9	77.8	52.9	8.5	23.3	30.4	33.5
Other net investment	21.0	28.3	–57.3	97.4	24.9	–43.9	–76.7	–92.5	–112.5	–50.3
Net official flows	21.2	17.2	3.4	11.7	0.4	23.5	44.7	3.0	14.4	6.6
Change in reserves[3]	–56.9	–63.7	–63.6	–117.9	–114.2	–73.1	–37.8	–78.5	–102.2	–100.7
Memorandum										
Current account[4]	–78.5	–118.9	–75.8	–107.0	–94.4	–72.1	–50.9	14.0	22.8	–25.5
Africa										
Net private capital flows[2]	–4.0	–1.8	2.9	10.9	7.5	16.7	11.5	14.8	16.1	15.9
Net direct investment	0.6	1.9	2.3	2.2	4.8	7.4	5.2	9.5	9.2	8.3
Net portfolio investment	1.8	1.0	2.0	1.4	1.3	3.7	4.3	4.4	2.6	2.3
Other net investment	–6.4	–4.7	–1.4	7.3	1.4	5.6	2.0	0.9	4.4	5.3
Net official flows	10.4	6.3	7.7	7.3	4.6	–1.4	2.5	1.6	–4.5	0.7
Change in reserves[3]	0.7	3.2	–6.0	–3.3	–9.2	–11.2	1.2	–3.0	–11.7	–7.4
Memorandum										
Current account[4]	–10.0	–11.2	–11.5	–16.5	–7.0	–7.4	–20.0	–16.8	–7.7	–13.8
Asia[5]										
Crisis countries[6]										
Net private capital flows[2]	29.0	31.8	36.1	74.2	65.8	–20.4	–25.6	–24.6	–40.6	–18.1
Net direct investment	7.3	7.6	8.8	7.5	8.4	10.3	8.6	10.2	12.0	7.2
Net portfolio investment	6.4	17.2	9.9	17.4	20.3	12.9	–6.0	6.3	6.6	3.0
Other net investment	15.3	7.0	17.4	49.2	37.1	–43.6	–28.2	–41.1	–59.2	–28.3
Net official flows	2.0	0.6	0.3	0.7	–0.4	17.9	19.7	–4.7	5.0	–1.9
Change in reserves[3]	–18.1	–20.6	–6.1	–18.5	–5.4	30.5	–52.1	–44.5	–17.2	–20.3
Memorandum										
Current account[4]	–16.1	–13.5	–23.2	–40.4	–53.0	–25.0	69.1	62.9	43.1	36.7
Other Asian emerging markets										
Net private capital flows[2]	–8.3	25.6	27.5	30.8	38.3	19.0	–17.0	–2.5	10.6	10.3
Net direct investment	8.4	26.3	38.3	39.1	44.6	45.1	49.7	39.6	41.3	39.3
Net portfolio investment	2.6	4.6	1.8	–3.2	–7.4	–9.4	–11.9	–11.9	–0.4	–3.5
Other net investment	–19.3	–5.3	–12.7	–5.1	1.1	–16.7	–54.7	–30.2	–30.4	–25.6
Net official flows	8.3	7.9	10.4	5.8	4.1	3.7	7.9	3.8	5.1	8.6
Change in reserves[3]	–6.6	–16.6	–47.3	–27.6	–44.8	–46.7	–18.2	–15.9	–32.9	–40.2
Memorandum										
Current account[4]	14.0	–8.2	16.8	–4.5	16.2	48.2	44.5	32.9	31.7	33.7

(continued on next page)

ance of $25½ billion would still be considerably below levels seen prior to the east Asian crisis.

The current account outlook for the emerging market economies remains subject to considerable uncertainty and could be affected by opposing forces. Stronger-than-expected recoveries led by domestic demand in east Asia and Latin America could result in wider-than-projected current account deficits, in part because sustaining the higher growth would require additional imports of capital goods. These higher deficits would probably be fully financed, to the extent that increased investor confidence associated with the improved growth prospects would tend to reduce spreads and boost inflows. Alternatively, unfavorable developments in the advanced economies, in particular higher-than-projected interest rate hikes or a sharper slowdown in the United States, could harm the prospects for emerging market economies for attracting inflows or boosting exports, and affect in particular economies with current account deficits. These economies would then need to adjust in order to reduce the deficits below those projected in the baseline scenario. This adjustment would require a combination of import compression and lower growth and could also lead to downward pressure on exchange rates.

Table 2.2 *(concluded)*

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Middle East and Europe[7]										
Net private capital flows[2]	38.0	28.7	16.0	13.9	15.2	24.0	21.9	27.1	–0.0	18.6
Net direct investment	1.1	4.3	6.1	5.5	2.1	2.9	2.7	3.3	8.7	9.5
Net portfolio investment	14.9	8.8	9.0	5.0	3.5	5.0	0.2	10.2	–0.1	7.9
Other net investment	22.0	15.7	0.8	3.3	9.6	16.0	19.1	13.5	–8.5	1.2
Net official flows	–1.3	2.3	–1.1	–1.2	–1.1	–0.7	–0.5	–1.8	0.6	–0.7
Change in reserves[3]	–8.7	1.6	–3.0	–9.2	–21.5	–20.7	14.7	–12.0	–13.7	–10.1
Memorandum										
Current account[4]	–26.7	–31.8	–7.9	–7.0	4.5	2.2	–31.1	–5.5	19.7	–4.7
Western Hemisphere										
Net private capital flows[2]	55.6	66.8	49.4	53.1	72.1	85.5	70.0	54.1	69.8	74.9
Net direct investment	13.9	13.4	23.1	24.7	39.5	53.1	56.1	63.6	57.0	55.4
Net portfolio investment	30.3	44.0	66.7	3.0	41.0	19.2	14.7	10.6	12.9	16.6
Other net investment	11.4	9.4	–40.4	25.5	–8.4	13.2	–0.8	–20.1	–0.2	2.9
Net official flows	–1.8	0.5	–3.6	8.1	–4.7	–3.6	6.1	3.6	6.8	–1.1
Change in reserves[3]	–22.6	–20.1	4.6	–21.9	–30.8	–15.3	17.4	5.1	–17.5	–12.0
Memorandum										
Current account[4]	–34.5	–46.0	–52.2	–36.8	–38.3	–64.1	–88.6	–54.2	–56.5	–60.8
Countries in transition										
Net private capital flows[2]	2.3	21.0	4.5	44.0	17.0	22.8	14.2	11.6	15.1	26.1
Net direct investment	4.2	6.0	5.4	13.6	13.7	19.7	21.0	23.5	24.8	24.8
Net portfolio investment	0.1	8.7	20.0	13.3	19.2	21.5	7.2	3.7	8.9	7.1
Other net investment	–2.0	6.3	–21.0	17.1	–15.8	–18.4	–14.0	–15.6	–18.6	–5.8
Net official flows	3.6	–0.4	–10.3	–9.0	–2.1	7.6	9.0	0.6	1.4	1.0
Change in reserves[3]	–1.7	–11.2	–5.7	–37.4	–2.4	–9.6	–0.8	–8.2	–9.2	–10.7
Memorandum										
Current account[4]	–5.1	–8.2	2.1	–1.8	–16.9	–26.1	–24.8	–5.3	–7.5	–16.7

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

Commodity Market Developments

World commodity prices have strengthened considerably since the middle of 1999, as reflected in an increase in the IMF's overall index of primary commodity prices by more than 25 percent in U.S. dollar terms between June 1999 and March 2000. While a large part of this has been due to the continued increases in oil prices, the index of nonfuel commodity prices has also begun to pick up, rising 5 percent during this period (Figure 2.5). This increase in nonfuel commodity prices has, however, not been uniform. There are significant differences in the behavior of prices across commodity groups, and these prices overall have yet to recover from their late 1990s slump (see Box 2.2).

In the oil market, the sharp rally in prices seen in the first half of 1999 gathered pace in the second half of the year, and in early March 2000 prices reached a nine-year high. The tightness of the world oil market has been mainly a consequence of the relatively high compliance to production cuts agreed to by major oil producing countries in March 1999. The one-year agreement stipulated that the Organization of Petroleum Exporting Countries (OPEC) members and four non-member countries (Mexico, Oman, Norway, and Russia) would cut supply by

4.7 million barrels a day, or about 6 percent of world output. The rate of compliance—the ratio of actual to agreed production cuts—declined from more than 90 percent in the late summer of 1999 to 75 percent in early 2000, but this decline did not put significant downward pressure on prices.

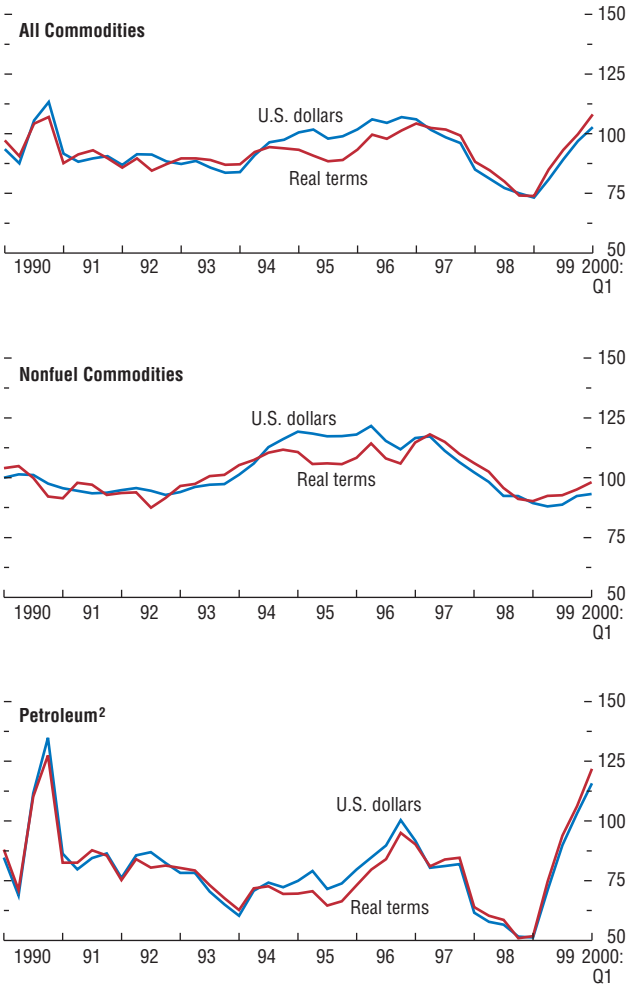
In late 1999 and early 2000, supply side constraints interacted with a sharp increase in demand partly due to the cold weather in North America and partly reflecting the strengthening of global activity. The result was a marked drawdown in commercial inventories, which fell to their lowest level since the 1970s. Oil prices peaked in early March 2000, but then eased on expectations that the OPEC meeting at the end of the month would agree to raise production. At the meeting, nine OPEC members indeed agreed to raise official production ceilings from April 1 by 1.45 million barrels a day or 7½ percent. Iran and non-members Mexico and Norway announced additional production and export increases to the tune of 0.5 million barrels a day. Following the end-March agreement, oil prices stabilized at around $25 per barrel, down by about 20 percent from the early-March high but still up by more than two-thirds from levels one year before.

Prospects for oil prices remain subject to considerable uncertainty stemming from both demand and supply factors. On the demand side, prospects are highly dependent on the strength of the rebound in global economic activity. The evolution of supply will reflect compliance by OPEC with the announced new production ceilings, Iraq's future output levels (Iraq is an OPEC member but operates outside OPEC agreements because of international sanctions), and the supply response to higher prices from non-constrained market sources. The latter could result from either the reactivation of oil fields closed during the 1998 oil price slump or, over a longer period, the introduction of new capacity. As discussed in Box 2.3, price reversals in the oil market can be abrupt and severe, and their timing cannot be predicted by referring to the pattern of past price cycles.

