INTERNATIONAL MONETARY FUND

Assessing the Determinants and Prospects for the Pace of Market Access by Countries Emerging from Crises—Country Cases

Prepared by the Policy Development and Review Department

In consultation with other Departments

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1. In response to a request by the Executive Board that the staff continue its work on the analytic issues involved in assessing the prospects for regaining market access that is a critical element of the framework on private sector involvement (BUFF/00/152), the staff prepared a paper entitled "Assessing the Determinants and Prospects for the Pace of Market Access by Countries Emerging from Crises" (EBS/01/157). This is an accompanying background paper that discusses the experience of ten countries with respect to regaining market access from 1993 to 2000, a period marked by the reemergence of bond financing as a major source of financing and severe crises resulting from external shocks and policy mistakes. The countries include the six largest emerging market debtors (Argentina, Brazil, Korea, Mexico, Russia, and Turkey) and four other significant but less systemically important debtors (Indonesia, Peru, Romania, and Thailand). These ten countries represent about 75 percent of J.P. Morgan Chase's Emerging Markets Bond Index Plus (EMBI+), the most widely used index of emerging market debt.

I. ARGENTINA

A. The Mexican Crisis

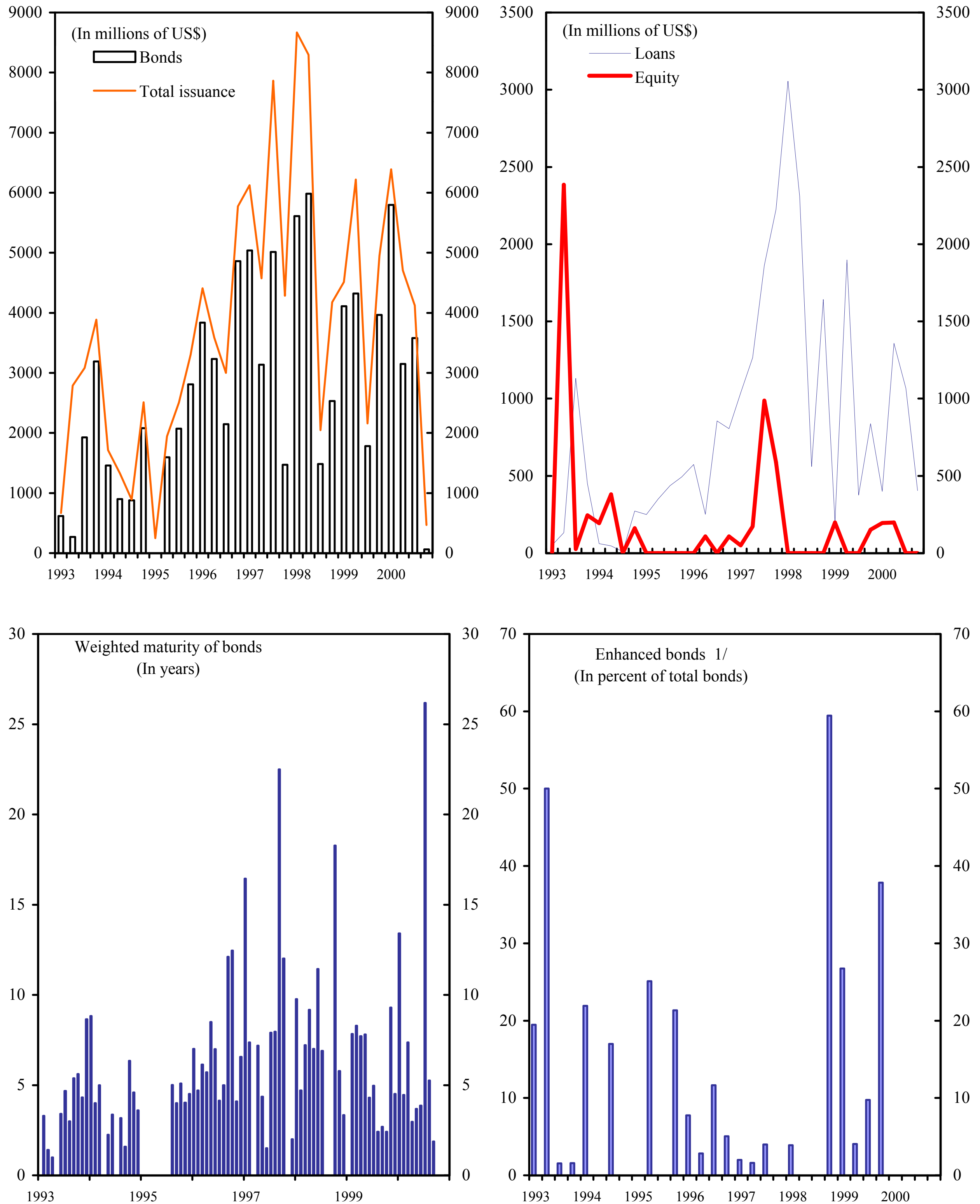
2. After receiving substantial private capital flows between 1990–1994, Argentina faced difficulties in accessing international capital markets following the Mexican peso devaluation on December 20, 1994 (Tequila effect).[1] International capital markets were abruptly closed to new issues of Argentine sovereign bonds, syndicated loans and equity issues, and secondary market spreads for Argentine debt increased sharply from 388 basis points at end-September 1994 to 945 basis points by March 1995 (Figures 1–3). In the face of relatively undeveloped domestic markets, refinancing maturing debt became difficult.

3. The history of coinciding collapses rendered Argentina particularly susceptible to contagion from developments in Mexico, as the two countries shared common macroeconomic features, including a fixed exchange regime, a banking system with a high level of nonperforming loans, and a large current account deficit. Argentina's vulnerability was also exacerbated by a weakening in its macroeconomic policies that led to the discontinuation of the Extended Fund Facility (EFF) arrangement before drawing the final tranche.[2] With presidential elections scheduled for May 1995, domestic and foreign investors began to doubt Argentina's commitment to the currency board. The combination of a

[1] Private market financing flows to Argentina increased from US$0.1 billion in 1990 to US$10 billion in 1993 before tapering down to US$5.3 billion in 1994.

[2] Reflecting these pressures, the Merval stock market index declined by 17 percent between September and December 1994 while secondary market spreads increased by almost 200 basis points over the same period.

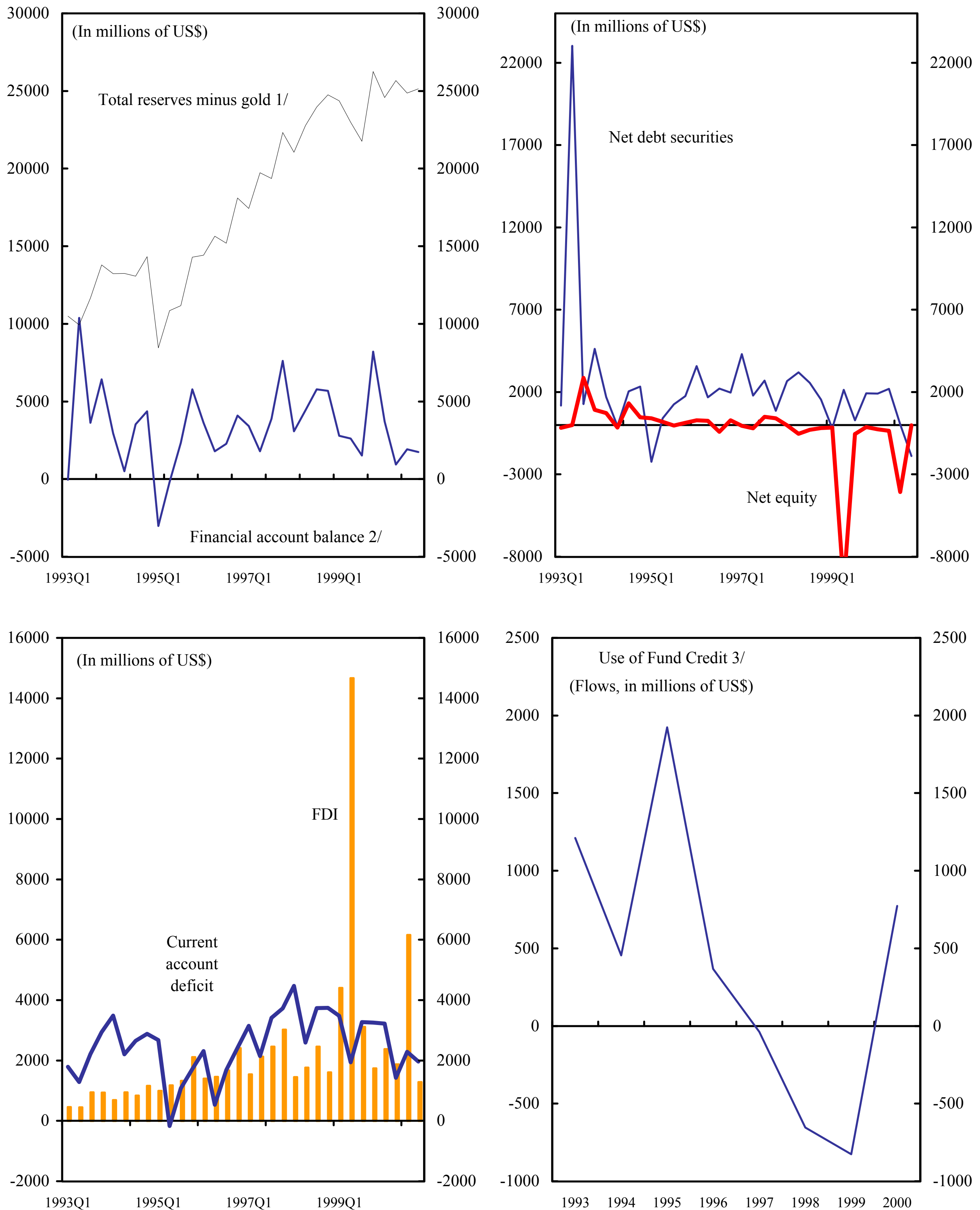
Figure 1. Argentina: Gross Issuance of Bonds, Loans, and Equity, Jan-1993 to Dec-2000



Sources: BEL database; Capital Data Bondware; Loanware; and staff calculations.

1/ Data on enhanced bonds from BEL is based on a strict definition of enhancement namely convertibles, secured, and put options.

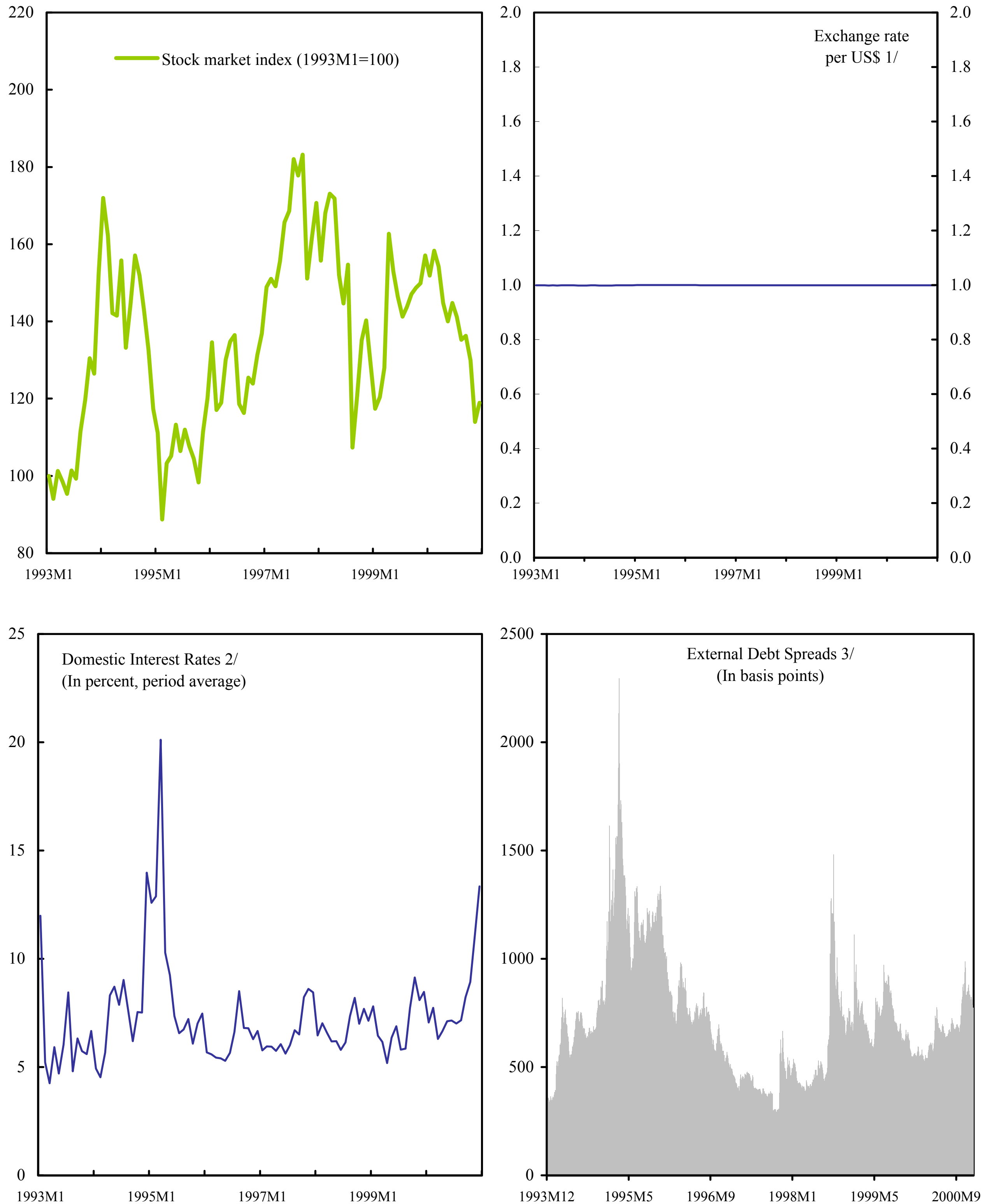
Figure 2. Argentina: Net Capital Flows, 1993-2000



Source: IMF, International Financial Statistics.

1/ Total reserves not adjusted for encumbered reserves.
2/ Excludes errors and omissions.
3/ Net.

Figure 3. Argentina: Financial Markets Developments, 1993-2000



Sources: IMF, International Financial Statistics; Bloomberg.

1/ Argentina has a currency board.
2/ Money market rate.
3/ EMBI Argentina subindex.

liberalized capital account with a currency board and emerging fears of a devaluation triggered a massive withdrawal of peso deposits, with the very short maturity of peso deposits facilitating the run on the currency.

4. The run on deposits caught several banks short of liquid assets and the ensuing contagion spread to a number of apparently solvent institutions. Withdrawals were extended to dollar deposits, and the banking system lost 18 percent of deposits in just three months. The central bank lost more than one-third of its international reserves over the same period. Domestic interest rates more than doubled, rising to about 20 percent. The decline in the stock price index accelerated after the beginning of the crisis, and by March 1995 the index was 37 percent lower than the level prevailing before the crisis. The economic boom evaporated into a recession, and the erosion of banks' capital due to the crisis brought about a prolonged period of credit retrenchment.

B. Policy Response and Return to Market Access

5. In the aftermath of the Tequila crisis, the Argentine government put together an economic program to address existing policy weaknesses and to minimize the financial impact of the crisis. In January 1995, the government announced measures to reduce the fiscal deficit and reaffirmed its strong commitment to a policy framework centered on the currency board. In March, additional measures were introduced to increase liquidity, support distressed banks, foster the privatization of provincial banks, as well as the capitalization and restructuring of private banks. In April, the government negotiated a fourth year extension of the EFF with parallel support from the World Bank, the Inter-American Development Bank (IDB), and the EXIMBANK of Japan. Multilateral loans were obtained to finance the new fiduciary funds that helped recapitalize the banking system and provided support to provincial banks in the process of being privatized.

6. The announcement and implementation of the authorities' program coupled with financial support from multilateral institutions proved effective in shoring up public and investor confidence, reflected inter alia in the resumption of spontaneous capital inflows, the recovery of bond and stock prices, the convergence of the dollar and peso prime rates and the stabilization of the level of deposits in the banking system. Spreads tightened, but did not return to pre-crisis levels until 1997. The government returned to international credit markets in April 1995 and accelerated its borrowing after June and August 1995. Bond issuance increased to US$6.5 billion in 1995 from US$5.3 billion in 1994 while loans increased to US$1.5 billion from a meager US$390 million in 1994. International equity issues remained absent until 1997. Argentina's share in total private capital flows to emerging markets increased from 9.9 percent in 1994 to 10.9 percent in 1995. However, the private sector experienced difficulties accessing the markets, with only the top-tier companies being able to do so.

C. The Asian Crisis

7. Argentina's economy was performing strongly prior to the Asian crisis, with real GDP growth of over 8 percent in 1997, low inflation of 0.2 percent, a fiscal deficit of 1.9 percent of GDP, and gross international reserves of US$19.8 billion, equivalent to 9.6 months of imports and 155 percent of short-term debt (Figure 4). The banking system had strengthened through improved prudential supervision and regulation, increased liquidity requirements, tighter capital requirements, the creation of a backup (repo) liquidity facility with international banks as well as increased penetration by foreign banks and consolidation of the number of financial institutions. The authorities had also introduced a policy of preborrowing (borrowing in advance of needs) and had diversified the sources of financing, lengthened the maturity structure of public external debt obligations, and reduced the share of floating rate instruments.