Figure 2.5. Prices of Crude Petroleum and Nonfuel Commodities[1]

(1990 = 100)

Oil prices have increased sharply since early 1999, while the recovery in nonfuel commodity prices has been more modest.



[1]Indices in real terms are obtained by deflating the nominal U.S. dollar price series by the unit value of manufactures exported by 20 industrial countries.

[2]Average Petroleum Spot index of UK Brent, Dubai, and West Texas.

Box 2.2. Cycles in Nonfuel Commodity Prices

Cycles are a dominant feature of movements in world commodity prices. Indeed, dealing with the economic consequences of rapid (and often unexpected) transitions from periods of rising prices to falling prices is among the most challenging issues facing policymakers from the many developing countries that rely on exports of primary commodities. It is therefore important to understand the properties of commodity-price cycles, and to put recent price movements in a longer-run perspective.[1]

In this Box, commodity-price cycles are identified with reference to turning points of the underlying price series, and are demarcated by price peaks and troughs that are determined using a cycle-dating procedure. Periods from troughs to peaks—that is, periods of generally rising commodity prices—can be described as booms, and periods from peaks to troughs as slumps.[2]

Cycles in the real index of prices of nonfuel commodities from 1957 to 1999 are depicted in the first figure, with booms denoted by no shading and slumps by dark shading. The cycles are demarcated by peaks (solid line) and troughs (dashed line). The first trough in nonfuel prices is in late 1960 and the first peak in early 1966, while the second trough is in late 1971. The first half of the 1960s is therefore the first boom phase for nonfuel prices, and the period of the late 1960s and early 1970s the first (completed) slump phase.

Cycles in Real Prices of Nonfuel Commodities, January 1957–November 1999[1]
(1990 = 100)

Sources: IMF, *International Financial Statistics;* and IMF staff estimates.

[1]Cycles are demarcated by peaks (solid line) and troughs (dashed line), with periods from peaks to troughs being slumps (shaded areas), and periods from troughs to peaks being booms (no shading).

There have been four completed cycles in the nonfuel index, and about 64 percent of the sample has been spent in a slump phase, indicating that there is quite a large difference in the duration of booms and slumps. The period during which the greatest slump in the nonfuel index occurred was from early 1977 to early 1987—almost an entire decade—when the index fell by close to 50 percent; the biggest boom occurred from late 1971 to early 1974, when the index rose by about 44 percent in just over two years, with almost all of the price rise occurring in the last few months of this period.

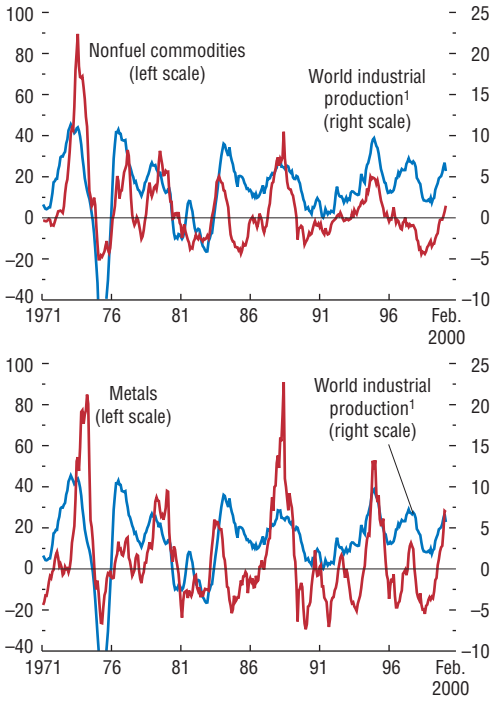
Imbalances between world consumption and production of commodities, related to develop-

[1]For analyses of the time series properties of commodity prices, see Angus Deaton and Guy Laroque, "On the Behaviour of Commodity Prices," *Review of Economic Studies*, Vol. 59 (1992), pp. 1–25; Angus Deaton, "Commodity Prices and Growth in Africa," *Journal of Economic Perspectives*, Vol. 13 (1999), pp. 23–40; and Paul Cashin, Hong Liang, and C. John McDermott, "How Persistent Are Shocks to World Commodity Prices?" *IMF Staff Papers*, forthcoming.

[2]This is done through a pattern-recognition procedure that determines the location of peaks and troughs using rules restricting the minimum length of booms, slumps, and complete cycles. A more detailed description of the procedure, and its application to dating booms and slumps in commodity prices, can be found in Paul Cashin, C. John McDermott, and Alasdair Scott, "Booms and Slumps in World Commodity Prices," IMF Working Paper 99/155 (Washington: International Monetary Fund, 1999).

World Industrial Production and Commodity Prices

(Percent change from a year earlier)



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

[1]Three-month centered moving average, based on data for 32 advanced and emerging market economies representing about 75 percent of world output. Data through 1994 exclude one or more countries.

ments in world industrial production, underpin the timing and duration of many of these booms and slumps (see the second figure). The long slump in nonfuel commodity prices during the period of the late 1970s to mid-1980s (which included some temporary upward price movements) was associated with a deceleration in real economic growth in industrial countries, as well as a number of supply factors: record production of food, beverages, and agricultural raw materials that created large carryover stocks, and high capacity and production of metals. The recovery in commodity prices over the next year-and-a-half followed the pickup in economic activity in industrial countries. The recovery was particularly pronounced for industrial inputs, after years of production cutbacks, but less so for food and beverages, as production of these goods had not been curtailed to the same extent during the preceding price slump.

The subsequent short-lived recovery was followed by another slump in commodity prices from mid-1988 to mid-1992. The decline in prices in the second half of 1989 was mainly due to large decreases in the prices of metals caused by a weakening demand from durable goods manufacturers, particularly in Japan and the United States. From mid-1992 to mid-1997 there was a recovery in prices (punctuated by some sharp price declines), following the strong economic performance by some major industrialized countries and many emerging market economies. From 1997 onwards the prices of nonfuel commodities entered another slump, from which they have yet to emerge, as the Asian crisis followed by the Brazilian and Russian crises contributed to a sharp downturn in commodities prices.

Several striking facts about these periods of boom and slump can be identified. There is an asymmetry in commodity-price cycles, as the average duration of slumps (63 months) is almost double the average duration of booms (37 months). The magnitude of price falls in a typical slump is slightly larger than the magnitude of price rebounds in a subsequent boom (falls of 37 percent and rises of 28 percent, respectively). This differing relative magnitude of price changes has resulted in an overall downward movement in real nonfuel commodity prices over the past 34 years. Third, large shocks to the nonfuel index occur quite frequently. Finally, there is no apparent relationship between the severity of price slumps and booms and their duration, nor does the probability of a boom or slump ending depend on the length of time already spent in the boom or slump.

There is a common perception that the prices of individual primary commodities move together. This proposition is broadly supported using correlations of prices for a set of unrelated commodities (cocoa, copper, cotton, crude oil,

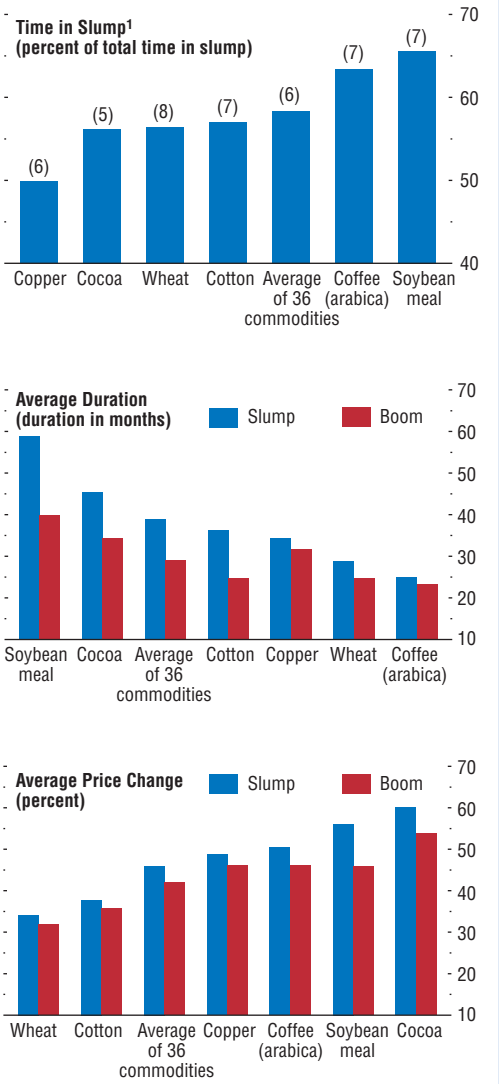
Box 2.2 *(concluded)*

gold, lumber, and wheat)—unrelated in that they are not coproduced, are not obvious substitutes or complements, and are not inputs to the production of another.[3] When co-movement is defined in terms the proportion of time that the prices of pairs of commodities are both in a boom or slump period, however, there is much less evidence that prices for these six commodities move together over the last 34 years, except for gold and oil prices, which may be linked by inflation expectations. Consequently, there is some doubt as to the validity of the notion that prices of unrelated commodities move together.[4] This reflects the importance of supply factors in the behavior of individual commodity prices. Movements in world demand can affect many commodity prices in a similar manner, but the supply side of markets for individual commodities differs considerably, limiting comovement in prices across individual commodities.

These results suggest that caution is warranted when drawing policy implications for developing countries from analyses of movements in aggregate commodity price indices, such as the IMF's index of nonoil commodity prices. For industrial countries, which import a wide range of commodities, aggregate commodity price indices may be useful indicators of general movements in commodity prices. But developing countries often export only a limited range of such goods. In such cases, market conditions faced by a particular commodity-exporting country will not be well-represented by an aggregate index formed from indices of individual commodities, whose prices do not move synchronously. Accordingly, it is important to examine developments in the prices of individual commodities.

Given the limited co-movement in the prices of individual commodities, an analysis of the key features of cycles in the prices of six important nonfuel commodities—cocoa, coffee (arabica), copper, cotton, soybean meal, and wheat—can be informative. These commodities are also representative of the range of outcomes observed

Features of Cycles in Selected Commodity Prices, January 1957–August 1999



Source: IMF staff estimates.
[1]Number of cycles in parentheses.

[3]See Robert Pindyck and Julio Rotemberg, "The Excess Co-Movement of Commodity Prices," *Economic Journal*, Vol. 100 (1990), pp. 1173–89.

[4]See Paul Cashin, C. John McDermott, and Alasdair Scott, "The Myth of Comoving Commodity Prices," IMF Working Paper 99/169 (Washington: International Monetary Fund, 1999).

for the 36 individual commodities that comprise the IMF's index of nonfuel commodities.[5]

For the six selected commodities, complete cycles range from a low of five for cocoa to a high of eight for wheat (see the third figure). The length of booms and slumps appears to be nearly symmetric for copper, yet the price of soybean meal has spent a clear majority of its time in a slump. Apart from the beverages (cocoa and arabica coffee), the biggest booms in prices coincide with the first oil shock of the early 1970s and largest slumps in prices (apart from cocoa and cotton) in the years immediately following this oil shock. For three of the six individual commodities (cocoa, arabica coffee, and wheat), there is some evidence that there is a relationship between the severity of commodity price slumps and their duration, yet for no commodity is there evidence of a relationship between the severity of price booms and their duration.[6]

The asymmetry in duration of slumps and booms observed in the aggregate index can also be seen for the six selected commodities in the third figure, which orders the commodities by the (decreasing) duration of slumps. The duration of the phases varies quite dramatically across the six commodities, ranging from an average slump of about 59 months for soybean meal to an average slump of 25 months for the price of arabica coffee. The average price decline during commodity price slumps is in most cases slightly larger than average price rise during commodity price booms. Indeed, for each of the six commodities analyzed, the differing relative magnitude of price movements in booms and slumps results in a downward trend in real prices.

These findings suggest that there is relatively little consistent pattern to cycles in the prices of individual nonfuel commodities, and emphasize the importance of examining developments in individual commodity markets, in addition to movements in aggregate commodity price indices.

[5]Monthly data on the real price of these commodities is taken from the International Monetary Fund's *International Financial Statistics*.

[6]These results are consistent with earlier findings in the literature, in particular of commodity prices declining at a steady rate, interspersed with sharp booms (see Angus Deaton and Guy Laroque, "On the Behaviour of Commodity Prices").

Indications are that OPEC members intend to keep oil prices at relatively moderate levels and want to avoid the large price swings observed between the end of 1998 and early 2000. They have announced more frequent meetings to review market developments and output adjustments if prices were to move outside the $22 to $28 per barrel range. As a result, the sharp price fluctuations seen in the first quarter of 2000 may be dampened and the "backwardation" (a situation whereby futures prices for the nearest months are higher than those for delivery in later months) in the oil futures markets reduced. The baseline assumption is for oil prices this year to average $24½ per barrel compared with $18¼ in 1999, an increase by 35 percent.

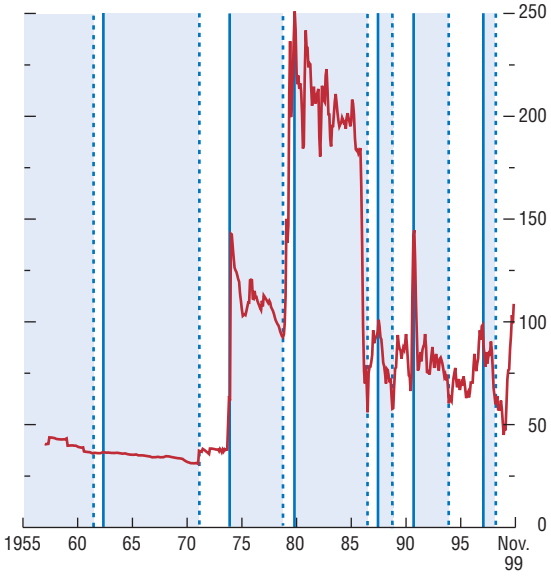
The higher level of world oil prices in 2000 is expected to raise significantly the export receipts of the oil exporting countries, with a corresponding increase in costs to oil importers. The direct (first round) effect on oil exports and imports of a $5 per barrel increase in world oil prices from their 1999 average levels is estimated to be around $60 billion, assuming the volume of oil trade was unchanged at 1999 levels. On a regional basis, the bulk of the higher oil export revenues would accrue to the Middle Eastern exporters, to the tune of almost $30 billion. Outside of the Middle East, oil trade is largely balanced across the main emerging market economy regions, so that oil importing advanced economies would absorb most of the higher oil import costs. Taking into account second round effects, however, the impact on current account positions would be significantly more limited. Oil exporting countries are likely

Box 2.3. Booms and Slumps in the World Oil Market

Movements in world petroleum prices have traditionally played an important part in world economic activity and inflation. Following the high-price period of the mid-1970s to mid-1980s, real petroleum prices have remained relatively flat. However, petroleum prices rose strongly during 1999 and early 2000, due largely to supply constraints, after having sharply declined during 1998. This Box presents a discussion of some stylized facts of cycles in oil prices.

Monthly data on the real price of oil, taken from the IMF's *International Financial Statistics* for the period 1957 to 1999, are shown in the figure. Also depicted are the results of the application of the cycle-dating procedure described in Box 2.2. The cycles are demarcated by peaks (solid line) and troughs (dashed line), with periods from peaks to troughs being slumps (dark shading), and periods from troughs to peaks being booms (no shading).[1]

Cycles in Real Petroleum Prices, January 1957–November 1999[1]
(1990 = 100)



Sources: IMF, *International Financial Statistics;* and IMF staff estimates.
[1]Cycles are demarcated by peaks (solid line) and troughs (dashed line), with periods from peaks to troughs being slumps (shaded areas), and periods from troughs to peaks being booms (no shading).

The first completed boom and slump phases, in the early 1960s and from the middle of 1962 to early 1971, are likely to be artifacts of the structure of world oil markets. During this period, oil prices were largely unchanged in nominal terms as a result of price-setting by the Seven Sisters oil oligopoly, but eroded in real terms in line with world inflation, with cyclical movements in real oil prices reflecting fluctuations in the relative price of manufactures. Oil prices rose sharply following the first and second Organization of Petroleum Exporting Countries (OPEC) oil shocks, and these shocks were the main factors underpinning the boom periods of the early and late 1970s. Following the short-lived 1978–79 boom, there was a long slump in prices from the end of 1979 until mid-1986, interspersed by some short-term ups and downs, particularly at the beginning of the period. The 1979–86 slump was largely attributable to the breakdown of OPEC's constraints on production, with almost all of the price decline occurring in the last few months of this period. During the rest of the 1980s, there were consecutive booms and slumps as OPEC's effectiveness in constraining supply waxed and waned, and demand for oil remained relatively flat. Following the sharp jump in oil prices caused by the 1990–91 Gulf crisis, the slump in the early 1990s was largely caused by the industrial country recession during that period. Oil prices boomed again between the end of 1993 and early 1997, due to rising demand for oil, but then entered another slump phase (distinguished by a rather sharp fall in prices of 2.8 percent a month), largely due to weak Asian demand for oil and excess supply. At present oil prices are in another boom phase, having

[1]For further details see Paul Cashin, C. John McDermott, and Alasdair Scott, "Booms and Slumps in World Commodity Prices," IMF Working Paper 99/155 (Washington: International Monetary Fund, 1999).

reached their lowpoint in December 1998, with price rises largely driven by high compliance with the latest OPEC agreement to curtail production.

The oil market has had six completed cycles over the sample period, spending 71 percent of the time in a slump phase. This indicates that oil price changes are not symmetric in duration. On average, the duration of slumps (51 months) is more than double the duration of booms (22 months). When they occur, price slumps and booms can sometimes be severe—the maximum change in oil prices during slumps is a fall of 79 percent and during booms a rise of 78 percent. Not surprisingly, the biggest boom period for oil occurred between early 1971 and early 1974 (at the time of the first oil shock), while the greatest slump occurred between late 1979 and mid-1986. On average, the magnitude of price falls in a slump is slightly smaller than the magnitude of price rebounds in a subsequent boom (falls of 45 percent and rebounds of 48 percent, respectively).

These features of past cycles, however, do not allow us to make inferences about the duration and shape of future cycles. There is little evidence of a consistent "pattern" to oil price cycles, as there is no relationship between the severity of oil price slumps and booms and their duration. There is also no indication that the probability of ending a slump or boom in oil prices is dependent on the time already spent in that slump or boom.

Consistent with earlier work, these empirical findings support the view that oil price shocks tend to be long-lived, with prices steadily declining in slumps, interspersed by sharp booms.[2] These booms and slumps are typically associated with institutional changes in the world oil market, such as the implementation and collapse of supply-constraining agreements among major oil producers. Following sharp and virtually uninterrupted increases since the beginning of 1999, oil prices in February 2000 were two-and-a-half times as high as one year earlier. Despite their pronounced character, these recent price movements are not informative for determining when the current boom in oil prices might end, which appears to depend much more on supply conditions and, in particular, the behavior of OPEC.

[2]The behavior of real oil prices exhibits a substantial asymmetry, as there are few large downward spikes to balance the many large upward spikes in prices.

to use some of the additional export revenue to ease spending restraints adopted during the 1997–98 price slump, and increase non-oil imports. A MULTIMOD simulation suggests that the overall deterioration in the current account positions of the oil importing main industrial countries could be about $20 billion. Financially constrained oil importing developing countries, however, would cut other imports to the extent the higher oil import bill could not be covered through additional external financing.

The projected higher level of oil prices will have an impact on other macroeconomic variables as well. As discussed in Box 1.4 of the October 1999 *World Economic Outlook*, the overall effect on inflation and growth in both the major industrial countries and the oil importing emerging market economies should remain relatively modest, in contrast to the early 1970s, due to the reduced importance of oil in world production and consumption. The scenario would become more unfavorable if the increase in oil prices were large enough to trigger a significant increase in inflationary pressures, which would necessitate preemptive monetary tightening in the industrial countries. However, the impact effect on inflation so far has been limited to the energy components of general price indices, without second round effects on wages and other costs. According to MULTIMOD, the overall inflationary effect of a $5 per barrel price increase is not expected to exceed ½ of 1 percent in the United States and the euro area and ¼ of 1 percent in Japan in the first year. The impact

on real GDP is also expected to be relatively small in both oil importers and exporters because rising oil prices have only limited effects on incentives to produce. The more important impact is on real incomes and domestic demand through the terms of trade. The simulation indicates that in response to a $5 per barrel oil price increase, domestic demand could decline by around ½ of 1 percent in the euro zone and by somewhat more than ¼ of 1 percent in Japan and the United States—about double the impact on real GDP in all three cases. The oil importing emerging market economies are expected to experience significant terms-of-trade losses, although these will be moderated in a number of cases, most notably Brazil and South Africa, by the impact of higher nonfuel commodity prices. The oil exporting countries will benefit from considerable terms-of-trade and real income gains. Outside the Middle East region, Indonesia, Mexico, Russia, and Venezuela will be the main beneficiaries.

With regard to nonfuel commodity prices, all the main aggregate price indices appear to have bottomed out since the summer of 1999. This has brought to an end a cyclical decline in nonfuel commodity prices by over 30 percent from their peak in May 1996 (Box 2.2). This decline had been longer and deeper than the two previous cyclical declines in the early and late 1980s. Part of the reason for the severity of the declines this cycle was a stronger than usual confluence of significant supply and demand shocks, with a deceleration in the rate of growth of world consumption that coincided with sustained production increases. The slowdown in consumption was associated particularly with the economic difficulties in east Asia: several of the Asian crisis countries had exhibited rapid growth in the consumption of primary commodities prior to the 1997–98 crisis. At the same time, production of many commodities had continued to increase rapidly, owing to technological innovations that lowered production costs, and, in the case of agricultural commodities, lengthy periods of favorable weather that resulted in exceptionally good harvests.

The recent pickup in nonfuel commodity prices is due to a reversal of these supply/demand factors. The story is somewhat different for specific commodities. For most agricultural products, tighter supply conditions due to bad weather and a pickup in demand growth have led to some limited price increases. The increase in prices for agricultural raw materials reflects mainly timber prices, which strengthened throughout 1999 due to strong demand in the U.S. housing sector and tight supplies of tropical timber in Asian markets. For industrial metals, prices tend to be driven by the cycle in world industrial production, and the upturn in the production cycle since the summer of 1999 has continued to push metals prices up. This has been aided by cuts in production, as in the case of copper, and supply disruptions, as in the case of nickel.

The prospects for the nonfuel commodity prices this year are mixed. The high level of stocks for most agricultural commodities are likely to preclude a significant rise in prices. In the case of metals, although stocks generally also remain at high levels, the synchronized increase in world growth is increasing demand rapidly. Metals prices are expected to continue to increase over the near term.