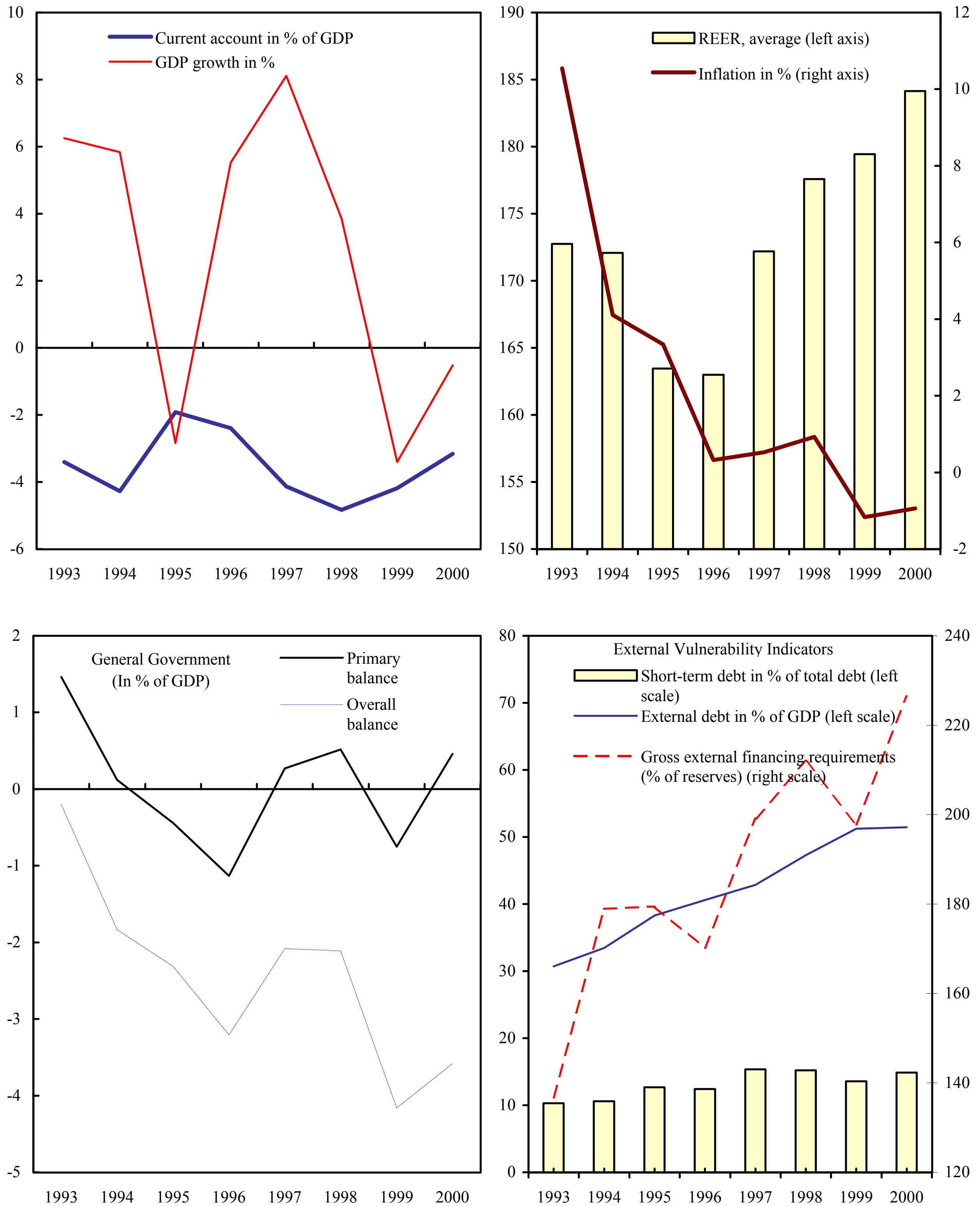
8. The Asian crisis exerted pressure on the domestic money and asset markets without affecting confidence in the banking system. Secondary market spreads widened to over 600 basis points at end-October 1997 from a trough of less than 300 basis points earlier that year, reflecting mostly concerns regarding how the country would meet its financing needs. The Merval stock index, which had been rising through August 1997, tumbled by 26 percent between October 1997 and January 1998. However, deposits in the financial system increased steadily while central bank foreign exchange reserves remained roughly unchanged. Since the crisis in large part reflected investor panic and not problems with the country's macroeconomic fundamentals, the authorities' response was to reaffirm their commitment to sound policies. The government returned to the international capital markets in November 1997, as spreads were on a downward trend, by tapping both the bond and syndicated loan markets. The majority of bond issues placed immediately after the crisis carried floating rates, while there was a shift away from collateralized and guaranteed bonds to bonds containing put options. In the first seven months of 1998, the government stepped up its borrowing, raising US$5.5 billion in loan commitments and placing US$13.1 billion in bonds—tapping six currency sectors including the euro, deutsche mark, Italian lira, Dutch guilder, French franc, as well as the U.S. dollar sector.

D. The Russian and Brazilian Crises

9. While in both cases jitters were felt and spreads on Argentina's debt increased significantly, the Argentine economy weathered well the Russian and the Brazilian crises in 1998–99. The country's resilience was facilitated by the strengthening of the banking system, the fiscal adjustment, and the external debt policies followed after the 1994 Mexican crisis.

10. In the aftermath of the Russian crisis, spreads on Argentina's debt peaked in August 1998 at 1,250 basis points, the stock market index declined by 40 percent, and reserves declined by US$1.6 billion in the two months following the Russian crisis. Argentina was able to withdraw from the market for approximately 70 days (between August and October 16, 1998) as its immediate financing requirements had already been met on account

Figure 4. Argentina: Fundamentals , 1993-20001/



Sources: IMF, International Financial Statistics; IMF, World Economic Outlook.

1/ The latest WEO data may not correspond exactly to the latest data from country staff reports.

of the pre-borrowing policy. Deposits in the banking system continued to grow, despite some flight to quality and liquidity problems experienced by weaker banks. The authorities adhered to the policies agreed to in the context of the EFF and covered financing needs through the first quarter of 1999 with additional loans obtained from the World Bank and the IDB and domestic placements of medium-term treasury bonds. Argentina's first placement in the international capital markets came in mid-October 1998, as creditors began to differentiate among emerging market countries. In the remainder of the year, net capital inflows allowed an increase in gross reserves. However, while spreads on Argentina sovereign debt had declined by about 500 basis points by mid-November, the yield spread remained on average some 200 basis points higher than in the preceding five years, bonds with put options increased, while average maturities shortened to some 7½ years.

11. Brazil's abandonment of its crawling peg exchange rate arrangement on January 13, 1999 also had limited contagion effects on the Argentine economy. Several factors may account for this. Foreign investors could have already deleveraged much of their exposure to emerging markets following the Russian crisis, and the Brazilian devaluation possibly had already been discounted. Domestically, banking sector reforms had reinforced the soundness of the Argentine banking system, making it, in the view of market participants, one of the strongest, most transparent, and internationalized systems among emerging market economies. Furthermore, net capital inflows during 1998 had facilitated an increase in reserves, providing the system with a sizeable cushion to withstand adverse shocks, while the public sector had already obtained or arranged resources sufficient to cover its financing needs for the first half of 1999. Within 19 days of the crisis, Argentina was able to place back-to-back bonds in the euro and dollar markets. Syndicated bank loans declined in the subsequent two months but picked up to substantial levels thereafter. However, sovereign bond spreads were 300–400 basis points over the levels observed in early 1998, and never returned to pre-Russia/Brazil crisis levels.

E. Renewed Market Concerns

12. Economic and political developments in 1999 gave rise to a period of heightened market concerns about the Argentine economy. Argentina suffered from an economic downturn in the region, an appreciation of the exchange rate, and terms of trade loss. The national and provincial elections in October 1999 made it difficult to adopt an appropriate policy response to such shocks. Fiscal discipline weakened, structural reforms came to a halt, and the EFF went off track. Economic activity declined in 1999, with real GDP dropping by 3.4 percent, and the unemployment rate rose to 14 percent. In this context, Argentine borrowers had reduced access to external financing at times in 1999.

13. The government that took office in December 1999 took steps to strengthen the macroeconomic policies (in particular budgetary policies) and revitalize structural reforms in an effort to buttress market confidence and facilitate economic recovery. The Argentine authorities also requested a precautionary stand-by arrangement (SBA) in an amount equivalent to 255 percent of quota. These steps, in the context of an improving external environment, provided a temporary boost to market confidence.

14. The external financing prospects of Argentina changed drastically in the third quarter of 2000. External financing to emerging markets fell significantly in mid-2000 as a result of uncertainty about interest rate policy in the United States. There were also increasing concerns about economic activity and its impact on the public finances in Argentina. These developments led to a rise in bond spreads through September 2000, with the EMBI+ sub-index for Argentina rising by about 150 basis points to a 650–700 basis point range. Nevertheless, the government followed through with its financing plan, securing more than 80 percent of its gross financing requirements (US$14.5 billion) through September. As concerns about the political situation reappeared in subsequent months, the external financing conditions worsened significantly.

15. In the face of these adverse developments, in November 2000 the authorities adopted measures to promote a recovery of investment and to accelerate implementation of structural reforms. Recognizing the importance of ensuring medium-term fiscal sustainability, the authorities also took steps to strengthen the fiscal stance by negotiating a new fiscal pact with the provinces, including a freeze on nominal primary spending at all levels of the government. To ease financing constraints and facilitate the return of Argentina to international capital markets, in December 2000 the government arranged a financial support package of around US$39 billion from official and private sector sources, including an augmentation of the existing SBA to 500 percent of quota (equivalent to US$13.7 billion); understandings with the World Bank and the IDB on new loan commitments amounting to US$4.8 billion in 2001–02; a loan from Spain of US$1 billion; and rollover commitments with market maker banks active in Argentina and local pension funds.

II. Brazil

A. The Real Plan

16. In July 1994, the Brazilian authorities embarked on an economic program, the Real Plan, aimed at reducing inflation sharply. The various elements of the program were introduced in a well-designed sequence of three phases: (i) measures to strengthen the public finances; (ii) the synchronization of price adjustments throughout the economy via the use of a unit of account in the denomination of prices and contracts; and (iii) the introduction on July 1, 1994 of a new currency, the *real*, with a floating exchange rate system that included a rule that the exchange rate would not be allowed to depreciate beyond parity with the U.S.

dollar, the freezing of public prices, and the prohibition of indexation in nonfinancial contracts with adjustment periods shorter than a year.[3]

17. Inflation declined markedly in the second half of 1994 and 1995 in response to the measures, a nominal and real effective appreciation of the real vis-à-vis the U.S. dollar, and an initial tightening of monetary and fiscal policy. A strong pickup in domestic demand (associated with the decline in the inflation tax, increases in real wages, and a large expansion of consumer credit) led to a real appreciation of the domestic currency and a marked deterioration in the external trade balance. The rate of growth of GDP accelerated from 2.7 percent in 1993 to 5.8 percent in 1994, but slowed to 4.2 percent in 1995 (Figure 5). Reflecting the high real interest rates and improving economic prospects, short-term capital inflows and portfolio investment surged.

18. The onset of the Mexican crisis in late December 1994, combined with concerns about the sustainability of Brazil's external trade situation, led to a slowdown in capital inflows in early 1995. In response to these events, in January 1995, the authorities adopted a series of measures to facilitate capital inflows. In early-March 1995, the authorities also introduced a system of exchange rate bands, initially setting the band at RS$0.86–RS$0.90 per U.S. dollar that was to be effective through May 1, 1995. However, the uncertainty about the new exchange rate policy prompted a run on the currency. On March 10, 1995 the authorities reset the band at RS$0.88–RS$0.93 per U.S. dollar, and announced that it would be effective for an indefinite period. (The band was modified on numerous subsequent occasions.)

19. As the new exchange rate band system restored confidence, capital inflows surged. On the back of this development, Brazil reentered international bond markets after a long absence, placing a five-year Yen 80 billion (US$921.6 million) with a coupon rate of 6 percent in May 1995 (Figures 6-7). In June 1995, Brazil placed a three-year DM 1 billion (US$713.9 million) bond at a spread of 385 basis points over the interest rates on a comparable Bund instrument. From 1996 to mid-1997, Brazil tapped international capital markets on various occasions, and Brazilian financial institutions and corporations increased their presence in those markets.

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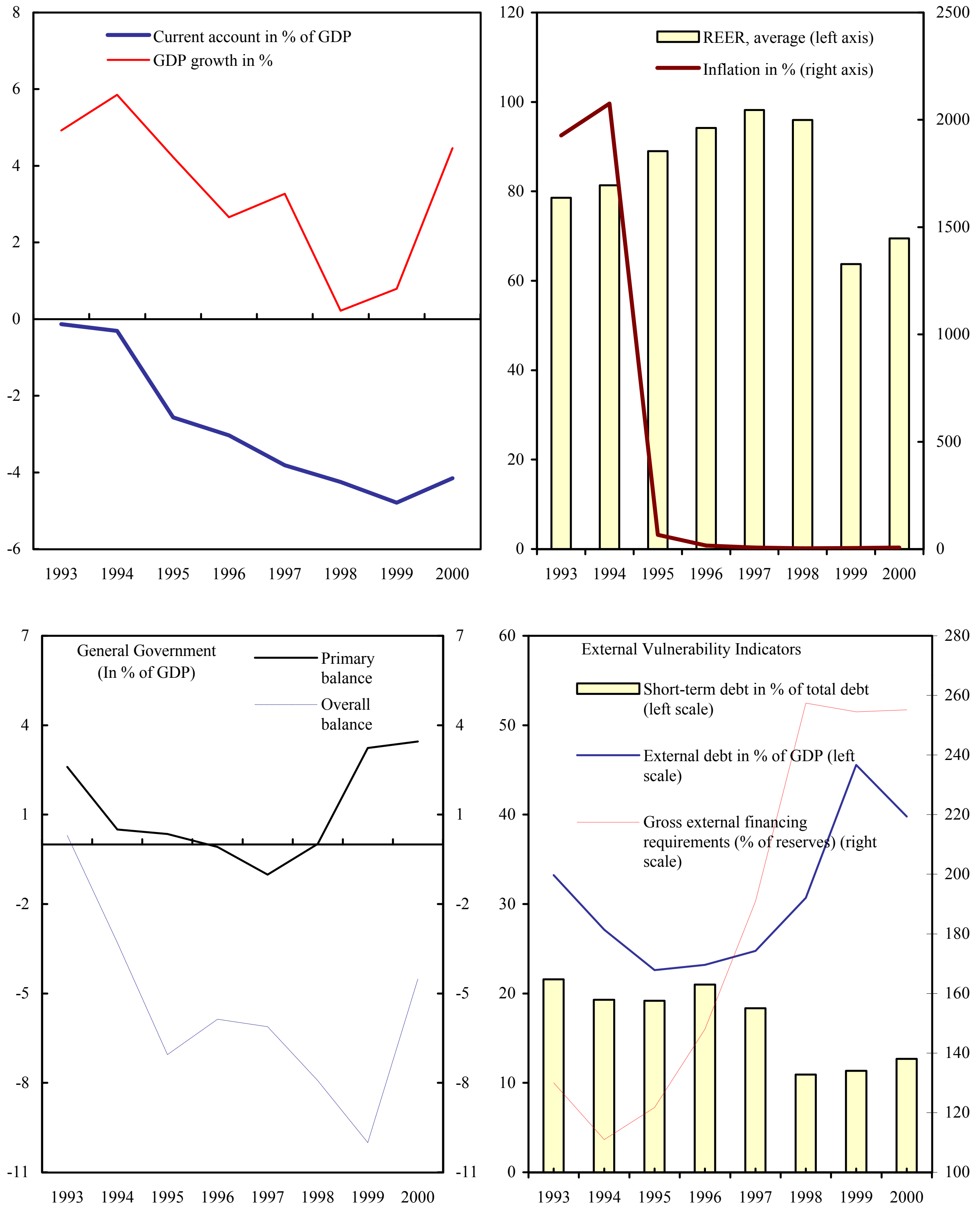
[3] In April 1994, Brazil reached an agreement with banks to restructure its external debt. This process had begun in early 1991 with the resumption of interest payments equivalent to 30 percent of accrued interest on eligible medium- and long-term public external debt (raised to 50 percent in January 1992). Prior to 1991, Brazil had maintained an 18-month moratorium on debt-service payments.

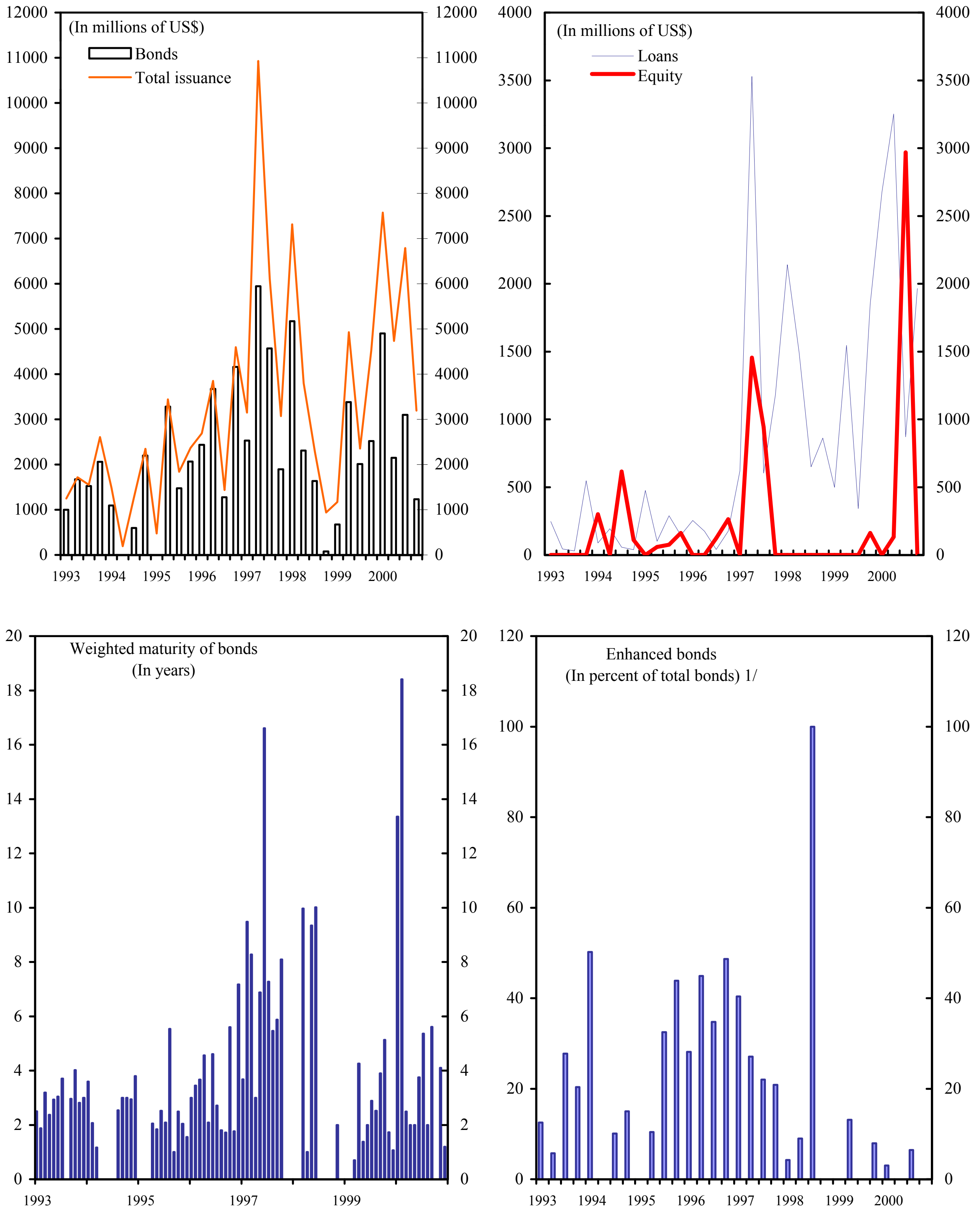
Figure 5. Brazil: Fundamentals , 1993-2000 1/



Sources: IMF, International Financial Statistics; IMF, World Economic Outlook.

1/. The latest WEO data may not correspond exactly to the latest data from country staff reports.

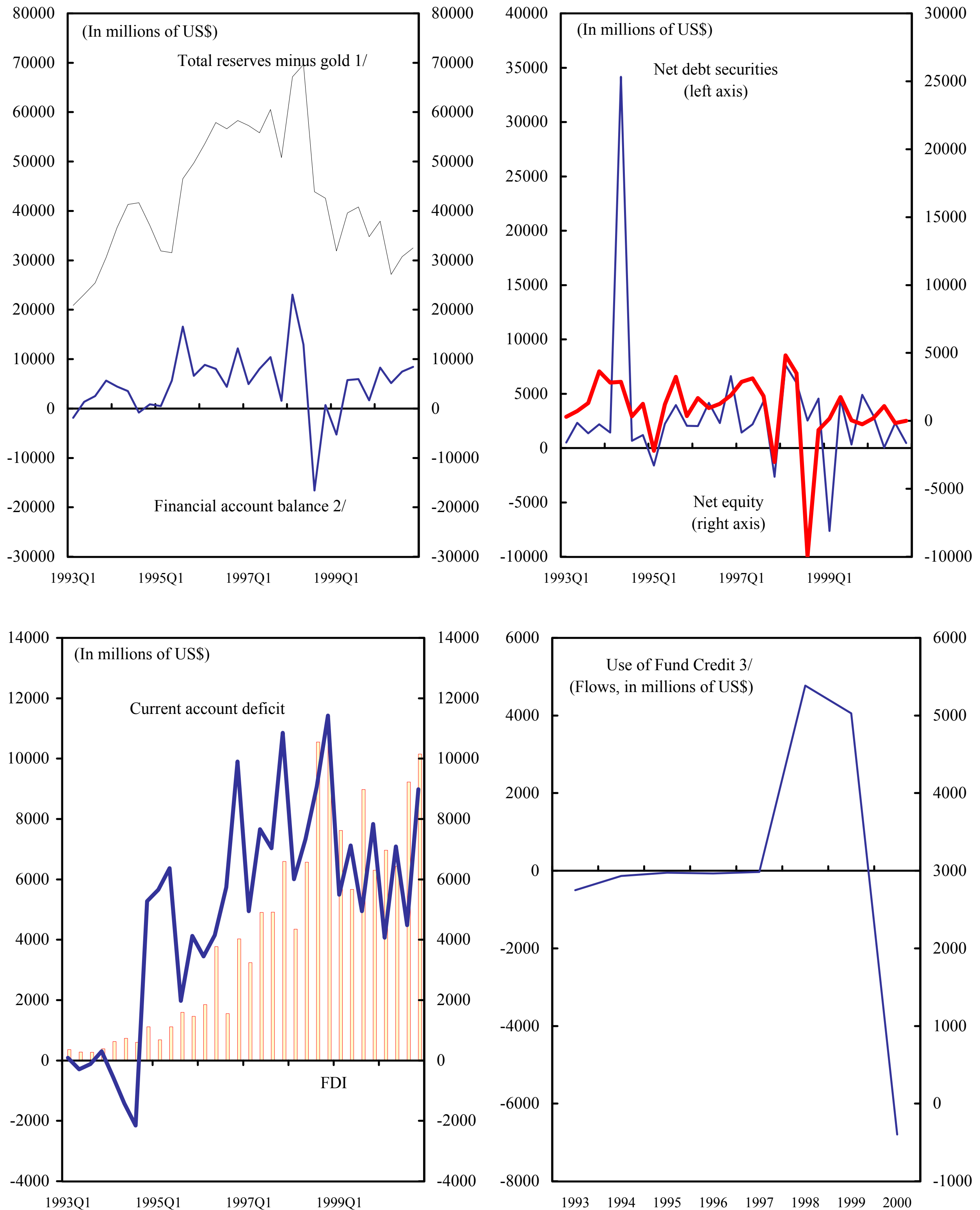
Figure 6. Brazil: Gross Issuance of Bonds, Loans, and Equity, Jan-1993 to Dec-2000



Sources: BEL database; Capital Data Bondware; Loanware; staff calculations.

1/ Data on enhanced bonds from BEL is based on a strict definition of enhancement namely convertibles, secured, and put options.

Figure 7. Brazil: Net Capital Flows, 1993-2000



Source: IMF, International Financial Statistics.

1/ Total reserves not adjusted for encumbered reserves.
2/ Excludes errors and omissions.
3/ Net.

B. The Asian Crisis

20. The economic program in Brazil since the inception of the Real Plan had centered on a tight monetary policy combined with a gradually improving but still not adequate fiscal stance, a continuing depreciation of the *real* within the context of the exchange rate band system, and an acceleration of the privatization program. However, the economic program came to the brink of collapse in mid-October 1997 in the face of large capital outflows prompted by the selling spree in international financial markets, forcing the Central Bank to intervene heavily in the foreign exchange market to reduce pressures on the *real*.

21. As the intervention by the Central Bank proved ineffective, the authorities adopted decisive and far-reaching measures on October 30, 1997. The Central Bank doubled the discount rate (TBC) from 20.7 percent to 43.3 percent. To set the conditions for lowering interest rates when the situation in international capital markets normalized and offset the adverse impact of this action on the fiscal accounts, in November 1997 the authorities announced a package of fiscal measures to yield some 2.5 percentage points of GDP in 1998.

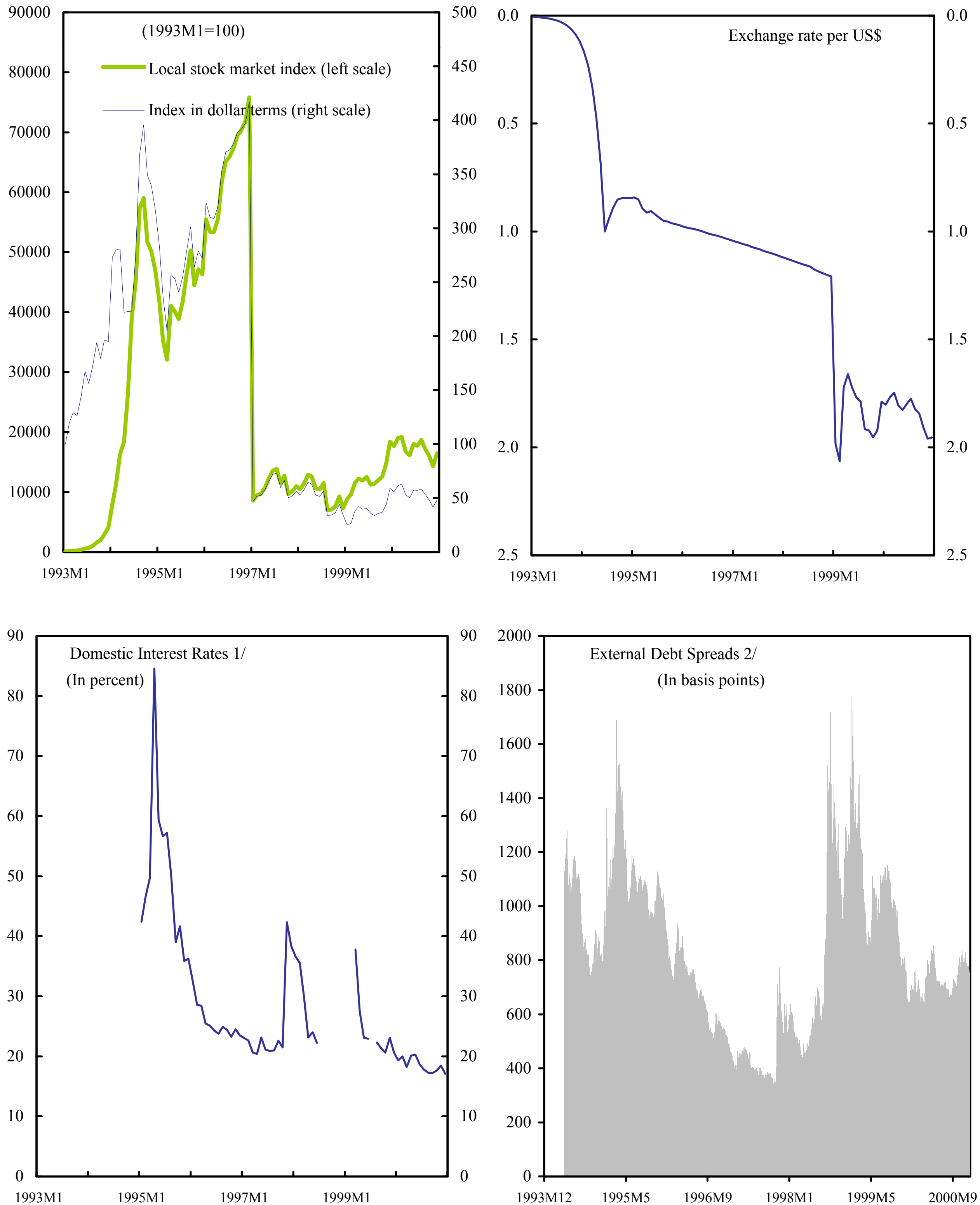
22. On the back of an overwhelmingly positive market reaction to the measures adopted, net portfolio investments surged and Brazil regained market access. Lured by the sharp increase in interest rates, investors began buying domestic public debt instruments again soon after the adoption of the corrective measures. Brazilian sovereign spreads, measured by the EMBI+ subindex for Brazil, which nearly doubled from end-September 1997 to late-October to 710 basis points, declined noticeably (Figure 8). In February 1998, Brazil placed a five-year Eurobond of €500 million (US$549 million) with a coupon rate of 8.6 percent and a spread of 390 basis points over the yield on a comparable European debt instrument. In March 1998, Brazil also placed a 10-year DM 750 (US$409 million) bond with a coupon rate of 10 percent and a spread of 305 basis points over the yield on the January 2008 Bund, and a 10-year global bond of US$1.3 billion with a coupon rate of 9.4 percent and a spread of 375 basis points over a comparable U.S. treasury debt instrument.

C. The Russian Crisis

23. In an effort to provide a boost to the economy and contain rising unemployment, the Central Bank began to lower interest rates in July 1998, and the fiscal stance became more expansionary. In light of rising concerns about the sustainability of the exchange rate policy, owing to the uncertainty associated with the forthcoming Presidential elections and a change in the macroeconomic policy stance in the context of a worsening situation in Russia, Brazil began to experience large capital outflows in August 1998. Recognizing the difficulties arising from the acceleration of capital outflows, the authorities adopted several, mainly administrative measures to contain capital outflows.

24. Concerns about the situation in Brazil continued to grow as the magnitude of capital outflows increased significantly. (International reserves declined by about US$25 billion in the third quarter of 1998.) These concerns were exacerbated by the Central Bank’s decision to

Figure 8. Brazil: Financial Markets Developments, 1993-2000



Sources: IMF, International Financial Statistics; Bloomberg.

1/ Treasury bill rate.
2/ EMBI Brazil subindex.

widen the wedge between the key discount rates. On September 2, the TBC was lowered from 19.8 percent to 19 percent, while the TBAN was raised from 25.8 percent to 29.8 percent. As the TBAN was essentially inoperative, this step was in effect a lowering of interest rates. On September 4, the Central Bank de facto increased interest rates by temporarily suspending discount operations at the TBC rate while requiring discount operations only at the TBAN rate. As this increase failed to slow capital outflows, on September 10 the Central Bank raised the TBAN rate to 49.8 percent. To offset the impact of the increase in interest rates on the public accounts, the authorities tightened the fiscal stance, and began discussions with the Fund on an economic program that could be supported by a formal arrangement. Agreement would be reached on a three-year Stand-By Arrangement in early-December 1998.

25. The Brazilian authorities' announcement of the economic program led only to a temporary improvement in market sentiment. In the context of a policy of gradual depreciation of the exchange rate vis-à-vis the U.S. dollar within a slowly widening band, market participants began to question the viability of the new economic program soon after its announcement, because of its reliance on an exchange rate policy that, in their view, was the main impediment to restoring economic growth. There were growing concerns about the public debt dynamics in light of the sharp increase in interest rates, and the ability of Brazil to obtain the necessary financing to meet its external financing requirements. Under these circumstances, the country risk premium rose by about 800 basis points in August 1998 to 1,421 basis points.

D. The Brazilian Crisis

26. In response to this situation, in October 1998 the Brazilian authorities introduced an economic program aimed at setting the conditions for a recovery of economic activity. The program was to center on a tightening of the fiscal stance over the medium term in context of the exchange rate band system, relying on increasing targets for the primary balance of the consolidated public sector to ensure that the public debt to GDP ratio returned to a sustainable path. To strengthen the fiscal stance over the medium term, the authorities sent to Congress a tax reform (which was not approved) and fiscal responsibility law (enacted in May 2000) that set limits on expenditure of all levels of government. In November 1998, Congress approved a reform of the social security system.

27. The improvement in market confidence following the introduction of these measures was not to last. The lower house of Congress failed to approve a key fiscal measure quickly, the Central Bank induced a sharp reduction in interest rates that led to renewed capital outflows, and the state of Minas Gerais declared a moratorium on the service of its debt to the federal government. In this context, strong pressures on international reserves reappeared, and on January 13, 1999 the central bank widened the exchange rate band in an effort to introduce more flexibility in the management of the exchange rate system. As pressures on international reserves did not subside, on January 15, 1999, the central bank abandoned the exchange rate band while introducing a floating exchange rate system. To support the new exchange rate policy and prevent an undue increase in inflation, the authorities tightened the fiscal stance and the Central Bank raised interest rates noticeably.

28. The adoption of a new exchange rate policy, the appointment of Mr. Arminio Fraga, a well-respected fund manager in New York and former government official, as President of the central bank and the initial success of the economic program provided a major boost to market confidence. In the months following the devaluation of the *real*, economic activity began to recover. Inflation, which the market expected to increase noticeably after the devaluation of the *real*, rose only moderately, and after an initial overshooting, the *real* appreciated. Fiscal performance exceeded the program targets, and monetary policy remained supportive of the new macroeconomic policy stance. The external environment also became more supportive to emerging markets.

29. In this context, capital inflows resumed in the first quarter of 1999 and Brazil regained access to international capital markets. Brazil continued to place domestic debt instruments during this period, but relied on issues of securities indexed to the exchange rate *after the devaluation of the real.* Private financial institutions and corporations began to access international capital markets intensively. An agreement on the rollover of international interbank lines appears to have played some role in catalyzing the resumption of capital flows and Brazil's reentry in international capital markets. The rollover rate of interbank credits, as monitored by the central bank, rose from 65 percent on average in January to more than 80 percent in the first three weeks of March. In April 1999, Brazil placed a five-year global bond of US$3 billion with a spread of 675 basis points over the interest rate on a comparable U.S. treasury debt instrument. Spreads remained above the pre-Russia crisis levels.

30. Pressures on the capital account reappeared in mid-1999 because of concerns about the sustainability of the fiscal effort in light of legal challenges to the measures announced in October 1998. In response to this situation, the authorities adopted a series of fiscal measures to offset the loss of revenue. The central bank also adopted an inflation-targeting framework to conduct monetary policy in July 1999. In this context, Brazil reentered international capital markets with little difficulty. In July 1999, Brazil placed a three-year €800 million (US$817.6 million) bond with a coupon rate of 9.5 percent and a spread of 600 basis points over a comparable European bond. While this was the largest Eurobond issue by an emerging market economy until then, the demand for the bond was overwhelming, picturesquely described as a "blow out." The placement of this bond also was the beginning of an uninterrupted period of access to international capital markets for Brazil. In October 1999, Brazil offered a Brady swap operation of debt with short maturity for debt with extended maturity.