For exporters of nonfuel commodities, the net effects of this year's projected 5 percent average price increase depend on the specific commodities that they export (in addition to quantity effects related to weather and other supply disturbances) and on the extent of their dependence on imported oil. On balance, growth prospects this year for nonfuel commodity exporters appear to be marginally worse than had been projected in the October 1999 *World Economic Outlook,* but these countries' external imbalances would be reduced.

Policy Responses and Vulnerabilities in Latin America

The Latin American economies experienced recessions in varying degrees in 1998–99 as they adjusted to contagion from the east Asian crisis

and from Brazil's currency devaluation in January 1999.[1] However, they generally avoided the sharp economic downturns observed in east Asia during the regional crisis. With a few notable exceptions, the recessions were mostly short-lived, and recoveries were already under way by the third quarter of 1999 as demand for the region's exports rose and conditions in international financial markets improved. Inflation continued to decline in most cases and, in spite of sizable currency depreciations, increased only moderately in Brazil and Colombia, held back by significant output gaps and, in Brazil, tight fiscal and monetary policies.

Compared with the generally similar output and inflation patterns among countries in east Asia during the 1997–98 crisis, developments during Latin America's region-wide recessions of 1999 were considerably more heterogeneous (Figure 2.6). In Mexico, year-on-year growth, while remaining positive, slowed in late 1998 and further in early 1999, but picked up to above 4 percent in the second half of the year. In Brazil, where growth had already turned negative in the latter part of 1998, the additional adverse output effects from the January 1999 financial crisis were shallow and short-lived, and output growth rebounded to 3 percent in the last quarter of the year compared with one year before. By contrast, Argentina, Chile, Colombia, and Venezuela continued to be confronted with rather sharp recessions in the first half of 1999, followed by recoveries in the fourth quarter (although year-on-year growth remained negative in Colombia and Venezuela in late 1999). Ecuador has yet to recover from its deep recession. The inflation picture was equally diverse, with consumer price inflation at the end of 1999 ranging from below zero in Argentina to 61 percent in Ecuador.

The recessions generally did not lead the authorities to relax macroeconomic policies, in marked contrast to episodes in earlier decades. Reflecting the heterogeneity in cyclical patterns, however, policy responses, while aimed overall at maintaining macroeconomic stability, were quite diverse. Moreover, underlying fiscal deficits in Latin America remain rather large, contributing to the region's relatively low national saving rates and sizable external financing needs, as discussed below. In a number of countries, the financial crises and ensuing weakness of activity also prompted the authorities to abandon fixed exchange rate regimes. Brazil, Chile, and Colombia adopted flexible exchange rate arrangements, while Ecuador moved toward dollarization.

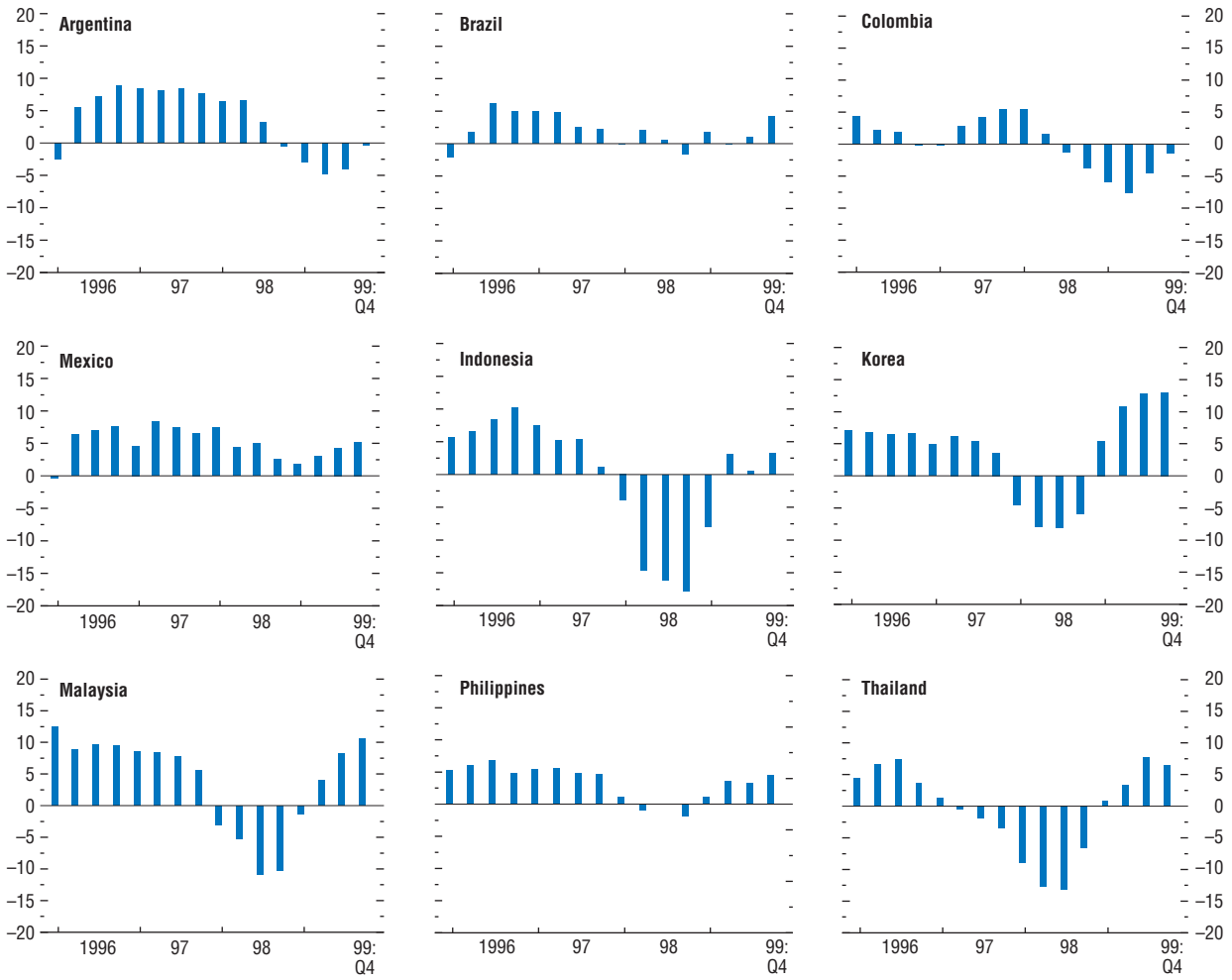
Brazil and Mexico generally pursued stability-oriented policies. Brazil's monetary policy was partially supportive of the recovery from April until late September 1999, but then turned more restrictive as concerns over a pickup in consumer price inflation and continuing pressure on the exchange rate prompted the central bank to refrain from further interest rate reductions. The fiscal authorities sustained their adjustment efforts in 1999 through a combination of tight expenditure controls and revenue enhancing measures, and the primary balance of the consolidated public sector swung into a surplus of just over 3 percent of GDP from a deficit of 1 percent in 1998; further consolidation and a surplus of 3¼ percent of GDP are targeted for 2000. In Mexico, monetary policy continued to focus on bringing down inflation to single digits, with progress toward this objective providing scope for further interest rate reductions. Sustained fiscal consolidation, facilitated by solid growth, helped Mexico achieve an overall fiscal deficit target of 1¼ percent of GDP for 1999 (Table 2.3). Chile, by contrast, was able to pursue counter-cyclical monetary and fiscal policies in response to the sharp downturn in early 1999. Real interest rates were brought down sharply and a fiscal stimulus package involving additional spending was introduced. Monetary policy was tightened in January 2000 and further in March to prevent inflation from picking up as the recovery gained momentum.

[1]For the purpose of this section, the Latin American economies comprise the Western Hemisphere developing countries for which private flows are the main source of external financing.

Figure 2.6. Selected Emerging Market Economies: Quarterly Real GDP

(Percent change from four quarters earlier)

The emerging market economies of Latin America experienced recessions of varying degrees in 1999. The east Asian countries have rebounded strongly from deep recessions.



Sources: Country authorities; and IMF staff estimates.

Table 2.3. General Government Balance
(Percent of GDP)

Country	1994	1995	1996	1997	1998	1999
Argentina	–1.8	–2.3	–3.2	–2.0	–2.1	–3.8
Brazil	–3.3	–7.0	–5.9	–6.3	–8.1	–10.0
Chile	2.5	3.9	3.1	2.5	0.1	–2.0
Colombia	–0.8	–0.8	–2.5	–3.0	–3.6	–6.4
Mexico	–0.1	–0.9	–0.3	–1.4	–1.2	–1.6
Indonesia	0.0	0.8	1.2	–0.7	–1.9	–2.3
Korea	1.0	1.3	1.0	–0.9	–4.0	–2.9
Malaysia	3.3	2.2	2.1	4.0	–1.0	–4.1
Philippines	–1.8	–1.4	–0.4	–0.8	–2.7	–4.4
Thailand	1.9	3.0	2.5	–0.9	–2.5	–3.0
			Of which: central government			
Argentina	–0.5	–1.5	–2.2	–1.1	–1.3	–2.5
Brazil	0.1	–2.3	–2.6	–2.6	–5.5	–7.4
Chile	2.5	3.9	3.1	2.5	0.1	–2.0
Colombia	–1.4	–2.8	–4.5	–3.5	–5.2	–7.1
Mexico	–0.4	–1.6	–1.0	–1.6	–1.6	–1.1
Venezuela	–7.3	–4.3	0.6	1.6	–2.6	–3.0
Indonesia	0.0	0.8	1.2	–0.7	–1.9	–2.3
Korea	0.1	0.3	0.0	–1.7	–4.4	–3.5
Malaysia	1.4	1.3	1.1	2.4	–1.5	–3.5
Philippines	–1.8	–1.4	–0.6	–0.8	–2.7	–4.4
Thailand	2.0	2.5	1.0	–1.7	–2.9	–3.7

The macroeconomic policy mix has been somewhat less balanced in Argentina, Colombia, and Venezuela. In Argentina, the fiscal deficit widened considerably toward the end of 1999, despite the incipient recovery, largely as a consequence of an election-related weakening in tax compliance and spending overruns at both the federal and provincial levels of government. Faced with the risk of a further deterioration of the public sector finances in 2000, the federal government at the beginning of the year introduced selective cutbacks in spending and enacted a package of tax measures so as to reduce the federal budget deficit to 1½ percent of GDP, down from 2½ percent in 1999. In Colombia, the fiscal position deteriorated markedly during the first half of 1999, as the economy contracted. A widening deficit was not so much the result of deliberate counter-cyclical measures but rather the consequence of unintended additional spending, in part because of an adjustment in nominal salaries and pensions based on inflation projections that exceeded the outturn. Subsequently, the authorities sought to tighten the fiscal stance and also introduced measures to address structural imbalances in the fiscal accounts, but loosened monetary policy. In Venezuela, monetary policy has continued to support an exchange rate crawl aimed at bringing down inflation. The use of a crawl as a disinflationary tool without the full backing of macroeconomic policies has proven costly in terms of losses in external competitiveness. The authorities adopted a moderately expansionary fiscal policy stance in late 1999 to provide a boost to activity, as the economy was slow to emerge from recession.

In Ecuador, assistance to troubled banks has both undermined monetary policy and severely weakened the fiscal position. Massive liquidity assistance to the banking sector led to a sharp acceleration in money growth. Substantial losses on central bank operations and higher costs of servicing U.S. dollar-denominated debt also offset the improvements in the fiscal accounts stemming from higher oil-related revenues and expenditure restraint.