III. Indonesia

A. Market Access Prior to the Asian Crisis

31. Indonesia gained significant access to international capital markets in the early to mid-1990s. As a result of a combination of factors, including a significant improvement in economic fundamentals, a liberalization of capital market restrictions, and improvements in global market conditions, Indonesia witnessed significant surges in private capital inflows in the period 1990 through 1996. The rebalancing of portfolios by investors in light of the Tequila crisis contributed to further capital inflows into Indonesia (Figures 9–10). Owing to improvements in the terms and conditions of access to international capital markets, reflected in sharp compression of sovereign spreads, net capital inflows to Indonesia averaged an annual 3 ½ percent of GDP in the years preceding the Asian crisis, with domestic financial institutions playing an important role in intermediating these inflows.

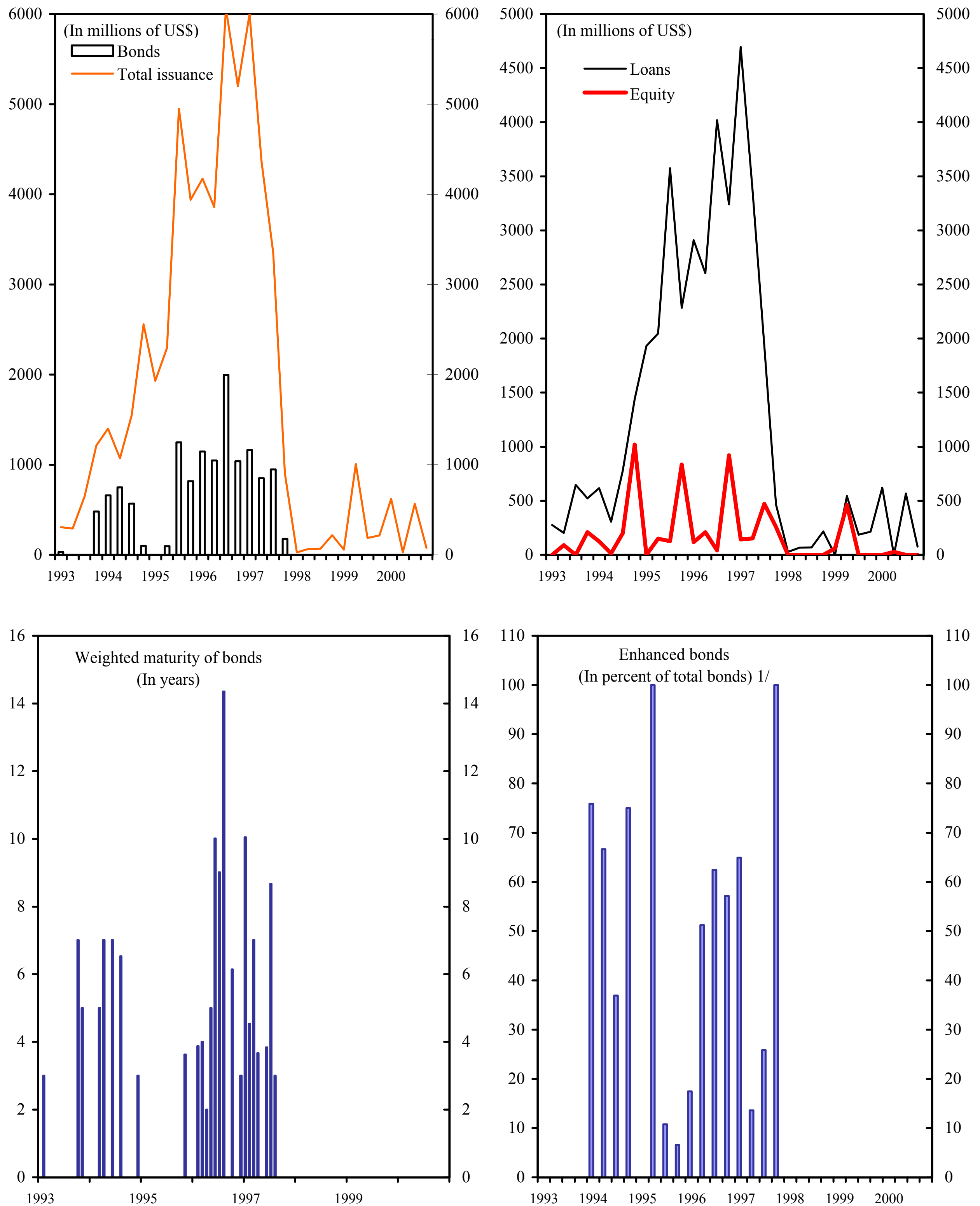
32. The rapid rise in capital inflows, however, led to the emergence of large unhedged exposures of domestic borrowers, especially with regard to exchange risk, with short-term external debt rising considerably faster than total debt. In addition to being exposed to exchange risk, domestic financial institutions, which were clearly not adequately supervised, were exposed quite heavily to the real estate sector. By end-1997, the share in total loans from the banks to the property sector was of the order of 20-30 percent.

B. The Asian Crisis

33. In July 1997, soon after the floating of the Thai baht, pressure on the rupiah intensified. Despite reasonably favorable macroeconomic fundamentals, the large and growing stock of short-term private sector external debt and evidence of significant weaknesses in the financial sector raised market concerns regarding the sustainability of the exchange peg. Following a brief flirtation with the widening of the intervention band from 8 to 12 percent, the rupiah was floated on August 14, 1997. With pressures on the exchange rate intensifying, because of inadequate domestic policy response and contagion from the worsening economic situation in Korea, the rupiah depreciated continuously and by mid-January 1998 had registered a cumulative depreciation from pre-crisis levels of some 75 percent, the largest by far of any country in the region (Figure 11). Stock prices, which had increased through mid-1997, fell dramatically in the aftermath of the Thai crisis, while property prices dropped significantly later in the year. Movements in the exchange rate and stock prices, in tandem with a slowdown in economic activity, aggravated the stock imbalances, and led to a self-reinforcing process of bankruptcies and the whole banking system in a full-blown and severe crisis.

34. Under these circumstances, the reversal of capital flows was an obvious outcome and the process of Indonesia's losing access to capital markets began. Although interbank loans, which accounted for a reasonably important share of bank lending to Indonesia, continued to grow through the third quarter of 1997 (US$3 billion), there was a sharp turnaround by

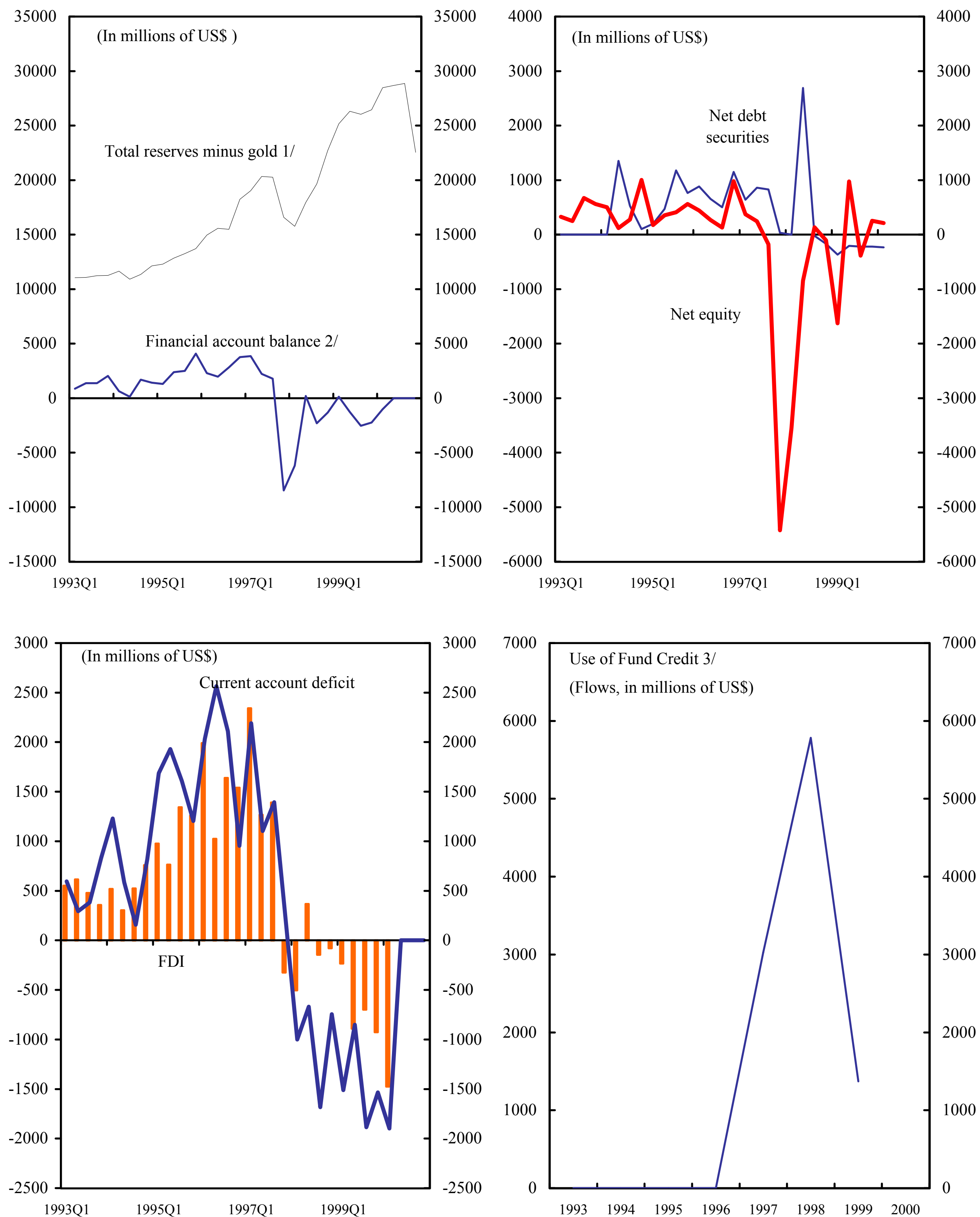
Figure 9. Indonesia: Gross Issuance of Bonds, Loans, and Equity, Jan-1993 to Dec-2000



Sources: BEL database; Capital Data Bondware; Loanware; and staff calculations.

1/ Data on enhanced bonds from BEL is based on a strict definition of enhancement namely convertibles, secured, and put options.

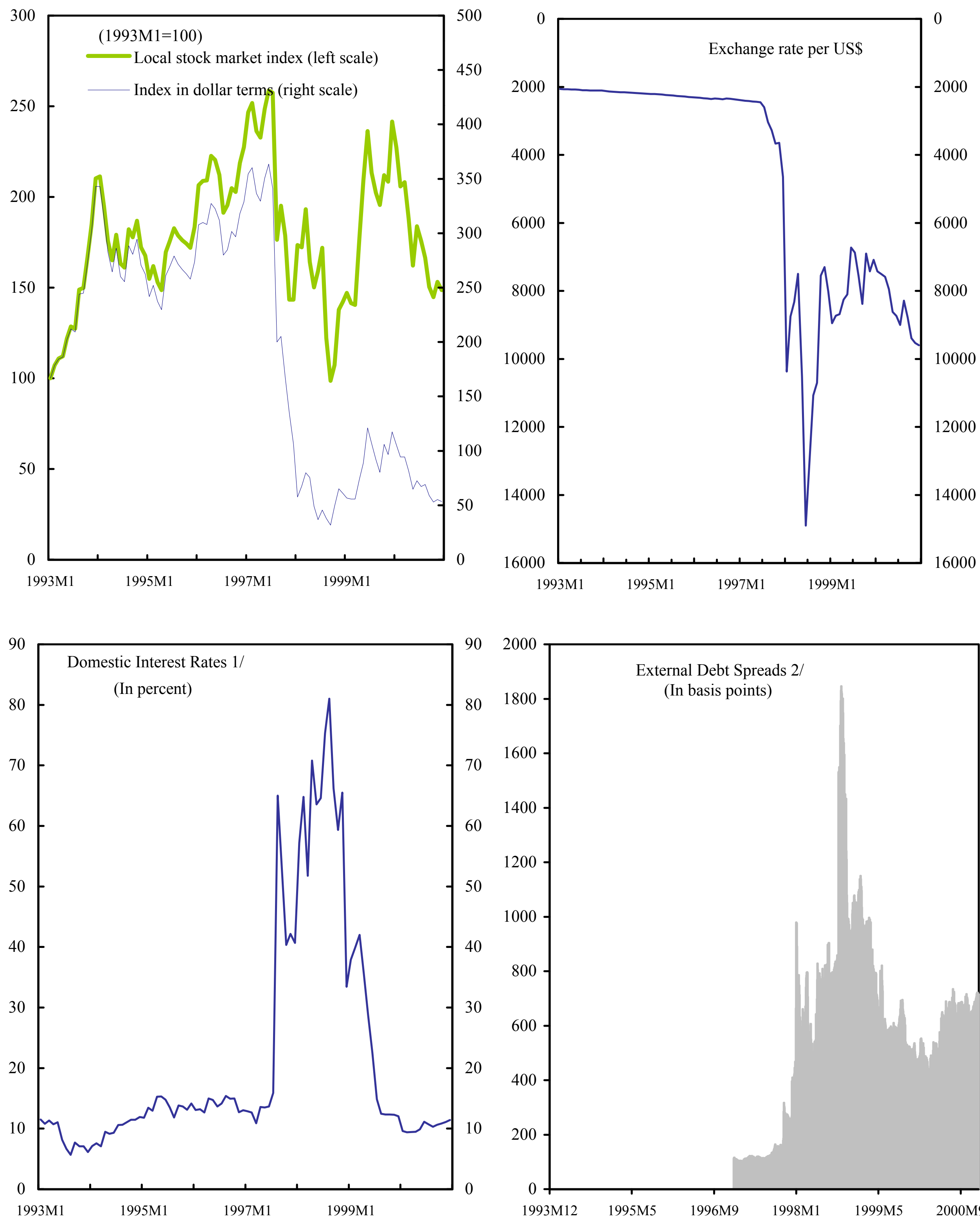
Figure 10. Indonesia: Net Capital Flows, 1993-2000



Source: IMF, International Financial Statistics.

1/ Total reserves not adjusted for encumbered reserves.
2/ Excludes errors and omissions.
3/ Net.

Figure 11. Indonesia: Financial Markets Developments, 1993-2000



Sources: IMF, International Financial Statistics; Bloomberg.

1/ Call money rate.
2/ Spread on the 7.75%, 2006 government bond.

year-end. The bid-ask spread on the rupiah, which prior to the crisis had been comparable to that for other major currencies, widened by a factor of 13 following the crisis, while the secondary market spread increased sharply to 979 basis points by year-end. Sovereign spreads further peaked in January 1998 when rating agencies unanimously downgraded Indonesia's sovereign debt. In the midst of the economic turmoil, foreign creditors refused to roll over maturing credit lines, and as a result pressures on the exchange rate intensified.

35. In the period beginning with the Thai crisis through the first quarter of 1998, the overall external payments position of Indonesia deteriorated sharply despite improvements in the trade account and a better than envisaged current account balance (Figure 12). The external private capital account deteriorated because of a decline in new flows, the reluctance of foreign creditors to rollover bank and corporate external debt, and the repatriation of portfolio investment. Gross reserves of the Bank of Indonesia plunged to US$16.5 billion at end-March from US$28 billion at end-September 1997.

C. Policy Response and the Role of the Fund

36. On November 5, 1997, the Fund approved a three-year stand-by arrangement with Indonesia in an amount equivalent to US$10 billion.[4] The main elements of the policy package included tight monetary policy, combined, when necessary, with exchange market intervention to stabilize the rupiah; measures to strengthen the underlying fiscal position to facilitate a current account adjustment; and structural reform of the financial and corporate sectors. Despite the positive initial response, the pursuit of a stop-and-go monetary policy, marked by vacillation between support for the exchange rate and strong liquidity expansion to ease the strain on the financial sector, and the uneven implementation of structural reform enhanced market perception of a lack of commitment to the economic reform agenda. Political uncertainty and the ill-conceived program of government guarantees for bank deposits added to the strain.