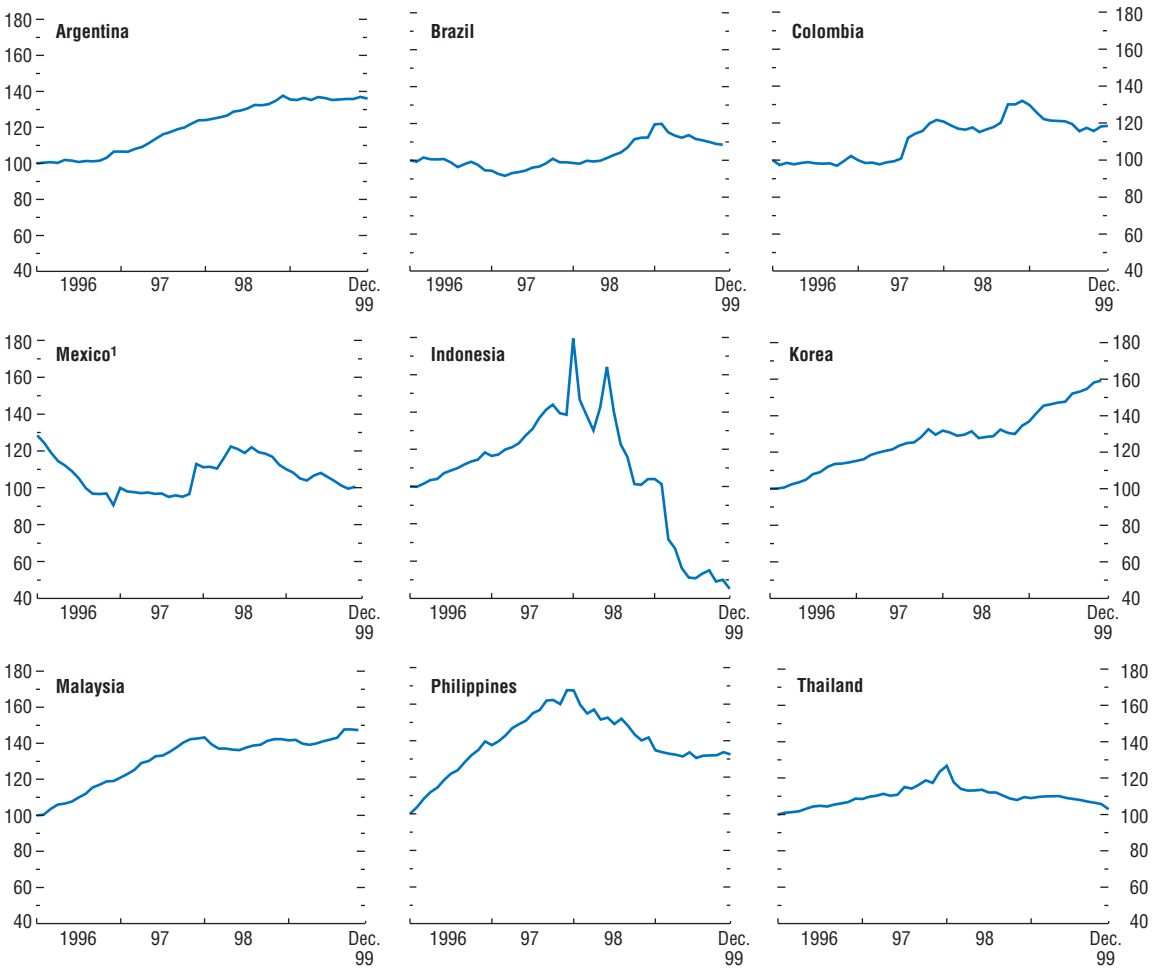
In contrast with east Asia during its 1997–98 crisis, Latin America avoided generalized financial distress in the banking and corporate sectors, although severe problems emerged in some cases—particularly in Ecuador. Policy efforts to strengthen financial systems were maintained or intensified. In most countries, however, bank lending to the private sector stagnated or even declined during the recession (Figure 2.7). As bank loans are still the dominant outside financing source for the region's corporate sector, continuation of this weakness could slow the pace of the recovery.

Financial sectors in Brazil and Mexico were little affected by the less favorable economic developments between late 1998 and early 1999. In Brazil, the corporate and financial sectors had largely hedged the risk of a devaluation, while in Mexico the growth slowdown was too short and shallow to have a significant impact on the quality of loan portfolios. Both countries made further progress in strengthening prudential regulations and supervision. In Brazil, authorities are auditing and evaluating the (publicly owned)

Figure 2.7. Selected Emerging Market Economies: Claims on Private Sector

(Real terms; January 1996 = 100)

Bank lending to Latin America's private sector stagnated or declined during the 1999 recession. Except in Korea, east Asia's recovery has not led to a pickup in bank credit to the private sector.



Source: IMF, *International Financial Statistics.*

[1]For Mexico, January 1997 = 100.

federal banks and preparing the privatization of 9 of the remaining 16 state banks. In Mexico, new legislation on bankruptcy and credit guarantees is expected to improve financial discipline. But the country also continues to deal with the consequences of the 1994–95 banking crisis, including a rising fiscal burden from the associated recapitalization measures and depressed bank lending activity.

The banking system in Argentina in 1999 remained generally sound, as in previous years, despite a relatively sharp fall in activity. Bank deposits grew and restructuring continued with increasing participation of foreign capital, although the recession and a related increase in nonperforming loans led to greater caution in bank lending. In Colombia, by contrast, the banking system was more affected by falling output, and pressures on the system already apparent in late 1998 intensified in 1999. The ratio of nonperforming to total loans continued to rise during most of the year, and solvency and liquidity indicators deteriorated further, particularly among public banks. The Colombian authorities responded by strengthening banking supervision and regulation. They also began to liquidate the largest public bank and introduced a recapitalization plan for viable private institutions.

In Ecuador, the banking sector entered a full-blown crisis as the country's recession deepened in early 1999. In the wake of the declaration of an early-March bank holiday, bank balance sheets continued to deteriorate as a result of a reduction in external credit lines, an increase in nonperforming loans—to more than 40 percent of total loans by the end of 1999—and capital flight. Following successive interventions by the country's deposit guarantee agency, the share of total banking system assets that remains privately owned has fallen to less than one-third. In the context of the country's dollarization, which was formally approved in early March 2000, the Ecuadorian authorities have taken steps to address major liquidity problems in the banking system and have designed a strategy for a more comprehensive restructuring of the banking system.

In addition to focusing attention on reducing financial sector vulnerabilities, the Latin American countries also remained generally committed to structural reform in other areas.[2] Fiscal reforms were introduced in a range of countries, and in some cases advanced significantly. Argentina and Brazil strengthened their overall fiscal policy framework by approving laws that establish limits on the deficit and public debt and improve the management and transparency of the public finances. In Mexico, the authorities have improved the efficiency of the tax system, and they are preparing a comprehensive tax reform aimed at broadening the tax base. In addition, Brazil and Colombia took steps to put their social security systems on a sounder financial footing. Also in Brazil, the authorities have initiated public debt management reforms to reduce the costs and interest rate sensitivity of debt service. To strengthen monetary policy credibility, Brazil adopted an inflation targeting framework in July 1999. In Chile, where such a framework is also in place, the authorities in the fall of 1999 announced their intention to target an inflation range (rather than a level) in 2001. Colombia and Mexico have been moving toward the introduction of an inflation targeting framework. In Argentina, the authorities took steps toward further deregulation of the labor market so as to increase the economy's resilience to shocks—an important direction of reform given that the exchange rate cannot be adjusted under the currency board arrangement.

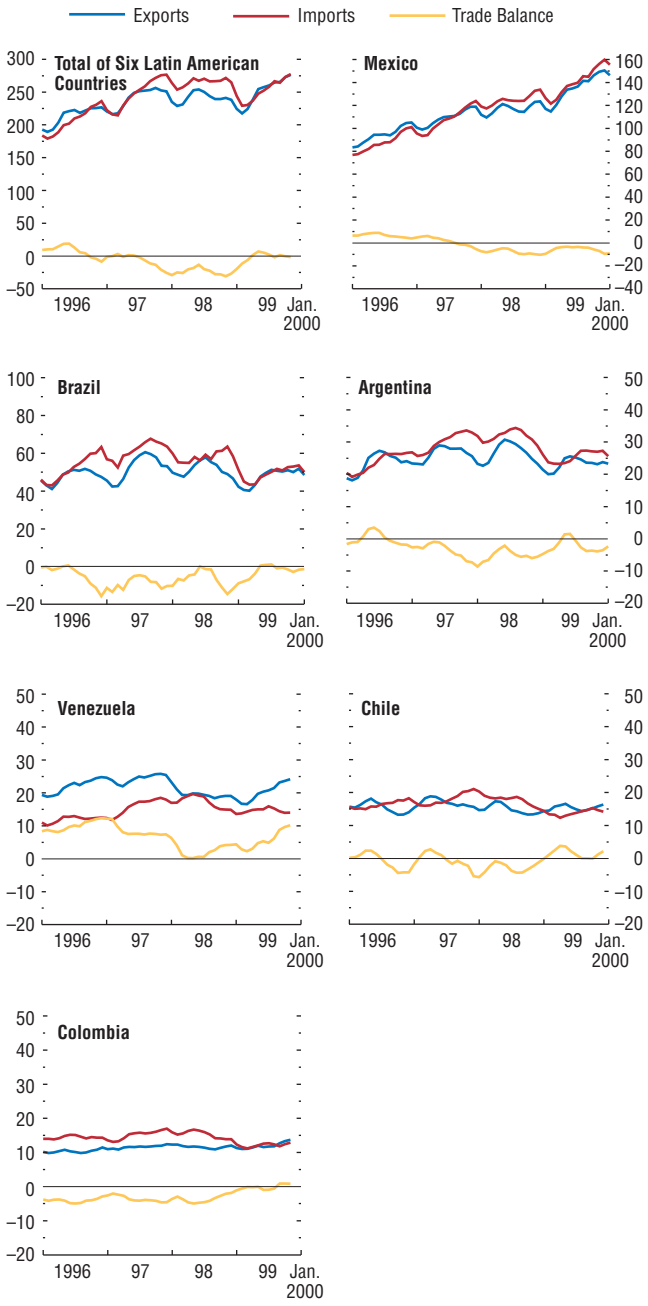
Latin America avoided a sharp region-wide contraction during 1999, and maintained its commitment to prudent macroeconomic policies and structural reform. The region remains vulnerable, however, in view of sizable net external financing requirements stemming from rather large and persistent current account deficits. These deficits partly reflect the region's significant external interest burden, and have as domestic counterpart relatively low national sav-

[2]See Box 2.3 of the October 1999 *World Economic Outlook* for a more detailed description.

Figure 2.8. Selected Latin American and East Asian Economies: Balance of Trade

(Billions of U.S. dollars; three-month centered moving average of annualized monthly data)

The trade balances of the Latin American economies generally improved in 1999. The east Asian crisis countries have consolidated the trade balance gains achieved in 1998.



ing rates that fail to fully match investment needs. Moreover, Latin America each year needs to refinance a significant fraction of its outstanding external debt owing to a relatively unfavorable debt maturity profile.

The current account deficit of the Latin American countries narrowed to around $55 billion in 1999 from a decade high of almost $90 billion in 1998 as trade balances improved on the back of contractions in domestic demand (Figure 2.8). For Brazil and Colombia real effective exchange rate depreciations and, for Mexico, robust import demand in the United States also helped improve trade balances (Figure 2.9). Despite this improvement, the regional current account deficit remained relatively high by the standards of the early 1990s. Moreover, it is expected to widen again in 2000 and 2001 owing to a robust recovery in imports that will only partially be offset by an increase in export revenues in line with stronger world demand and higher commodity prices.