37. With the announcement of a strengthened economic program on January 15, 1998, the rupiah briefly appreciated, but collapsed again because of grave concerns regarding the financial sector and general political uncertainty, and as a result, the economic program quickly went off track. A modified Fund-supported reform program (May 1998) sought to contain monetary growth, while allowing for some relaxation of the fiscal position, accelerate structural reforms, and initiate talks on agreement with private creditors regarding the restructuring of corporate sector obligations and the rollover of short-term bank debt. These discussions broke down, owing in part to civil unrest, which subsequently led to the resignation of President Suharto. The rupiah nose-dived and hit an all-time low of 16,650

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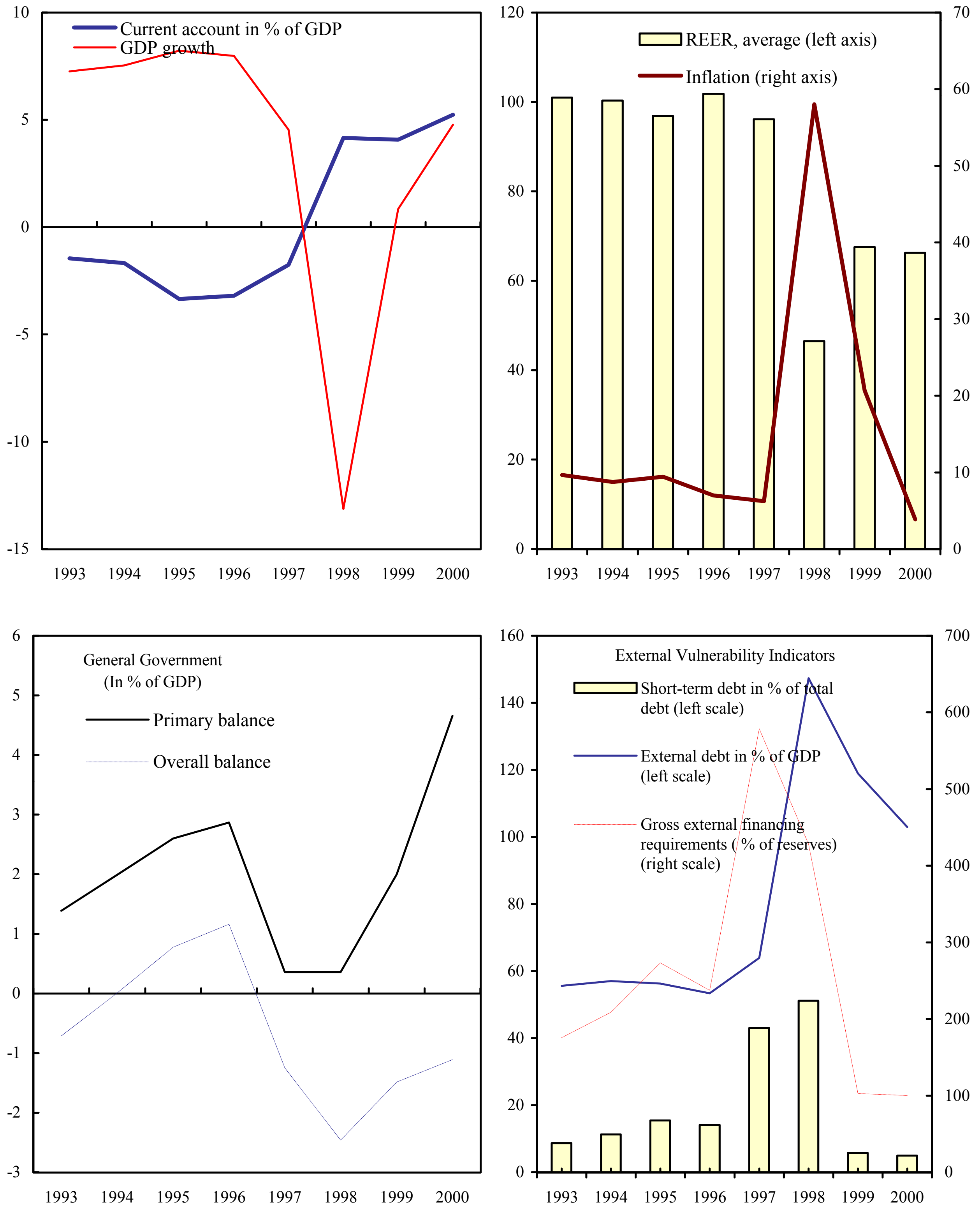
[4] As a share of Indonesia's quota, the amount committed under the SBA was 490 percent. Additional financing commitments, including from the World Band, the Asian Development Bank, and bilateral creditors, totaled US$26 billion.

Figure 12. Indonesia: Fundamentals , 1993-2000 1/



Sources: IMF, International Financial Statistics; IMF, World Economic Outlook.

1/. The latest WEO data may not totally correspond to the latest data from country staff reports.

against the U.S. dollar in mid-June 1998 (a cumulative depreciation of 85 percent since June 1997).

38. On August 25, 1998, the Executive Board approved the authorities' request to replace the stand-by arrangement by an extended arrangement with the same access (US$6.3 billion; 312 percent of quota; for the remaining 26 months) and phasing as envisaged under the SBA. On September 23, 1998, an agreement was reached on the rescheduling or refinancing of Indonesia's bilateral external debt to official creditors.

D. Market Reaccess

39. An agreement with a steering committee of private creditors was reached on June 4, 1998. The agreement covered the restructuring of interbank debt falling due before March 1999, the establishment of a trade facility to help restore normal trade financing, and a framework for the voluntary restructuring of corporate debt, involving a government exchange guarantee scheme (INDRA scheme). In March 1999, there was a second interbank exchange offer that covered maturities falling due in the period between April 1999 and December 2001. This represented the bulk of private capital inflows to Indonesia since the crisis.

40. Capital flows to Indonesia through most of 1998 did not revert to their earlier level, while the equity market continued to remain depressed. The worsening situation in Russia contributed to the failure of confidence to improve. For example, cross-border claims of BIS banks on the domestic banking sector declined from US$11.5 billion in 1997 to US$5.2 billion in 1998. While emerging markets recovered substantially during the fourth quarter of 1998, amid an easing of official interest rates in most industrial countries and agreement on a program between the Fund and Brazil, market perception of Indonesia was still downbeat.

41. In 1999, as a result of the overall favorable global environment, strengthening oil prices, and improving macroeconomic conditions in a number of key emerging economies, emerging markets rallied in February-April. Around this time, spreads on Indonesian external debt moved down to the range of 650–700 basis points, declining further to 550 basis points by end-June. In the first six months of 1999, the IFC Investable Index for Indonesia rose by more than 60 percent. Despite a pick up in economic growth, however, investment growth remained weak, reflecting subdued, and sometime waning, market confidence. While gross international reserves at end-year were above the projected level, there was little evidence that flight capital had begun to return, and new equity flows remained weak. Over this period, Indonesia issued no new bonds, despite the fact that sovereign spreads through most of the second half of the year had narrowed and were in the range of 550–650 basis points.

42. In February 2000, the Fund approved an extended arrangement. While economic recovery under the program gained momentum, evidenced by the significant increase in electricity consumption, vehicle production and sales, and mining output, it did not translate into an improvement in the investment climate and a resumption in market access. Market sentiment was adversely affected by rising political tension and unrest in some provinces. Consequently,

the rupiah drifted to a lower range of Rp 7,400 to 7,500 to the U.S. dollar. The stock market fell substantially, and sovereign bond spreads widened sharply. Widening risk premia were reflected in upward pressures on domestic interest rates. In April, the Paris Club and Indonesian authorities reached an agreement on the rescheduling of all principal obligations falling due through March 2002.

43. Despite the economic recovery being stronger than expected under the Fund program and a successful Paris Club rescheduling of external debt, the slow and uneven progress in structural reforms, especially in the core bank and restructuring areas, and the lack of commitment for improving fiscal transparency and governance in the public sector undermined investor confidence in the government's reform efforts. The exchange rate remained under pressure throughout 2000, stock prices continued to fall and foreign exchange risk premia continued to rise sharply. Under such circumstances, Indonesia did not regain market access.

IV. KOREA

A. Market Access Prior to the Asian Crisis

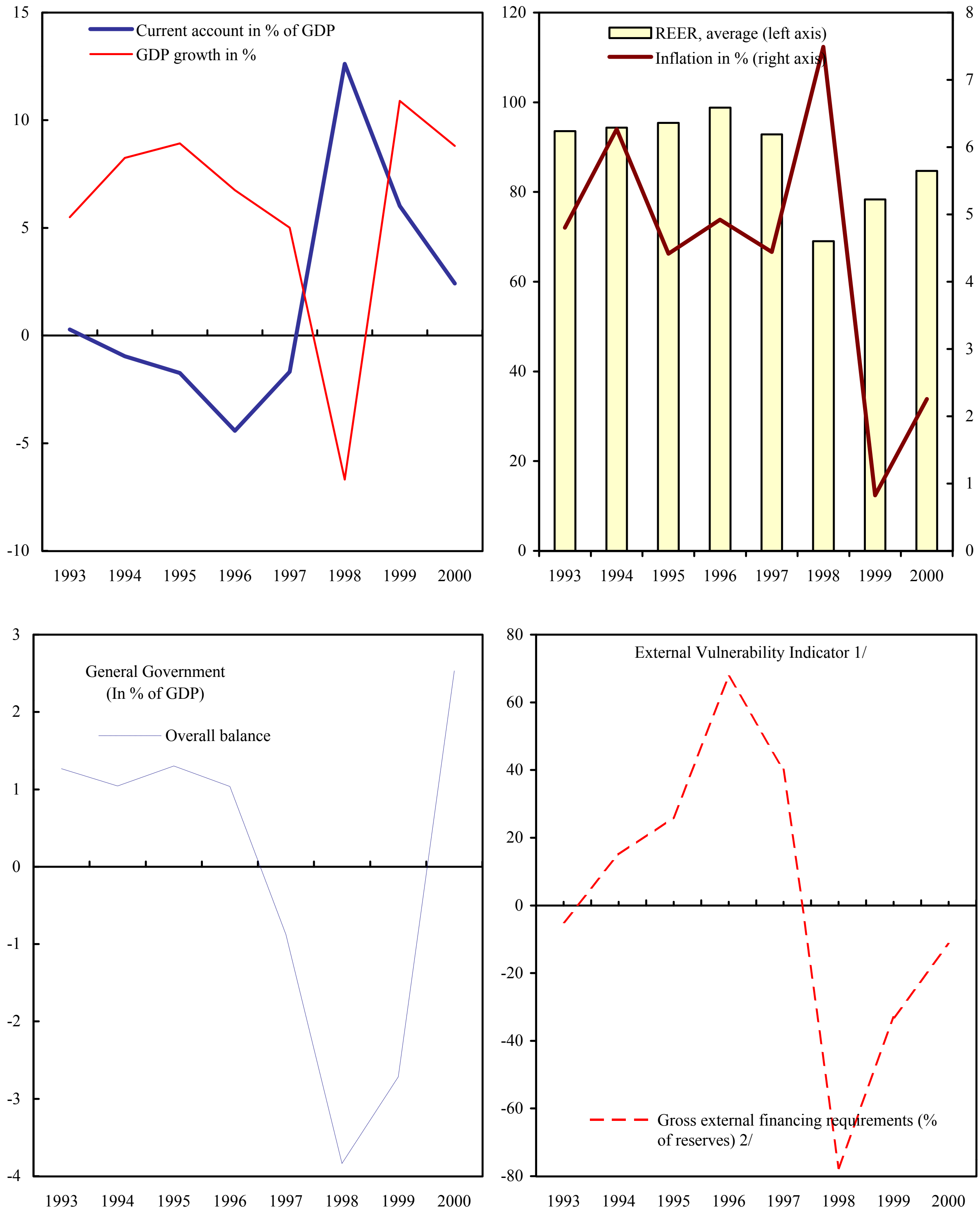
44. Over the first half of the 1990s Korea witnessed rapid economic growth, high savings and investment rates, near balanced budget and external current accounts, and moderate inflation rates (Figure 13). The openness of the economy, combined with financial policies geared toward maintaining a stable macroeconomic environment, enabled Korea to take advantage of the strong expansion of world trade. During this period, Korea was able to attract significant private capital inflows, with gross (net) bond and loan placements increasing rapidly to reach US$28 billion (US$10 billion) in 1996 (Figures 14–15). Owing, in large part, to strong macroeconomic fundamentals, Korea was largely unaffected by the Mexican crisis. At end-1994, among all emerging market developing countries, Korea was the largest borrower in the bond market, led by placements by public banking institutions with launch spreads for unenhanced bond issues at below 50 basis points (Figure 16). In April 1995, S&P upgraded Korea's sovereign rating to AA- from A+. Korea joined the OECD in December 1996.

B. The Asian Crisis

Build up of vulnerabilities and loss of market access

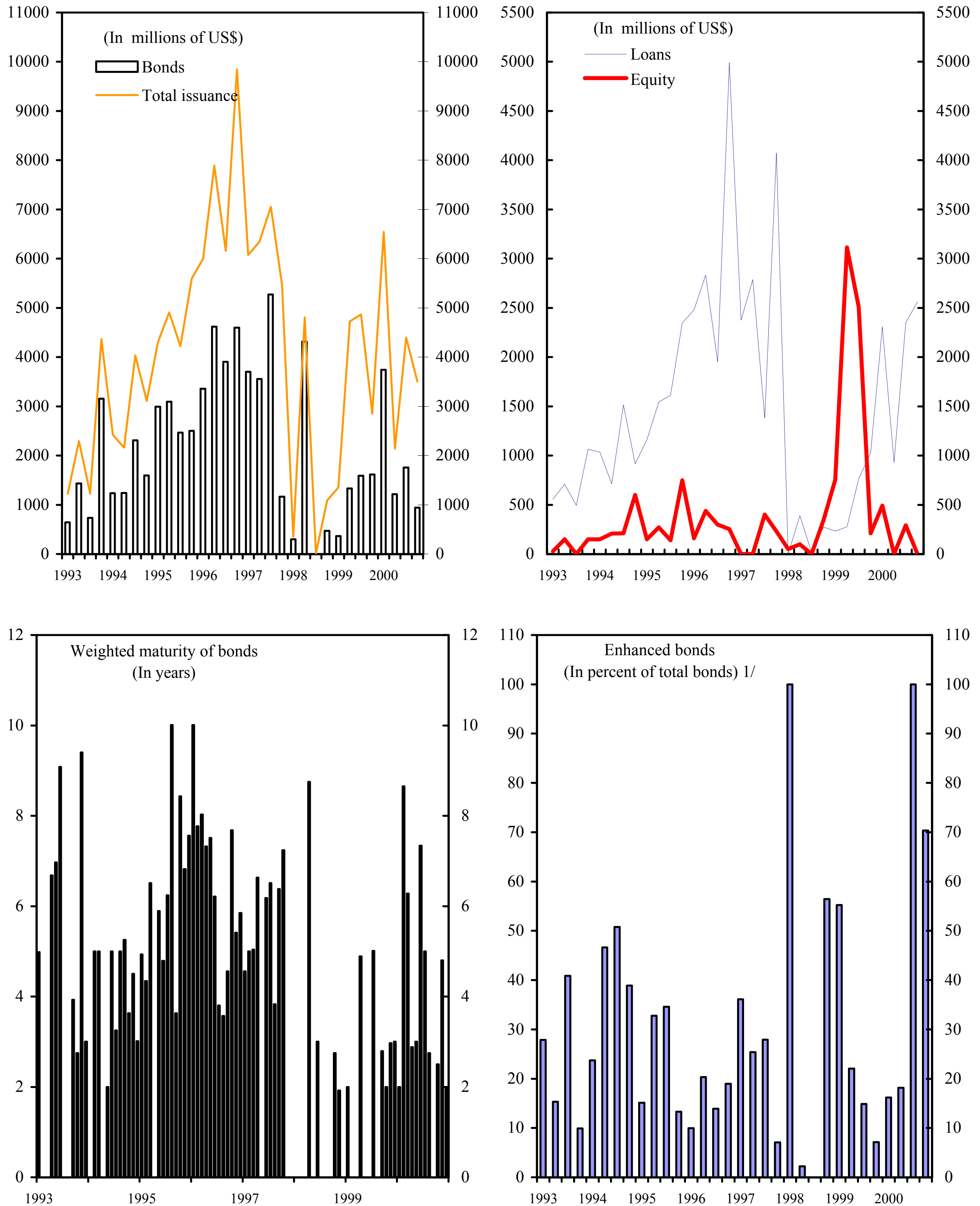
45. Korea succumbed to the crisis in the period following the turbulence in Hong Kong's financial markets in late-October 1997, although weaknesses had become apparent much earlier. In fact, concerns about excess capacity, declining profitability, and increasing nonperforming assets in the financial sector had arisen in late-1996 and early-1997. Large corporate conglomerates were heavily dependent on debt with much of the corporate debt supplied directly, or guaranteed by, Korean financial institutions. Banks, in turn, were made

Figure 13. Korea: Fundamentals , 1993-2000 1/



Sources: IMF, International Financial Statistics; IMF, World Economic Outlook.
1/. The latest WEO data may not correspond exactly to the latest data from country staff reports.
2/ Gross external financing requirements do not include short-term debt.

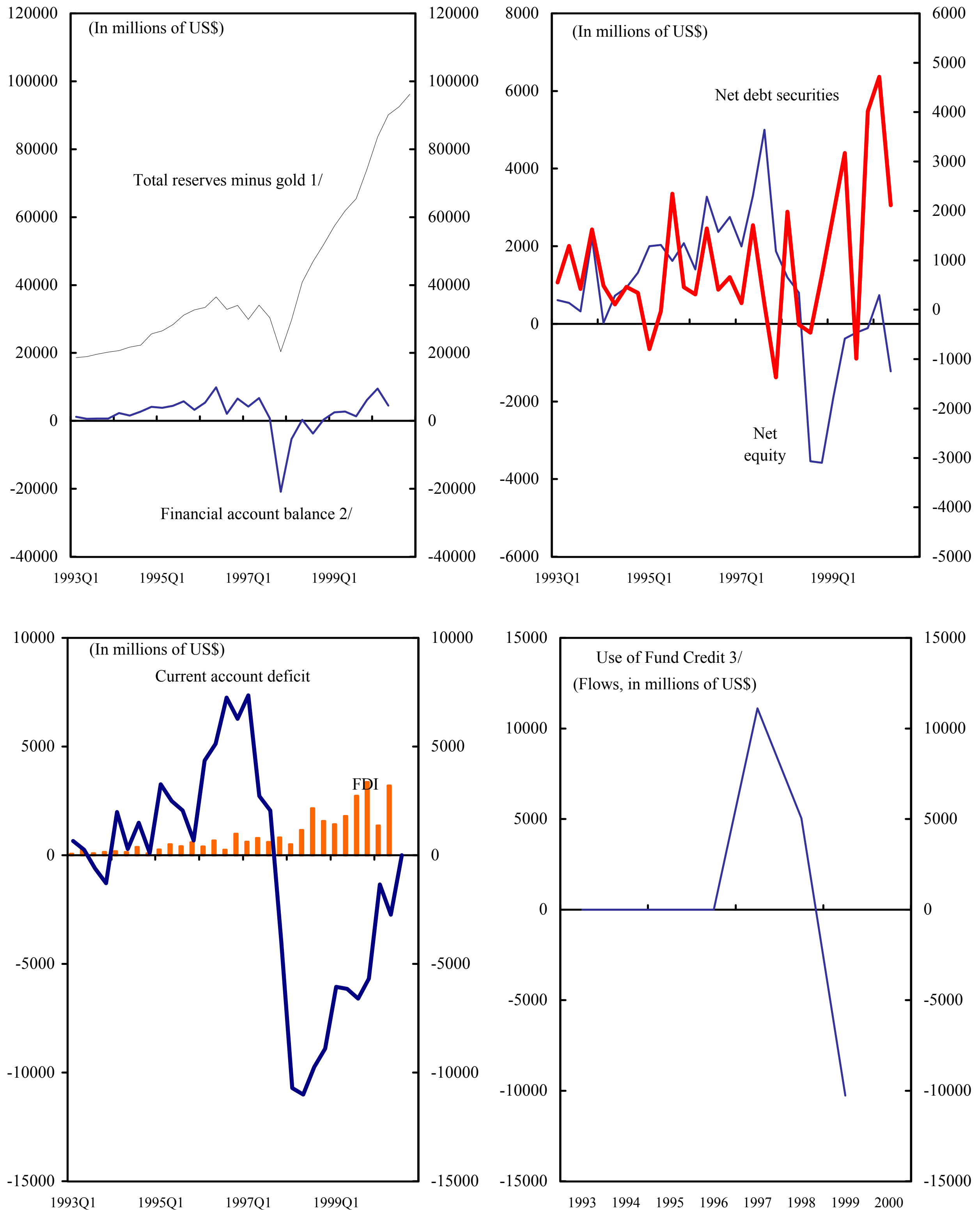
Figure 14. Korea: Gross Issuance of Bonds, Loans, and Equity, Jan-1993 to Dec-2000



Sources: BEL database; Capital Data Bondware; Loanware; and staff calculations.

1/ Data on enhanced bonds from BEL is based on a strict definition of enhancement namely convertibles, secured, and put options.

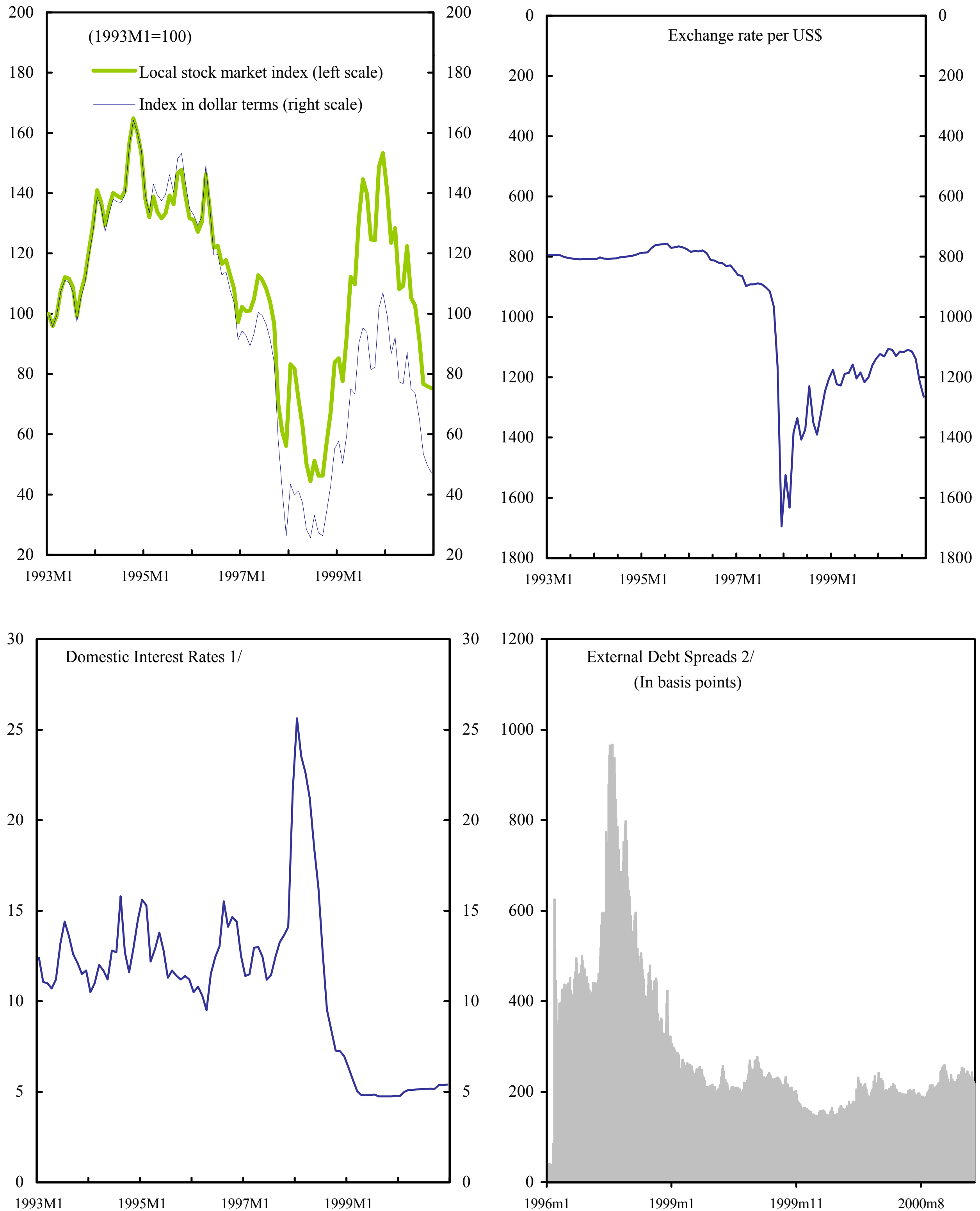
Figure 15. Korea: Net Capital Flows, 1993-2000



Source: IMF, International Financial Statistics.

1/ Total reserves not adjusted for encumbered reserves.
2/ Excludes errors and omissions.
3/ Net.

Figure 16. Korea: Financial Markets Developments, 1993-2000



Sources: IMF, International Financial Statistics, Bloomberg.

1/ Money market rate.
2/ EMBI Korea subindex, monthly data, end of period.

vulnerable by the accumulation of large amounts of short-term foreign currency debt (which they on-lent to enterprises) and little hedging. By end-1996, short-term liabilities had risen to 280 percent of foreign exchange reserves.

46. In January–July 1997, incidents of corporate distress[5] intensified fears of a liquidity crisis among creditor banks and prompted the BOK to inject substantial liquidity into the financial system and to take measures to address the rapidly deteriorating condition of banks. Early signs of growing vulnerabilities were overlooked by investors and credit rating agencies, and Korea maintained market access until October, when six Korean entities placed bonds totaling US$1.1 billion. Syndicated lending and interbank loans continued to grow in the second quarter of 1999, while there was only a small retrenchment of US$0.8 million in the third quarter in net claims on Korean banks. Foreign lenders took comfort from the broad notion that the government was capable of rendering support if needed, particularly to the banking system.

47. In November-December 1997, market sentiment deteriorated significantly and the retrenchment of interbank claims was dramatic as foreign banks refused to renew their maturing credits. Overall, some US$18 billion, about 30 percent of the total outstanding in the beginning of the quarter, was withdrawn in the fourth quarter; a sudden reversal of private capital inflows that amounted to about four percent of GDP. In November–December, the bond market closed for the sovereign, as well as public and private enterprises.

48. The approval of the Fund-supported program[6] on December 4 had a short-lived impact. Confidence was undermined by new information about the low level of useable reserves that showed available resources substantially below market expectations. Concerns over local financial problems, the possibility of mass corporate failures, and the downgrade of Korea's sovereign rating to below investment grade sent the won to 2000 per U.S. dollar and secondary market spreads peaked at 890 basis points. With short-term foreign debt maturing at a rate of US$1 billion a day, it seemed inevitable that reserves would be quickly exhausted. Against this background, with the help of the Fund, on December 24 the Korean authorities reached an agreement with the G-10 and selected other countries whereby creditor banks would be encouraged to rollover their exposure to Korean banks. The application of moral suasion was successful in stabilizing a critical situation, allowing Korean financial institutions to avoid a default and providing time for the government to negotiate a comprehensive restructuring package. In late-January 1998, Korea reached agreement with private bank creditors to convert US$21.8 billion of interbank deposits and short-term loans falling due in the first quarter into sovereign guaranteed bonds with a maturity of 1–3 years and spreads of 225 to 275 basis points,

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[5] Six of the thirty largest chaebols filed for court protection in January-October 1997.

[6] A three-year SBA amounting to US$21 billion (1,939 percent of quota). The World Bank and the Asian Development Bank committed an additional US$14 billion. Interested countries pledged US$22 billion in a second line of defense.

which were considerably higher than the original terms but lower than the prevailing market rates.[7]

Recovery and restoration of market access

49. The rollover and then restructuring of short-term debt in early 1998 went to the heart of the pressure on the won, thereby paving the way for Korea's return to markets. The sense of panic receded quickly. Strong adherence to the Fund-supported program and a rapid improvement in the current account helped restore foreign investors' confidence and stability in the foreign exchange market. Capital began to flow back in the first quarter of 1998 driven by the expectation that the markets had hit bottom. The stock market rebounded in January and February 1998 following some US$3.5 billion in foreign inflows in the equity market and US$1 billion in the domestic sovereign and quasi sovereign bond market. Reportedly, the majority of the inflows were from hedge funds, while traditional investors (mutual and pension funds) stayed away. However, markets' enthusiasm was very volatile, the stock market remained vulnerable, and the initial inflows were partly reversed as the specter of a deep economic recession, labor unrest, and corporate failures loomed large.

50. Korea's return to the international bond market was rapid. The sovereign reentered in April, with a US$4 billion issue (US$3 billion of 10–year paper at 355 basis points over comparable U.S. treasuries and US$1 billion of five-year notes at 345 basis points). Nonsovereign borrowing started two weeks earlier with US$250 million, won-linked private placement from a Korean corporate, that limited the downside risk to foreign investors from further depreciation, but allowed investors to share the upside from currency appreciation.

51. Overall, in the first half of 1998, net inflows from bonds and loans reached US$2 billion and from equity US$3.5 billion, although interbank claims on Korean banks declined by US$3.5 billion as some banks ran down lines rather than convert them. Trade financing remained difficult, particularly for small and medium-sized enterprises.

52. Policy implementation under the Fund-supported program remained firmly on track throughout 1998, providing evidence of the authorities' commitment to undertake the necessary reforms. By July 1998, Korea had made substantial progress in overcoming the crisis. The speedy adjustment was possible due to the ability of the private sector to adjust quickly to changing macroeconomic circumstances and trim its consumption and imports, and

[7] The conversion deal was de jure voluntary as there was no legal restriction against running down credit lines and controls limiting foreign exchange availability to repay short-term loans.

the relative low public debt that allowed the government to extend guarantees, place bonds, and have great latitude in countercyclical policies and in absorbing bank restructuring costs. The economy began to grow again in the third quarter of 1998, less than one year after the onset of the crisis.

C. The Russian and Brazilian Crises

53. The events in Russia (and to a secondary extent the introduction of capital controls in Malaysia in September 1998) and the subsequent flight to quality raised Korea's sovereign spreads to above 1000 basis points and reduced trading volume of its debt from an estimated US$27 billion in the second quarter of 1998 to US$3 billion in the third quarter. However, by early-November the spreads had declined, driven by a general recognition that market prices had overestimated default probabilities for many emerging markets, the prospect for official support for Brazil, an easing of monetary policies in a number of mature economies, and the completion of the portfolio adjustments of a number of highly leveraged institutions. In addition, Korea's external financing needs were relatively small in view of the large current account surplus. The exchange rate, which had appreciated in conjunction with interest rates cuts in the summer, depreciated modestly in September and early-October and started to appreciate again in November.

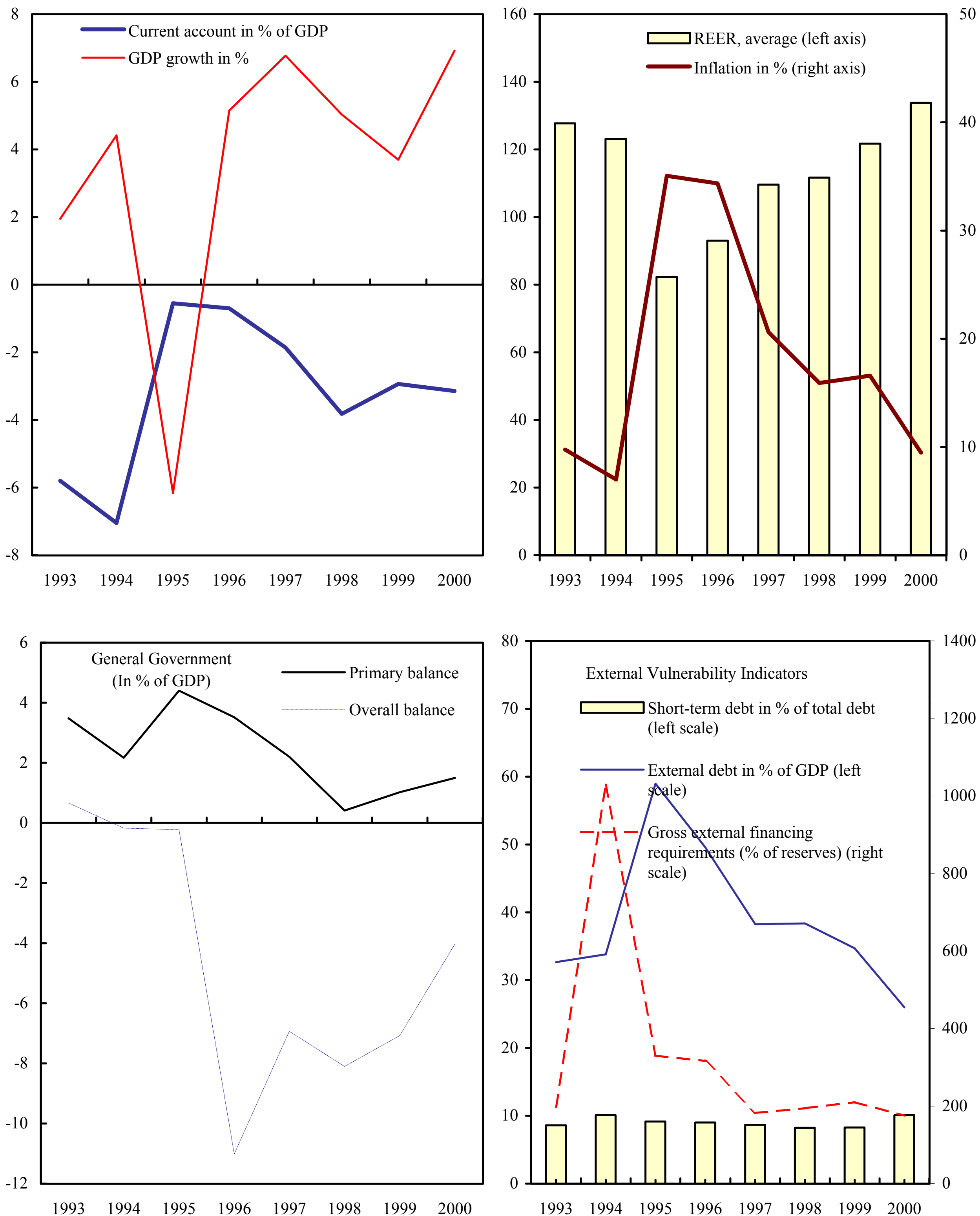
54. In late 1998 and early 1999, the turnaround in economic activity was impressive. Although the recovery was externally driven in 1998, it broadened to include a higher private consumption and investment in 1999. Market sentiment remained favorable, supported by the restoration of Korea's investment grade credit rating in January 1999. Although spreads fell rapidly, they did not return to their pre-crisis levels.

V. MEXICO

A. The Mexican Crisis

55. Notwithstanding the introduction of wide-reaching macroeconomic and structural reforms, severe macroeconomic imbalances emerged in the Mexican economy during the early 1990s (Figure 17). The pegged exchange rate, coupled with robust domestic demand fueled by sizable capital inflows and a weakening fiscal policy, resulted in a real appreciation of the exchange rate and a sharp widening of the external current account deficit. Unsettling political developments and rising international interest rates during 1994 cast doubts on the part of international investors about the sustainability of these deficits and resulted in upward pressure on domestic interest rates. The authorities' attempt to lower interest rates by issuing Tesobonos (dollar-indexed short-term debt) and by sterilized intervention failed, and led to severe reserve losses during 1994 (Figure 18). With financial market turbulence gathering momentum in the fourth quarter of 1994, the peg was abandoned in December 1994 and a full-blown financial crisis ensued (Figure 19).