Latin America's current account deficits are large compared with the pool of external financing projected to be available for the emerging markets. In view of the relatively closed nature of the region's economies and sizable net external interest payments, the deficits are also large relative to underlying export and import levels. Current account adjustment prompted by reduced availability of external financing would therefore require significant exchange rate depreciation or domestic demand contraction to generate the needed expansion in exports and reduction in imports. In addition, in view of unfavorable conditions in local capital markets, domestic borrowers, including the public sector, have turned to international markets to cover a substantial portion of their financing requirements. This lack of domestic intermediation, which mainly reflects financial market imperfections and the consequences of high inflation in the past, has increased even more the region's foreign currency debt exposure (Table 2.4).

In view of these financial vulnerabilities, the most significant risk to Latin America's near-

Table 2.4. External Debt

(Percent of GDP)

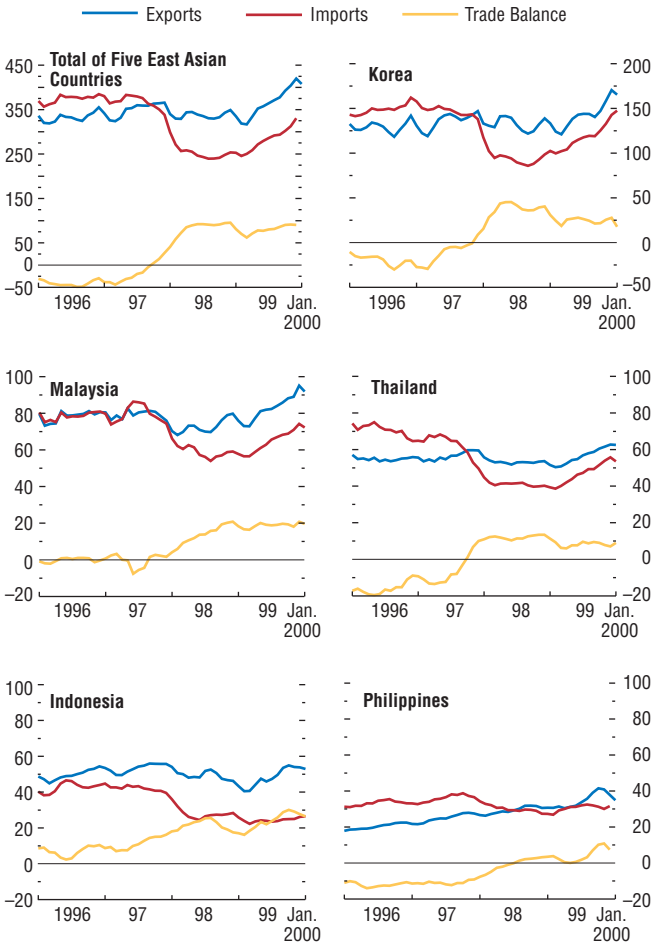
Country	1994	1995	1996	1997	1998	1999
Argentina	33.3	38.2	40.3	42.5	46.9	52.1
Brazil	18.2	22.6	23.2	24.9	31.4	39.7
Chile[1]	42.2	33.3	33.5	35.3	43.5	49.5
Colombia	27.4	27.9	31.6	31.5	35.8	41.7
Mexico	33.7	58.7	49.5	38.1	38.1	33.0
Venezuela	68.7	49.3	53.1	41.1	39.3	36.7
Indonesia[1]	57.0	56.3	53.4	63.9	149.4	95.5
Korea	24.1	26.0	31.6	33.4	46.9	33.0
Malaysia	38.6	37.6	38.4	44.0	58.8	55.3
Philippines	60.4	53.1	50.5	55.3	73.3	68.0
Thailand	44.9	49.1	49.8	62.0	76.8	61.5
Of which: short-term debt						
Argentina	3.5	4.8	5.0	6.5	7.2	6.8
Brazil	3.5	4.3	4.9	4.6	3.0	4.1
Chile[1]	10.7	7.9	6.5	4.8	5.4	5.7
Colombia	5.4	5.8	5.1	4.4	4.6	4.3
Mexico	7.5	9.1	7.7	5.6	6.6	5.5
Venezuela	4.3	1.9	2.6	2.7	2.2	1.5
Indonesia[1]	6.5	8.7	7.5	27.5	76.4	45.1
Korea	13.3	14.6	17.9	13.4	9.6	10.9
Malaysia	7.5	7.2	9.9	11.1	11.7	9.4
Philippines	8.1	7.1	8.7	10.3	11.0	3.6
Thailand	20.2	24.5	25.1	24.6	27.0	21.1

[1]The data for Chile and Indonesia exclude trade credits.

term outlook stems from potential unfavorable developments in the advanced economies, in particular higher-than-expected interest rate hikes in the United States and associated reductions in private capital flows. A considerable external adjustment effort would be required in this case, mostly in countries such as Argentina and Brazil that combine sizable current account deficits with large refinancing requirements on maturing external debt.

In addition, the move toward a more balanced growth pattern among the major advanced economies may involve a sharper-than-expected growth slowdown in the United States or strong movements among the three major exchange rates. Such developments would also have an impact on the emerging market economies of Latin America, but on a differentiated basis. A sharp slowdown and fall in import demand in the United States would mostly affect countries with strong trade links to the United States, especially Mexico, while a weakening of the U.S. dollar could benefit

Figure 2.8 (*concluded*)

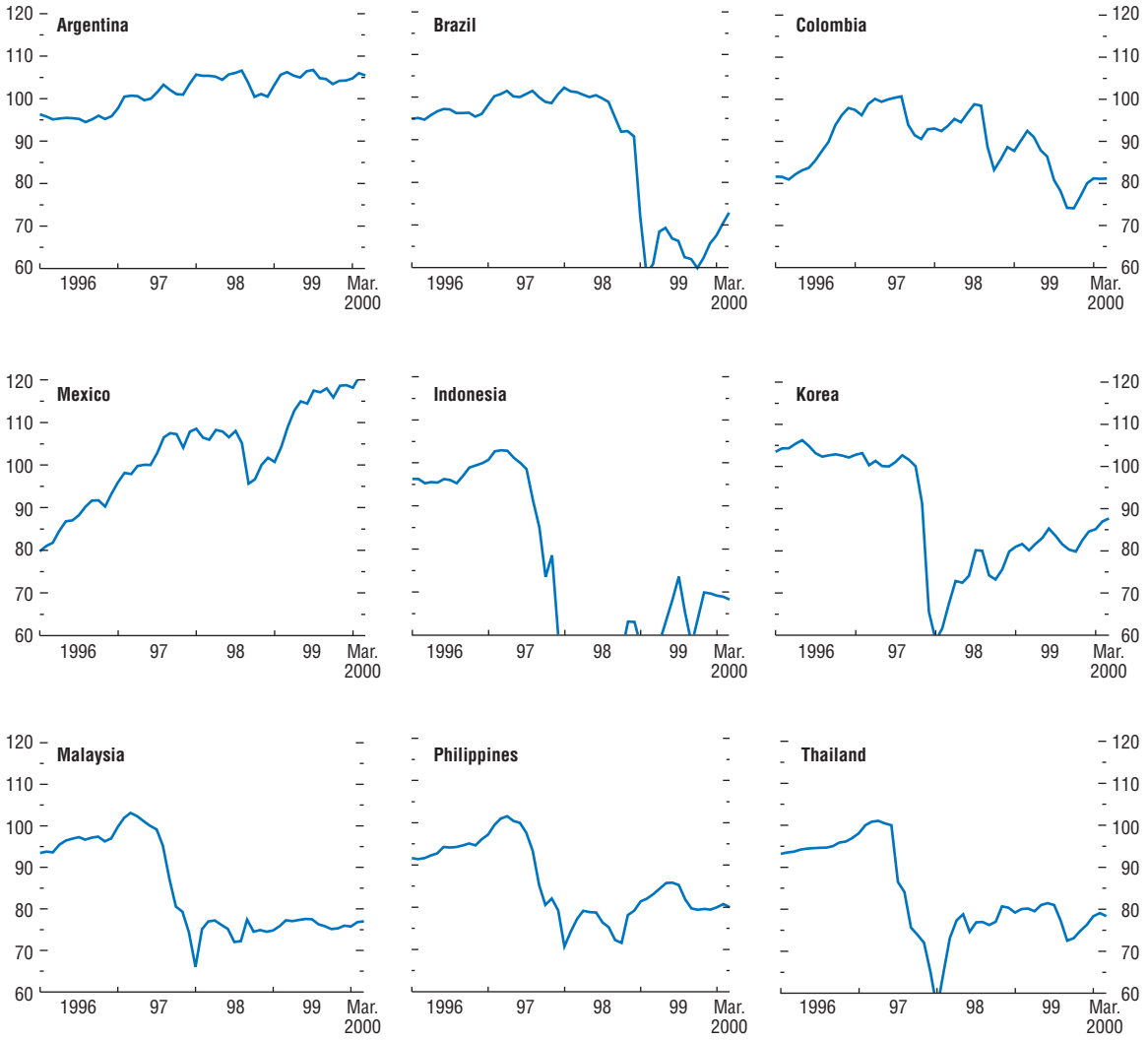


Sources: Country authorities; and IMF staff estimates.

Figure 2.9. Selected Emerging Market Economies: Real Effective Exchange Rates[1]

(June 1997 = 100)

Real effective exchange rates have depreciated in Brazil and Colombia since early 1999, but have strengthened in Mexico. They remain significantly below pre-crisis levels in east Asia.



Source: IMF staff estimates.

[1]Defined in terms of relative consumer prices based on 1988–90 trade weights.

Argentina and possibly also Brazil and Chile, reflecting these countries' trade orientation and exchange rate regimes. Some of the Latin American countries are also major commodity exporters and hence are also exposed to risks stemming from fluctuations in commodity prices. Overall, however, the external position of these commodity exporters has improved as a result of the recent increases in oil and non-fuel commodity prices.

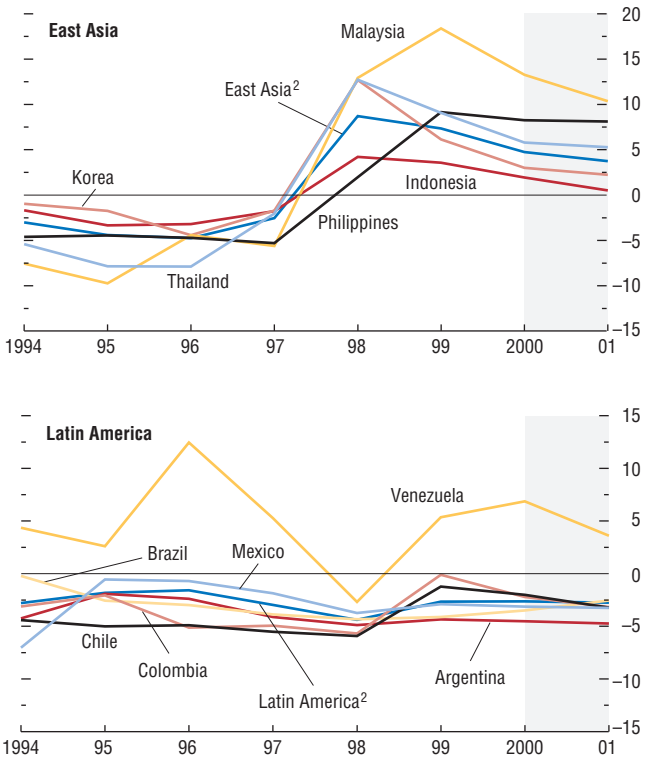
Improved Outlook in East Asia, But Policy Challenges Remain

The adjustment efforts in the emerging market economies of east Asia in the wake of the 1997–98 crisis have reduced the region's external vulnerabilities substantially. Foreign currency liabilities, especially those with short maturities, have fallen; current account balances have swung strongly into surplus; and exchange rate misalignments have been corrected. The strength of the recovery that is now under way in part mirrors the depth of the recession earlier, however, and the region now faces the challenge of transforming the recovery into high and sustained growth. This will require rebalancing macroeconomic policies toward a more neutral stance and stepping up structural reform efforts.

The external adjustment process following the onset of the east Asian crisis has resulted in a sharp turnaround in the current account balances of the crisis countries (Figure 2.10). Reflecting a deep import contraction, the countries' combined trade balances improved by almost $100 billion in 1998, or an average of more than 10 percent of GDP. Imports fell by more than 25 percent in U.S. dollars in Indonesia, Korea, Thailand, and Malaysia. Exports in U.S. dollar terms also declined in 1998, by an average of around 5 percent. The value of exports failed to pick up due to a number of factors, including lower worldwide commodity and electronics prices, currency adjustments and demand contraction in other crisis countries, and a pass-through to export prices of depreciations vis-à-

Figure 2.10. Selected East Asian and Latin American Economies: Current Account Balance[1]
(Percent of GDP)

The current account positions of the east Asian economies have improved considerably since the crisis, but those of the Latin American countries remain relatively weak.



[1]Shaded areas indicate IMF staff projections.
[2]Weighted average.

vis the U.S. dollar.[3] In addition, export volumes responded with a considerable lag to improvements in overall competitiveness in the wake of substantial currency depreciations.

The current account gains achieved in 1998 were largely consolidated in 1999, as more robust export growth for the most part offset a sharp rebound in imports. Exports were boosted by the competitiveness gains from currency realignments, the effects of which began to be felt in late 1998. A surge in worldwide sales of electronics, robust import demand in the United States, and, in the second half of 1999, further currency depreciations relative to the Japanese yen had additional positive effects. The export recovery was outpaced, however, by an even faster rebound in imports, which surged in U.S. dollar terms by more than 40 percent in Korea, more than 30 percent in Thailand, and more than 20 percent in Malaysia in the fourth quarter of 1999 compared with corresponding levels one year before. In most of the east Asian countries, this import surge has been underpinned by the very strong revival in domestic demand associated with the arrival of the more advanced stages of the recovery, and has been accompanied by a self-sustaining rebound in intraregional trade.

Despite narrowing current account surpluses and also significant repayments on external loans, the overall balance of payments positions of the emerging market economies of east Asia continued to improve in 1999, as net portfolio and foreign direct investment inflows picked up, in particular in Korea. These inflows reflected improved market sentiment, with expectations of further currency appreciation and more equity price gains. In Korea, an increase in foreign equity participation in the financial sector has been an additional source of inflows. Balance of payments surpluses have allowed the crisis countries to accumulate additional international reserves and let currencies gradually appreciate (Figure 2.11). Unlike the early 1990s, the recent capital inflows in Korea have been mostly non-debt creating, and so the country has been able to reduce further its total external liabilities. With short-term liabilities in particular being redeemed, the maturity profile of the external debt has improved significantly.

Robust current account surpluses and renewed non-debt-creating capital flows have reduced east Asia's external vulnerabilities considerably, but they also confront authorities with new policy challenges. This is particularly the case for Korea, where the recovery has been very robust and the rebound in inflows strong and where the exchange rate has been under upward pressure. On a more prospective basis, other countries in the region, including Malaysia and Thailand, face similar challenges. To meet these challenges, exchange rate policies need to find the right balance between additional reserve accumulation through intervention and further gradual currency appreciations. A case can be made for acquiring some additional international reserves in view of still relatively high ratios of short-term external debt obligations to international reserves. At the same time, the sizable current account surpluses and other indicators of relatively strong external competitiveness, including real effective exchange rates that are still significantly below pre-crisis levels, suggest that there is still scope for further currency strengthening before possible overvaluation becomes an issue.

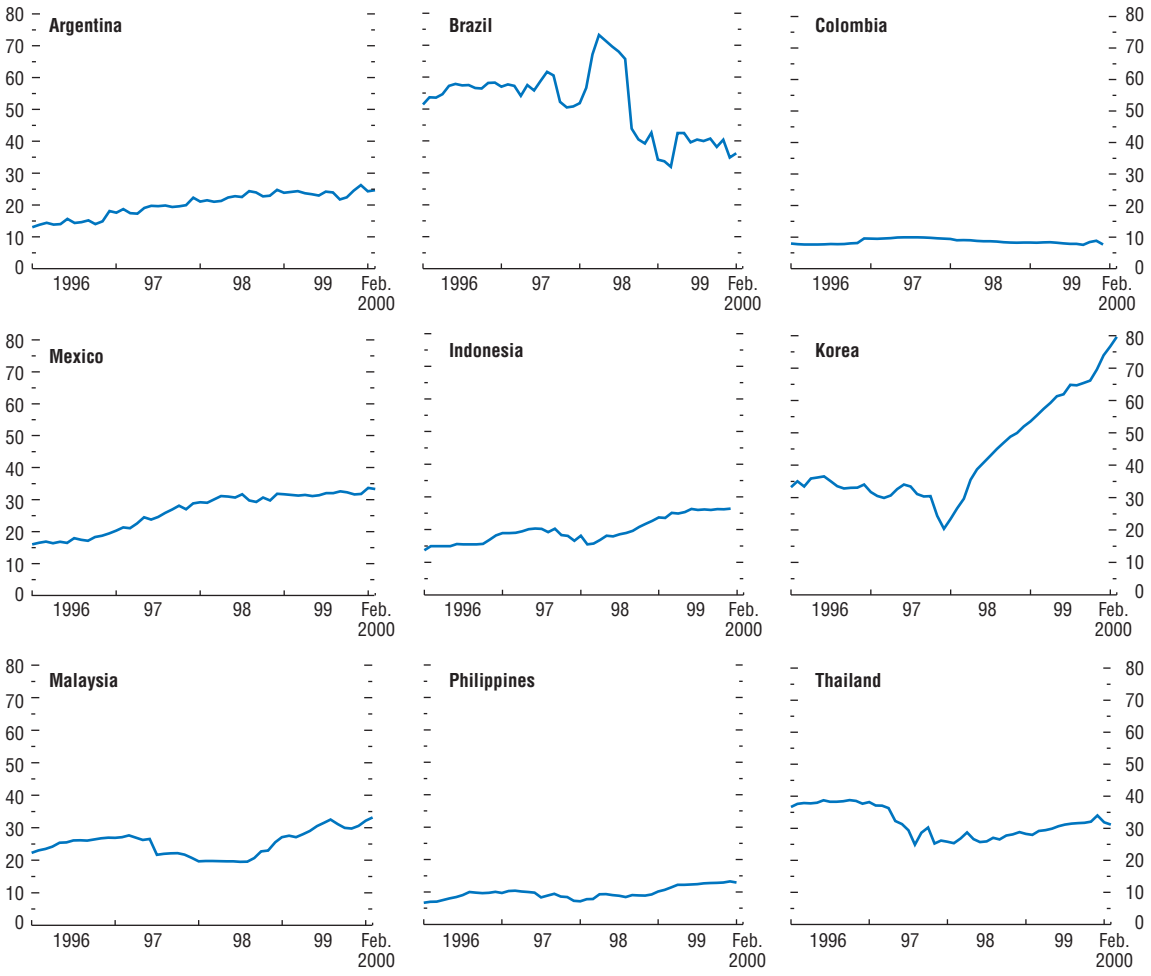
In this regard, the implications for monetary policy also need to be considered. As interest rates have to be kept at relatively low levels to facilitate corporate and financial restructuring, further exchange rate appreciation could provide the tightening in monetary conditions that is required to keep inflationary pressures in check. In view of its potentially strong impact on banking sector soundness, the composition of the new capital inflows also requires careful monitoring. In particular, a shift toward short-term debt-creating inflows could increase the

[3]For a discussion of these factors, see Rupa Duttagupta and Antonio Spilimbergo, "What Happened to Asian Trade During the Crisis?" IMF Working Paper (Washington: International Monetary Fund, forthcoming).

Figure 2.11. Selected Emerging Market Economies: Total Reserves Excluding Gold

(Billions of U.S. dollars)

Brazil's international reserve position has stabilized in the wake of the currency crisis in early 1999. The east Asian countries, in particular Korea, have strengthened their international reserve positions since 1998.



Source: IMF, *International Financial Statistics*.

Table 2.5. Indonesia, Korea, and Thailand: Sources of Changes in the Fiscal Balance
(Percent of GDP as of October 1999; a negative number indicates a fiscal deterioration)

	Indonesia[1]			Korea			Thailand[2]		
	1997/98	1998/99	1999/00	1997	1998	1999	1996/97	1997/98	1998/99
Fiscal balance (level)[3]	–0.9	–2.2	–6.8	0.0	–3.2	–5.6	–1.6	–5.1	–5.3
Changes in fiscal balance	–2.2	–1.0	–4.7	–0.3	–3.4	–2.5	–4.0	–3.0	–0.2
Changes due to economic environment[4]	–4.2	–3.7	2.2	. . .	–1.6	–0.4	–0.3	–2.8	0.6
Policy changes	2.7	2.6	–7.4	. . .	–2.1	–1.4	–2.6	–0.2	–0.9
Expenditures	2.7	2.2	–6.7	. . .	–3.6	–1.7	–2.6	0.3	–0.3
Bank restructuring	0.0	–0.4	–6.9	. . .	–0.3	–0.8	–0.7	–1.9	0.5
Other[5]	2.7	2.6	0.2	. . .	–3.3	–0.9	–1.9	2.2	–0.8
Statutary revenue change	0.0	0.4	–0.7	. . .	1.4	0.4	0.0	–0.4	–0.6
Residual (unexplained)	–0.7	0.1	0.5	. . .	0.3	–0.7	–1.1	0.0	0.0

Source: Jack Boorman and others, "Managing Financial Crises: The Experience in East Asia," *Carnegie–Rochester Public Policy Conference Series*, forthcoming; and IMF staff estimates.
[1]For Indonesia, the fiscal year runs from April 1 to March 31.
[2]For Thailand, the fiscal year runs from October 1 to September 30.
[3]According to data as of March 2000, the fiscal balance for Indonesia was estimated at –3.8 percent of GDP in 1999/00 and for Korea at –2.9 percent of GDP in 1999.
[4]Comprises changes in fiscal position attributable to economic activity, the exchange rate, interest rates, and (in the case of Indonesia) oil prices.
[5]Includes outlays for social safety nets and other expenditures.

vulnerability of the financial system if the associated risks are not well managed. To avoid difficulties in this area, authorities need to ensure that prudential regulation and supervision are effectively enforced.

A key feature of the east Asian recovery process has been the supportive role of monetary and fiscal policy.[4] Monetary policies remained accommodative in the second half of 1999 and early 2000. In Korea, Malaysia, and Thailand, money market interest rates have been broadly unchanged since the middle of 1999 at levels significantly below those observed before the crisis in 1997. In Indonesia, a market-led decline in short-term interest rates resumed in the late fall of 1999 as political uncertainty eased, but interest rate levels continue to exceed those elsewhere in the region. Lower interest rates have helped reduce the pressure on heavily indebted corporates and contain the nonperforming loans problem. With the exception of Korea, however, the transmission of lower money market rates to bank lending rates has been slow, and credit to the private sector has stagnated or fallen in real terms.