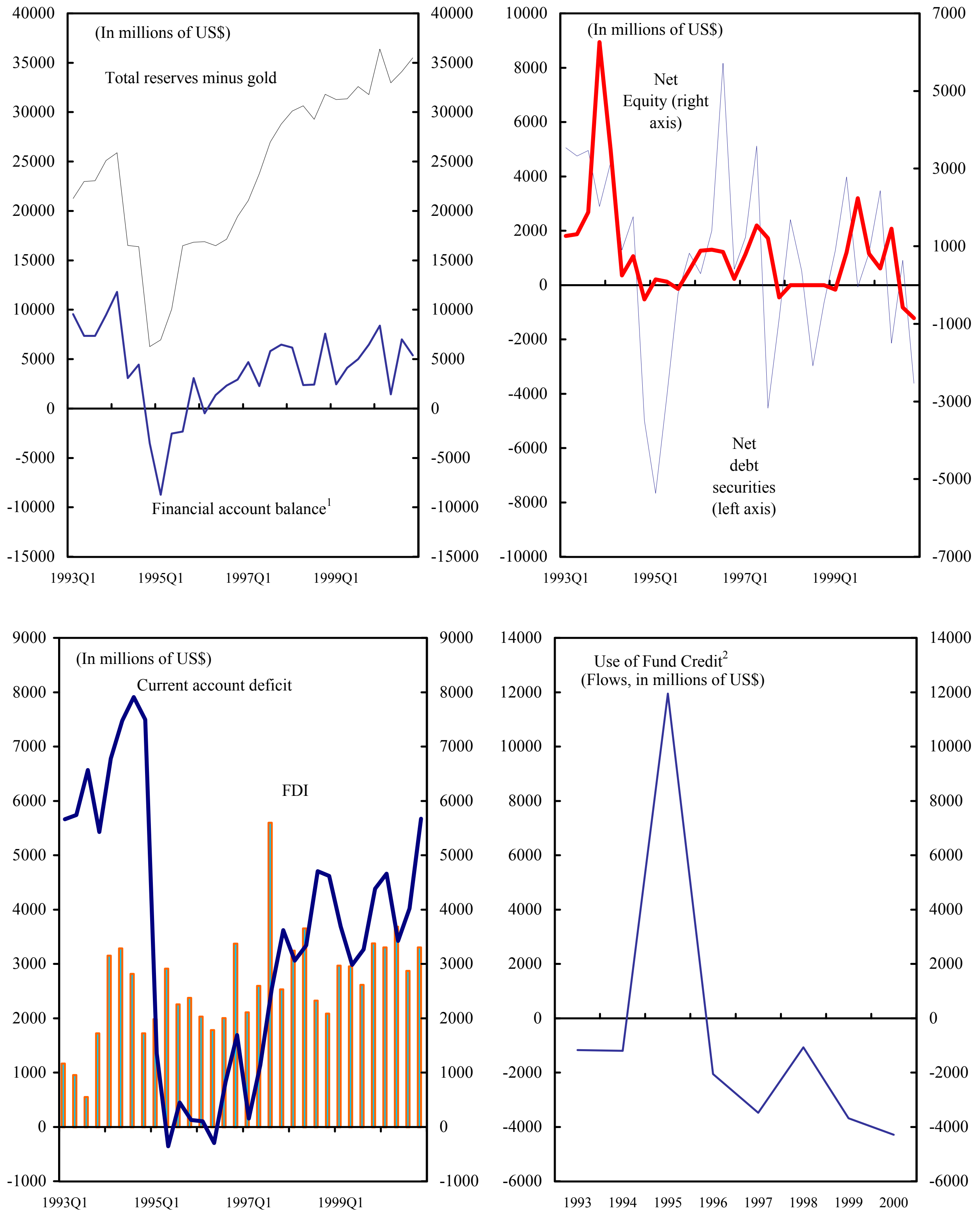
Figure 17. Mexico: Fundamentals , 1993-2000 1/



Sources: IMF, International Financial Statistics; IMF, World Economic Outlook.

1/. The latest WEO data may not correspond exactly to the latest data from country staff reports.

Figure 18. Mexico: Net Capital Flows, 1993-2000

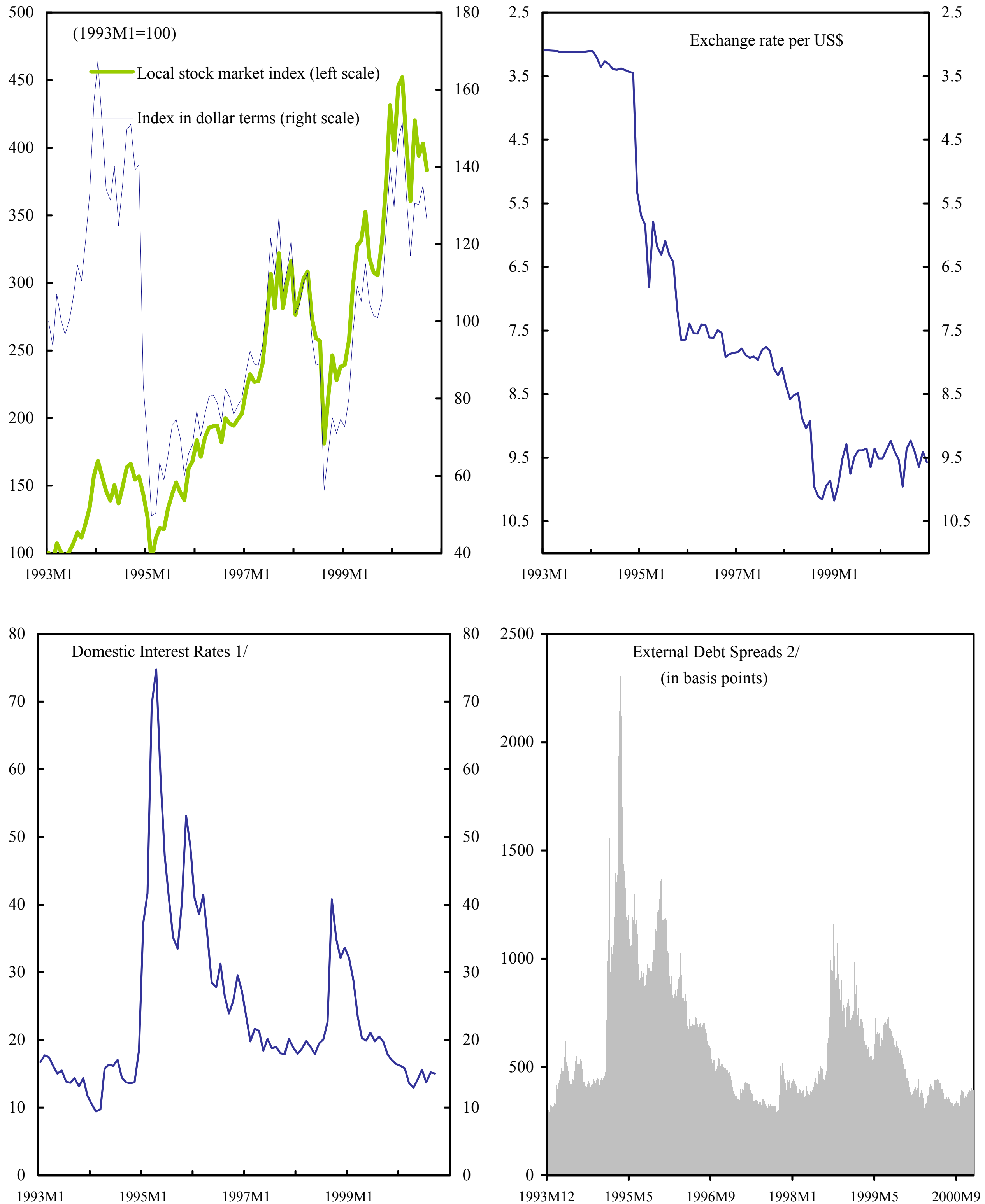


Source: IMF, International Financial Statistics.

[1]Excludes errors and omissions

[2]Net

Figure 19. Mexico: Financial Markets Developments, 1993-2000



Sources: IMF, International Financial Statistics; Bloomberg.

1/ 28-day T-bill.
2/ EMBI Mexico subindex.

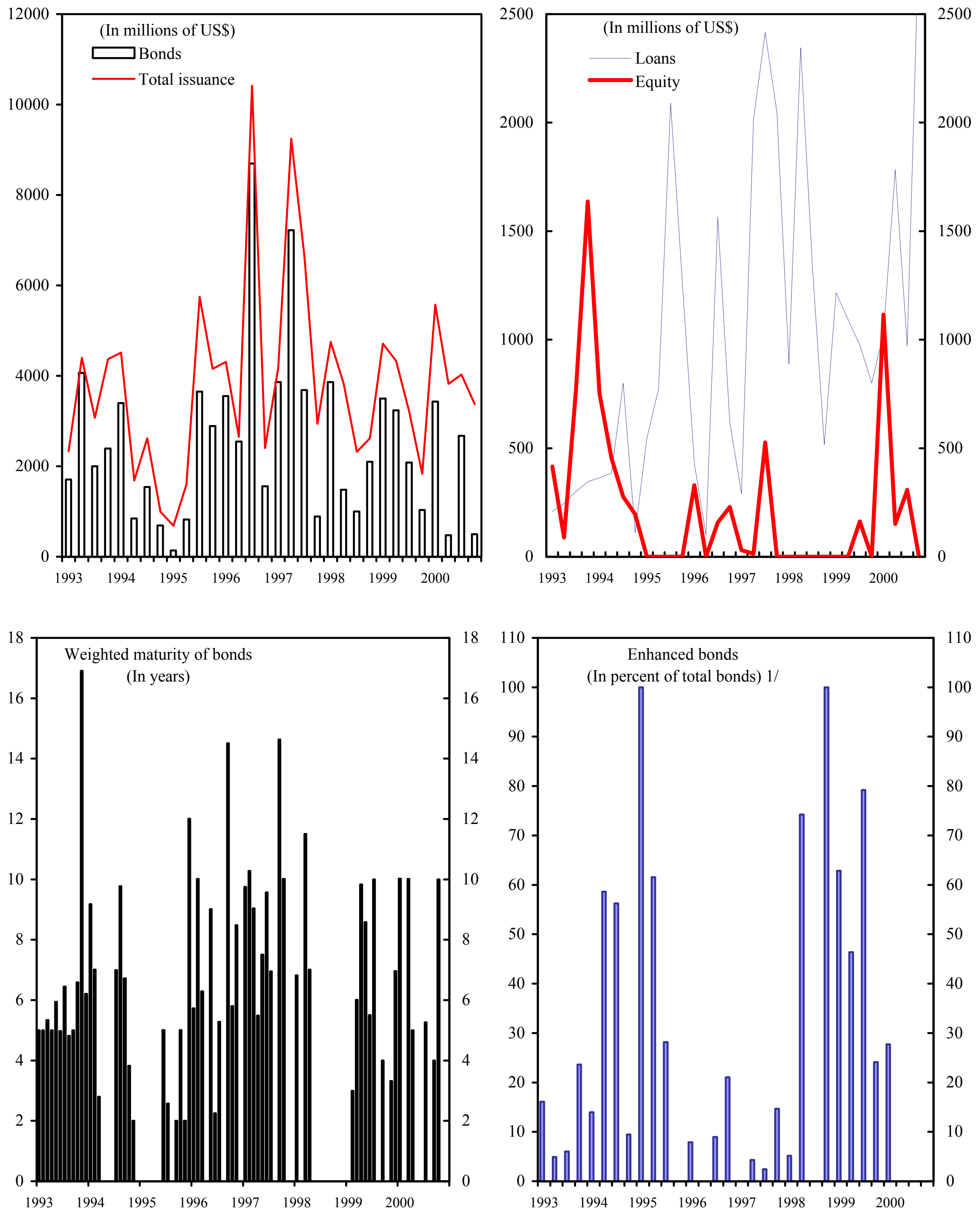
56. Total gross issuance (bonds, loans, and equities) had already started declining in March 1994 (Figure 20). By November-December 1994 it averaged US$190 million, compared to US$1.4 billion for January 1993-February 1994. Gross bond flows were the first to contract, and apart from a U.S. EXIMBANK-guaranteed US$137 million Pemex bond, issuance dried up for four months. Equity and loan flows started contracting in August. During 1994, total issuance declined over 40 percent, but loan issuance increased by 50 percent. Equity issuance dried up completely from December 1994 until February 1996. Net capital flows (excluding FDI) turned negative (US$4 billion outflow) in the second half of 1994 after averaging US$5.8 billion per quarter in 1993. Outflows amounted to US$4 billion in the fourth quarter of 1994 and intensified to US$12.6 billion in the first quarter 1995. Spreads on Mexico's EMBI sub-index peaked at 2,300 basis points and on Mexican Eurobonds at about 1,000 basis points, up from 150 basis points before the crisis.

57. Despite the announcement of a Fund-supported program, the initial policy package failed to restore confidence, mainly because of uncertainties relating to other elements of the financing package. A strengthened package with the following features was introduced in mid-March: (i) a US$20 billion loan from the U.S. Exchange Stabilization Fund, which eased financing concerns; (ii) a greater fiscal adjustment; (iii) sharply tighter monetary policy; and (iv) a plan to address banking sector problems. Market sentiment toward Mexico improved thereafter, buttressed inter alia by a more favorable international market outlook, the improvement in the trade deficit, and the significant reduction in the stock of Tesobonos. The improved availability and timeliness of data also helped.

58. Well-established, nonsovereign entities (such as Banamex) were the first to issue bonds following the crisis (April/May), by securitizing receivables or providing collateral. Maturities were usually shorter (up to 5 years) than before the crisis (up to 10 years), and significantly shorter for unenhanced notes (maximum 2 years). Most bonds were floating rate notes (FRNs), with spreads 200–350 basis points higher than before the crisis. The sovereign re-entered the market in July with an oversubscribed US$1 billion 2-year FRN, which incorporated an option of converting the principal and accrued interest into shares of financial institutions or using it to pay for privatizations. The government also waived sovereign immunity. The first post-crisis Eurobond, issued in mid-July, was in Yen, at 350 basis points over Yen Libor with a three-year maturity. After this deal, maturities lengthened and fixed rate bonds came back.

59. The sovereign note marked the complete re-opening of capital markets for Mexican issuers, and total issuance in July 1995 reached a record US$4.1 billion. Gross issuance in the second half of 1995 averaged US$1.6 billion a month, 20 percent higher than in the year to March 1994. By 1996, international market sentiment and Mexico's economic prospects had improved to such an extent that the government was able to obtain a US$6 billion syndicated loan (at 200 basis points over Libor), which was partly used for early repayment of the U.S. government loan and for a US$1 billion early Fund repurchase. Loan issuance was higher than bond issuance in the first few months of 1995; nevertheless, a more substantial increase in loans occurred only in June. Equity issuance took by far the longest time to resume

Figure 20. Mexico: Gross Issuance of Bonds, Loans, and Equity, Jan-1993 to Dec-2000



Sources: BEL database; Capital Data Bondware; Loanware; and staff calculations.

1/ Data on enhanced bonds from BEL is based on a strict definition of enhancement namely convertibles, secured, and put options.

(February 1996). During 1995, bonds accounted for 62 percent of total issuance (with the rest accounted for by loans), while in 1993, bonds had accounted for 72 percent, loans for 8 percent, and equity for 20 percent. Net portfolio flows (excluding FDI) turned positive in the fourth quarter of 1995, but total net flows remained negative until the third quarter of 1996. Market reentry followed a period of positive financial market performance: the Mexico EMBI sub-index fell below 1,000 basis points by June 1995 and domestic interest rates dropped sharply. However, Mexico's spreads only returned to pre-crisis levels in 1997.

B. The Asian Crisis

60. As could be expected, contagion from the Asian crisis affected Mexico's issuance in international capital markets less than the Tequila crisis, as the economy was strengthening and had lower external vulnerabilities. Average monthly issuance in November 1997–February 1998 dropped to US$0.5 billion compared to US$2.2 billion in the first 10 months of 1997. As during the Tequila crisis, loans were the last to fall and thus loans' share of total issuance increased markedly. Equity issuance dried up through August 1999, a period even longer than after the 1994 crisis. There was no issuance of bonds in the immediate aftermath of the Thai crisis and again in November-December 1997. Portfolio flows were a negative US$1.5 billion in the third quarter 1997, but the capital account balance registered a US$6.5 billion surplus.

61. Sound economic policy allowed Mexican issuers to regain market access once international markets recovered. Even though Mexico did not have a program with the Fund after its SBA expired in February 1997, the government's medium-term economic program was sufficient to reassure markets. The authorities were more actively managing debt, with the aim of lengthening maturities (up to 30 years), smoothing the repayment profile (eliminating the bumps resulting from the 1994/5 official financing package), and diversifying the investor base and currency composition of external debt. Also, the government arranged a US$2.5 billion liquidity standby facility with a 30-bank syndicate. Spreads were 25–175 basis points depending on the length of the drawing and on Mexico's credit rating at the time of the drawing.

62. The pattern of market access post-Asian crisis was similar to that after the Tequila crisis: a significant presence of enhanced/structured deals, including A/B loans, and it was preceded by a recovery in Mexican asset prices.[8] International developments rather than domestic events determined the timing of the re-entry, as the crisis had originated abroad. Modest official external financing needs for 1998 (US$1.5 billion) allowed the government to carefully time issuance to minimize spreads; the sovereign issued a US$1 billion bond in March. Issuance by Mexican entities rose significantly from March 1998 and averaged US$1.6 billion a month during March-July 1998. Following the strong performance of portfolio investment, the capital account registered a sizable US$3.9 billion surplus in the first quarter of 1998. Spreads tightened more quickly than after the Tequila crisis, while the disturbance in money markets was reflected mainly in increased volatility.

C. The Russian and Brazilian Crises

63. Net capital flows were low as portfolio outflows intensified significantly in the second and third quarter of 1998. Total issuance, which consisted entirely of loans during August-October 1998, averaged no more than US$80 million a month in September–October. Mexico's asset prices suffered markedly, and external debt spreads increased from less than 500 basis points in July to 1,100 basis points by early September. The Mexican authorities responded promptly by tightening policies; this also addressed the terms of trade shock resulting from the oil price collapse. In sharp contrast with 1994, monetary policy was repeatedly tightened, with domestic interest rates rising some 700 basis points in August alone. Fiscal prudence was also maintained. The small remaining external financing need was met by drawing on the standby liquidity facility previously arranged with private banks. Net capital inflows rebounded in the fourth quarter of 1998 (US$5.5 billion). The increase in issuance was preceded by positive developments in financial markets, albeit with a shorter lag than at the time of the Tequila crisis.

64. The Brazilian crisis represented only a hiatus in the full recovery of international capital market access. While Mexico's gross issuance in January 1999 (composed entirely of loans) registered one of its lowest levels ever (US$90 million), this episode was extremely short-lived. An outflow of US$900 million was due to an increase in residents' assets abroad, suggesting that the Brazilian crisis influenced Mexican residents more than international investors. External debt spreads rose some 200 basis points, but resumed their downward trend from end-February onwards.

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[8] B-loans are instrument used by Multilateral Development Banks (MDBs) to mobilize private financing. MDBs are the lender of record to private sector companies for the entire amount of the loan under the A/B structure. The MDBs keep a portion of the loan on their own accounts (the A-loan) and syndicate the remainder (the B-loan) to private financial institutions.