Fiscal policies generally have provided further support for the recovery (Table 2.5). In Korea, a supplementary budget adopted in August 1999 was aimed at providing additional stimulus, while targeting a consolidated central government deficit of 5 percent of GDP for 1999. Even higher deficit targets for the financial years covering the bulk of calendar year 1999 were adopted in Indonesia and Thailand, with the Thai budget also including measures to stimulate specific components of domestic demand. In all three cases, however, actual deficits have fallen short of the budget targets. In Indonesia, this was due to spending delays, while in Korea, the shortfall stemmed primarily from the operation of automatic stabilizers, as the robust recovery boosted tax revenues and reduced unemployment-related outlays. In the Philippines, however, the 1999 deficit overshot the budget target, mainly owing to weaknesses in the country's revenue management.

While stimulative fiscal policies generally have been appropriate, such support has to be balanced against the objective of reducing the public debt burden. Rising deficits in combination

[4]For an in-depth analysis, see Jack Boorman and others, "Managing Financial Crises: The Experience in East Asia," *Carnegie-Rochester Public Policy Conference Series*, forthcoming.

Table 2.6. Gross Public Debt in the East Asian Countries
(Percent of GDP)

Country	1996	1997	1998	1999
Indonesia[1]	24.5	106.4	103.4	96.0
of which financial sector restructuring	. . .	39.9	55.3	60.1
Korea	8.8	12.7	24.4	29.6
of which financial sector restructuring	. . .	1.5	8.5	12.9
Malaysia	47.7	49.0	53.5	56.4
Philippines	68.2	66.4	72.9	74.4
Thailand	14.5	31.1	49.5	56.3
of which financial sector restructuring	1.2	13.8	28.9	31.0

Source: IMF staff estimates.
[1]Financial years running through the end of March.

with very substantial financial sector restructuring costs have contributed to a rapid increase in public sector debt since the onset of the crisis. Relative to GDP, Indonesia and Thailand have experienced the largest debt buildup since 1996, much of which is the result of financial sector restructuring, and they now face very considerable debt burdens (Table 2.6).[5] Despite a rapid debt buildup for similar reasons, Korea's debt-to-GDP ratio remains relatively low, reflecting the country's favorable debt position before the crisis. Public debt accumulation during the crisis was less rapid in Malaysia and the Philippines, but these countries started with higher pre-crisis public debt burdens. While a resumption of output growth and, for foreign currency denominated debt, real exchange rate appreciations are expected to help bring down public debt-to-GDP ratios from their current peak levels, deficit reduction and asset recovery from nonperforming loans taken over from the financial sector will also be required.

The case for a gradual shift in fiscal policies toward a more neutral stance is reinforced by the need for macroeconomic restraint as output gaps narrow and inflationary pressures may reemerge. Since interest rates need to be kept at low levels to facilitate corporate and financial sector restructuring, the bulk of the adjustment in the macroeconomic policy stance should be borne by fiscal policy. The more than usual uncertainty regarding the sustainability of the ongoing sharp output recovery, which could be interpreted either as a cyclical rebound from the steep output falls during the initial crisis stages or as an indicator of incipient overheating risks, strengthens the argument for fiscal caution. This argument holds in particular for Korea, where the output gap could close as early as 2001 and where there is also considerable uncertainty about the outlook for cost-price behavior as the gap closes. Appropriately, Korea intends to bring down the budget deficit target from 5 percent of GDP in 1999 to 3½ percent in 2000 and to eliminate the deficit in the next few years. In Thailand, the public sector deficit in 2000 is projected to remain relatively large, at more than 5 percent of GDP, and additional tax revenue from faster-than-expected growth should be used to bring down the fiscal deficit below this target.

A particularly acute fiscal challenge faces Indonesia's authorities, as they have to weigh carefully the balance between supporting the recovery and beginning fiscal consolidation. A target for the fiscal deficit of 5 percent of GDP in 2000 is appropriate given the depth of the economic downturn during the crisis and the lagged recovery compared with the other east Asian economies. But public debt is now above 90 percent of GDP, and further rounds of bank recapitalization are still required, with interest payments on outstanding bank restructuring bonds expected to already reach 4¾ percent of GDP in 2000. The deficit could be even higher if authorities fail to properly sequence and implement a far-reaching fiscal decentralization program. Moreover, authorities will have to meet the financing needs stemming from the budget deficit. Financing for around half the deficit is expected to come from privatization proceeds and asset sales from state controlled banks,

[5]These numbers should be interpreted with caution as the coverage of the public sector and the costs of financial sector restructuring is not uniform across the east Asian countries.

where results to date have been generally below target. As room for noninflationary domestic financing is still limited, in the absence of a developed bond market, the remainder of the deficit is expected to be financed from external public sources, including a rescheduling of external debt held by Paris Club creditors.

A distinguishing characteristic of east Asia's financial crisis has been the extent of corporate and financial sector distress it has caused. The distress resulted from a combination of heavy dependence on bank financing and associated high debt-equity ratios in the corporate sector and lax risk management practices, as manifested in considerable external exposures. Nonperforming loans have risen to levels far in excess of those observed in other crises in emerging markets, including the 1994–95 tequila crisis. This is particularly the case in Indonesia and Thailand. In view of the scope of the financial crisis, authorities in the east Asian countries have given high priority to financial and corporate sector restructuring.[6] Both the restructuring strategies and progress toward corresponding reform objectives continue to vary from country to country, and the reform agenda is far from completed.[7]

Korea and Malaysia have achieved the most progress in restructuring and strengthening the financial sector. In Korea, the government asset management company set up to take over nonperforming loans from the financial sector has been relatively successful in terms of both the overall transfer rate and the subsequent liquidation of claims. Nonperforming loans of the financial system in the fall of 1999 stabilized at around 10 percent of total loans in the financial system (equivalent to 12 percent of GDP), and Korean banks have strengthened further their capital bases with both public and private money, including significant foreign investment. The reform agenda is far from finished, however, and weaknesses remain, in particular in the nonbank financial sector. These weaknesses were exposed in the early fall of 1999, when the investment trust industry faced considerable redemption pressure in the wake of debt servicing problems by the major *chaebol* Daewoo, which prompted financial institutions to establish a bond market stabilization fund to stabilize markets. Malaysia has also adopted the asset management company approach, and this company has been relatively successful in taking over nonperforming loans, with a view to rehabilitating them. By the end of 1999, recapitalization requirements for the financial sector had been largely met, and the ratio of nonperforming to total loans in the financial system (including those held by the asset management company Danaharta) had fallen to around 25 percent. Malaysia has also made progress in its plans to streamline the financial sector through extensive mergers between problem institutions and profitable banks.

In Thailand, which has opted for a strategy of virtually closing the nonbank financial sector but letting banks deal with problem loans on a decentralized basis, the major commercial banks have met Bank for International Settlements (BIS) capital adequacy ratios through raising additional capital, including from foreign investors. While private banks formally meet regulatory requirements, concerns exist that their underlying value is less than that derived from the application of prudential regulations. The public banks continue to be in a weak financial position. Despite a significant reduction in the second half of 1999, the nonperforming loans ratio remains relatively high, at around 39 percent at the end of the year (equivalent to 45 percent of GDP).

Financial sector restructuring is less advanced in Indonesia, in part because the financial distress induced by the crisis has been deeper and

[6]For a more detailed analysis, see Carl-Johan Lindgren and others, *Financial Sector Crisis and Restructuring; Lessons from Asia,* Occasional Paper No. 188 (Washington: International Monetary Fund, 2000.)

[7]The Philippines largely avoided the systemic banking sector problems that afflicted other emerging market economies in east Asia. This can be attributed in part to the beneficial effects of reforms implemented in the mid-1990s.

more widespread. The ratio of nonperforming loans to total loans remains above 60 percent (equivalent to more than 40 percent of GDP). The Indonesian Bank Recovery Agency has taken over the bulk of nonperforming loans, but the agency's asset recovery efforts have only been partially successful. Most of the financial sector is still in a precarious financial position, and less than 30 percent of the banking system remains privately held. Financial sector restructuring in Indonesia needs to remain focused on operational restructuring of the state banks and on moving ahead with loan recovery efforts.

Authorities in the east Asian economies most affected by the crisis have also been confronted with large-scale financial distress in the corporate sector, the counterpart to the nonperforming loan problem. In response, they have established out-of-court procedures to settle claims, and also introduced institutional and legal reforms, where needed, to strengthen bankruptcy systems and improve financial transparency and corporate governance. This corporate reform process has advanced the most in Korea and Malaysia, which have made the best use of out-of-court arrangements, in part because of stronger legal enforceability, and in part because of the relatively small number of cases. To streamline the process, and recognizing that the country's top five *chaebol* were too large and complex to be involved in an out-of-court work process, Korean authorities let these companies develop their own restructuring plans. In the wake of Daewoo's debt servicing problems in mid-1999, however, the authorities strengthened the restructuring framework for the other *chaebol* in the top five groups. Reform efforts now need to be extended into broader operational restructuring among the smaller *chaebol* as well.

Voluntary debt restructuring has met with less success in Thailand, however, in part because of more widespread balance sheet problems—by the end of 1999, almost 2,000 debtor firms were involved in voluntary arrangements—and in part because of a bankruptcy legislation that failed to provide strong incentives to comply with such arrangements. The bankruptcy law was reformed in March 1999, but shortcomings in the bankruptcy procedures remain. Indications are that corporate debt restructuring arrangements have mainly involved rescheduling debt to longer maturities at temporarily low interest rates, but with little debt relief in net present value terms.

Corporate sector restructuring is less advanced in Indonesia, where authorities have been unable to sustain the implementation of the corporate restructuring program. Continued weakness in the procedural capacities of key institutions established for this purpose, including the bank recovery agency and the Jakarta Initiative Task Force, and of the court system has been an important factor. Improvements in accountability and transparency in corporate governance have also fallen short of expectations.

The strength of the recoveries that are under way has not changed the need to make further progress toward financial and corporate sector restructuring in the east Asian crisis countries. As capital markets in the region are developing only slowly, bank credit will remain the main outside funding source for the corporate sector. Absent further reductions in nonperforming loans and improvements in corporate sector balance sheets, the lending capacity of the banking sector and corporate incentives to invest will remain impaired, and investment efforts, much curtailed during the crisis, will fail to return to levels required for robust and sustained growth. In view of the deep corporate sector weaknesses brought to the fore by the crisis, the transformation of the current recoveries into long-term growth will also require stepped-up efforts toward corporate restructuring, supported by higher rates of capital accumulation. The need to limit the risks stemming from renewed private inflows commonly associated with an improving growth outlook provides an additional rationale for further corporate and financial sector reform, including a strengthening of risk management practices. Ultimately, such reforms provide the best safeguards against a repetition of the 1997–98 financial turmoil and social hardship.

The tentative conclusions that emerge from this chapter suggest that the likelihood of an

early repetition of the turmoil in emerging markets seen in recent years has declined considerably as a result of a variety of factors. These include notably the macroeconomic adjustment and structural reform efforts by many emerging market economies; the recoveries in commodity prices, in particular oil prices, which have helped improve the external position of many countries; and greater risk awareness on the part of international investors. Some Latin American economies nevertheless remain vulnerable to potential changes in investor sentiment and to developments that would adversely affect their external positions and the cost and availability of external financing. These vulnerabilities underscore the need for continued efforts to safeguard macroeconomic stability, increase national saving, and attain sustained growth through increases in efficiency and productivity. The emerging market economies more generally, including the east Asian countries that have achieved current account surpluses, still need to persevere with structural reforms to reduce the risk of a repetition of the recent crises.