65. The Mexican authorities tightened monetary policy once again after the Brazilian crisis, while no adjustments were made in the fiscal area. In July 1999, the Fund approved a 15-month Stand-By Arrangement amounting to 120 percent of quota (SDR 3.1 billion), which would see Mexico through the traditionally economically uncertain run-up to the presidential elections (which took place in July 2000). Performance under the program was generally good, and the arrangement was treated as precautionary from July 2000.

66. Mexico's gross issuance rebounded sharply in February–March 1999 (averaging US$2.3 billion). The recovery gained momentum in 2000, and although total issuance did not regain the levels reached in 1996-97, equity issuance finally picked up, with its share increasing to about 9 percent of total issuance in 2000. Net capital flows also rebounded beginning in the second quarter of 1999 and have been positive ever since. Moody's upgrade of Mexico's credit rating from Ba2 to Ba1 (one notch below investment grade) in August 1999 and the March 2000 upgrade to investment grade further boosted capital flows. Bond issues in 1999 and 2000 resorted less frequently to credit enhancements, but average maturity did not increase in 1999 and actually declined in 2000, due to rising international interest rates.

VI. PERU

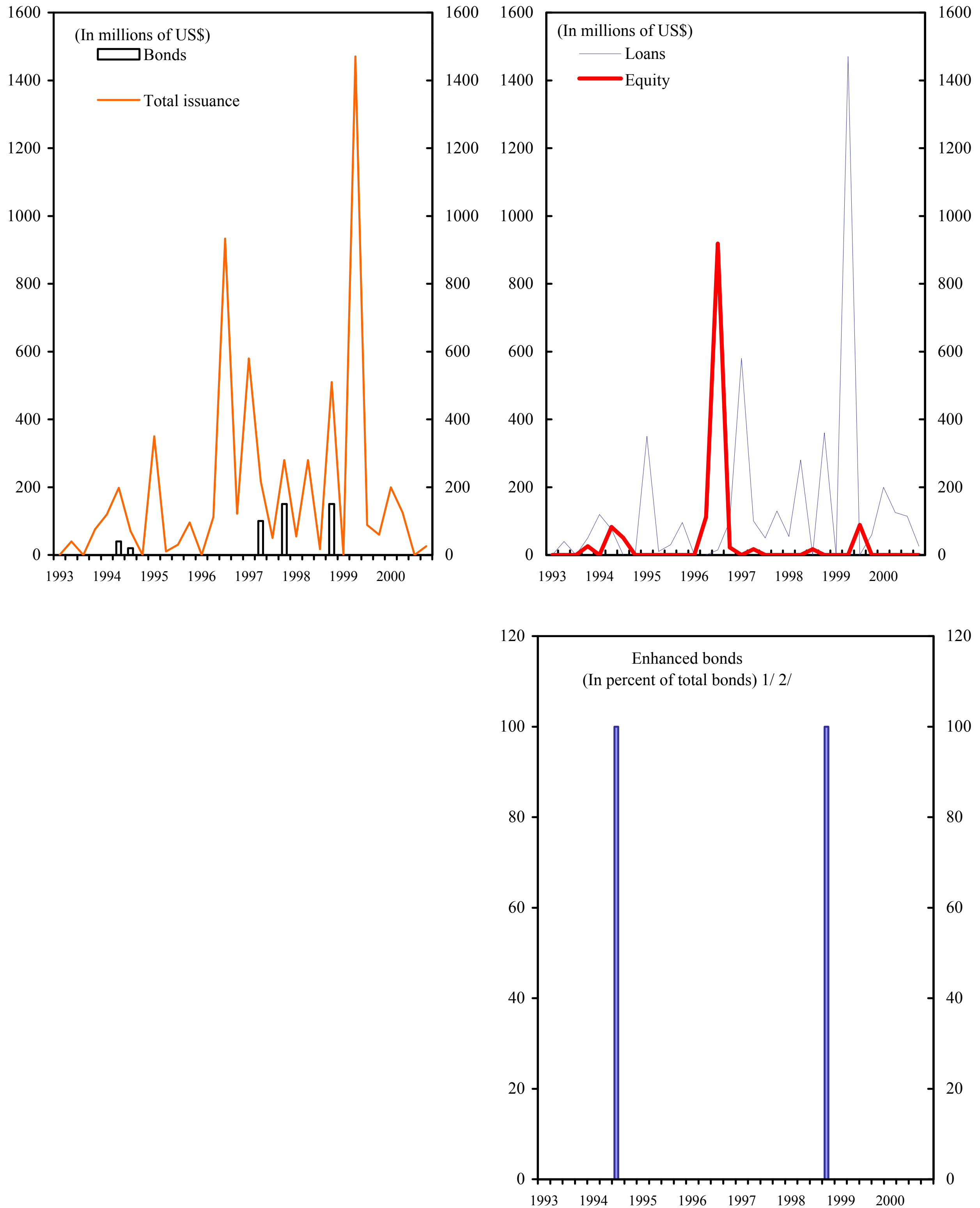
A. Market Access in the Early 1990s

67. In light of the difficult macroeconomic situation through the 1980s that culminated in a unilateral debt-service moratorium in 1986, Peru was completely cut off from all forms of external financing for the rest of the decade. Following the adoption of an anti-inflation stabilization program in 1990, which liberalized Peru's current and capital accounts and lifted all restrictions on outward capital transfers, Peru gradually regained access to private capital markets. Peru cleared its arrears with official creditors through a Rights Accumulation Program with the Fund (1991–93) and several Paris Club reschedulings (1991, 1993, and 1996). Peru did not reach initial agreement on restructuring its commercial debt (Brady deal) until October 1995, with the formal closure only occurring on March 7, 1997.

B. The Mexican Crisis

68. Peru was still in the process of re-establishing relations with external creditors when the Tequila crisis broke out in December 1994 and, thus, Peru was relatively insulated from the crisis. Net short-term capital inflows, which had peaked at US$810 million in the fourth quarter of 1994, fell to US$256 million in the first quarter of 1995, and turned negative in the second quarter of 1995 (Figures 21–22). This was primarily due to a sharp fall in short-term inflows to enterprises in the first quarter of 1995, and to banks in the second quarter of 1995. Net medium- and long-term private capital flows dropped to US$221 million in the first quarter of 1995, from US$620 million in the fourth quarter of 1994, but rebounded quickly in the second quarter of 1995 to US$830 million. The fall was primarily due to a decline in

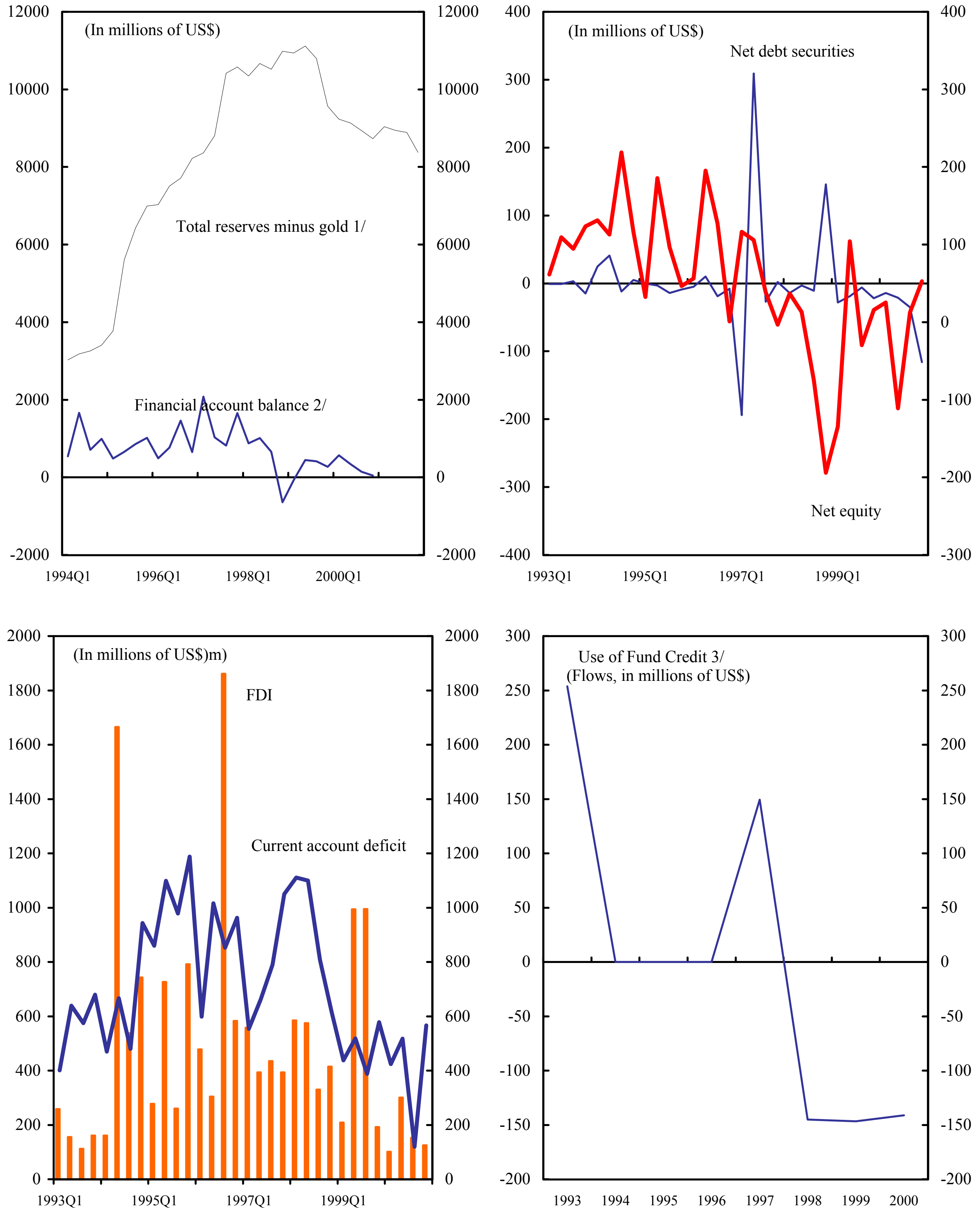
Figure 21. Peru: Gross Issuance of Bonds, Loans, and Equity, Jan-1993 to Dec-2000



Sources: BEL database; Capital Data Bondware; Loanware; and staff calculations.

1/ Data incomplete.
2/ Data on enhanced bonds from BEL is based on a strict definition of enhancement namely convertibles, secured, and put options.

Figure 22. Peru: Net Capital Flows, 1993-2000



Source: IMF, International Financial Statistics.

1/ Total reserves not adjusted for encumbered reserves.
2/ Excludes errors and omissions.
3/ Net.

portfolio investment. Private capital flows during 1995 were significant, and large corporate loans were placed in early 1995.

C. The Asian Crisis

69. By the time the Asian crisis broke out, Peru's private sector had regained significant access to international capital markets. During 1997, it obtained US$1.7 billion in gross debt inflows, of which US$1.5 billion was in the form of loans.[9] The effect of the Asian crisis on short-term capital flows appears to have worked primarily through banks' external credit lines. Total net short-term inflows rose from US$290 million in the third quarter of 1997 to US$1.2 billion in the fourth quarter of 1997 (with banks increasing their liabilities by US$660 million), but then contracted in the first quarter of 1998 to US$360 million. For net medium- and long-term private flows (excluding privatization proceeds) there was an immediate effect, as these net flows fell to US$222 million in the fourth quarter of 1997, from US$475 million in the previous quarter. The majority of this decline was in FDI.

70. The spread on Peru's EMBI-subindex, which had averaged roughly 345 basis points from mid-August to end-September 1997, began to rise sharply at the end of October, and peaked at 604 basis points in mid-November (Figure 23). During the period June–December 1997, the increase in Peru's EMBI between its minimum and its maximum level was 285 basis points. This compares favorably with the analogous increase in the spread for Argentina (375 basis points), Brazil (435 basis points), and Ecuador (488 basis points), although the increases in spreads on Panamanian (193 basis points), Mexican (247 basis points), and Venezuelan bonds (271 basis points) were somewhat lower.

D. The Russian and Brazilian Crises

71. As happened for emerging markets in general, the Russian crisis had a sizable impact on Peru through contagion. There was a sharp turnaround in net short-term capital flows in late 1998, from an inflow of US$355 million in the third quarter of 1998 to an outflow of US$1.3 billion in the fourth quarter of 1998, as banks and enterprises' credit lines were significantly cut. In fact, the Russian crisis set off a period of significant reduction in the exposure of Peruvian banks to short-term external credit, which between the third quarter of

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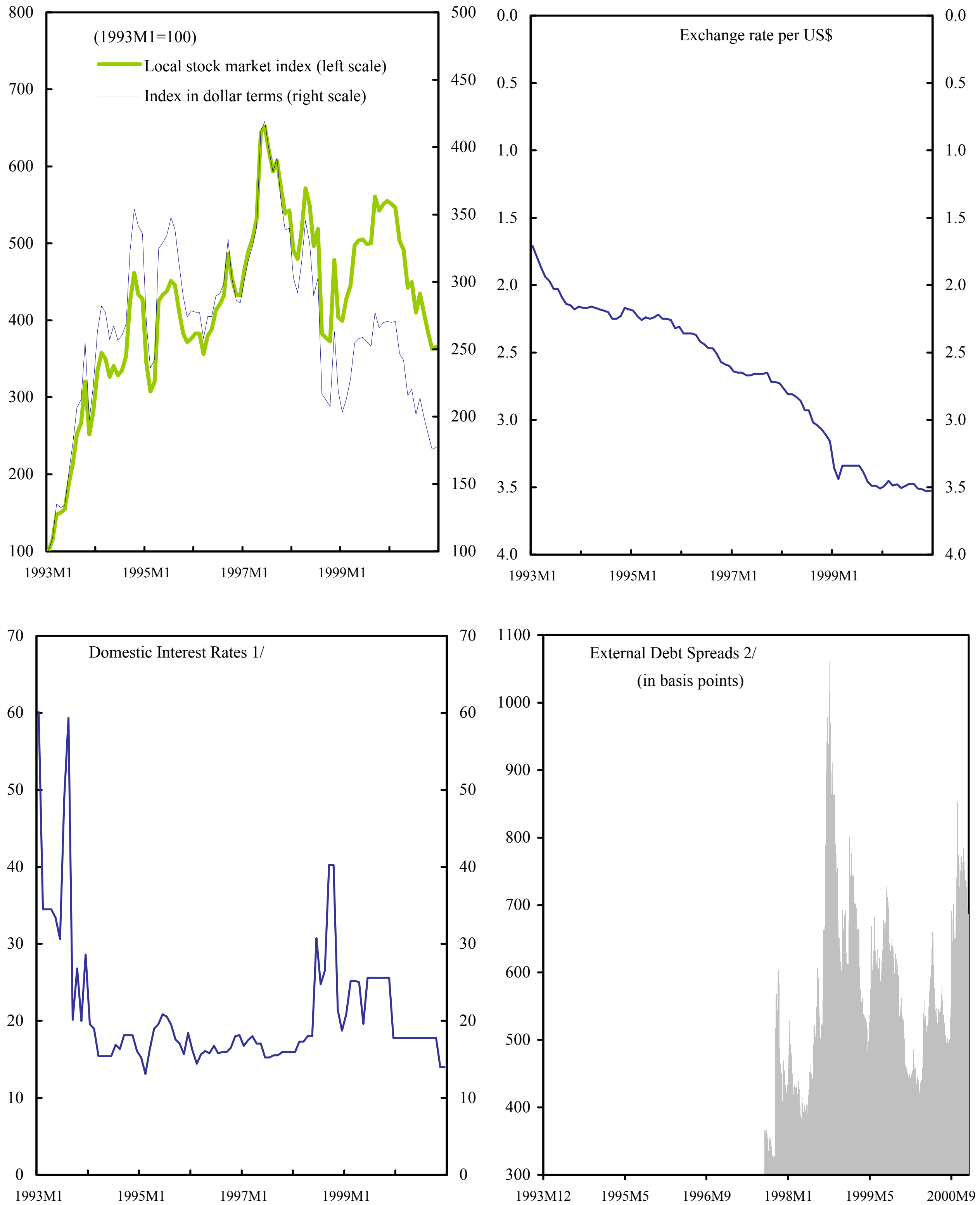
[9] Peruvian corporates have relied predominantly on loans as a source of foreign financing during the last decade. One reason may be that there has been no useful sovereign benchmark (representing pure Peru risk) for pricing Peruvian corporate bonds. There have only been five external corporate bond issues since 1993, totaling US$460 million, whereas total loan issuance to Peruvian corporates has exceeded US$6.2 billion.

Figure 23. Peru: Financial Markets Developments, 1993-2000



Sources: IMF, International Financial Statistics, Bloomberg.

1/ Peru discount rate (eop)
2/ EMBI Peru subindex.

1998 and the second quarter of 1999 fell by roughly US$2 billion. Although some of this decline (especially in late 1998 and early 1999) represents the increase in the price of market access, the continued contraction during 1999 was due to the lack of onlending possibilities in Peru, where growth had slowed considerably as a result of El Niño. Net medium- and long-term private flows contracted significantly in the third quarter of 1998 to US$180 million from an average of US$550 million in the previous two quarters, but rebounded in the fourth quarter of 1998 to US$590 million. The first quarter of 1999 was again a depressed quarter (US$314 million), while the second quarter of 1999 saw a return to near-record levels of medium- and long-term inflows (US$830 million).

72. As was the case for other Latin American countries, the Russian crisis had a much larger effect on Peru's Brady bonds than the Asian crisis, with spreads peaking at 1,061 basis points on September 10. Once again, the spread on Peru's Bradys increased by less than for most other Latin American countries. The difference between the minimum and the maximum EMBI for Peru during 1998 was 684 basis points, higher than was the case for Panama (489 basis points), but significantly lower than for Mexico (807 basis points), Argentina (1,100 points), Ecuador (1,800 basis points), and Venezuela (2,300 basis points).

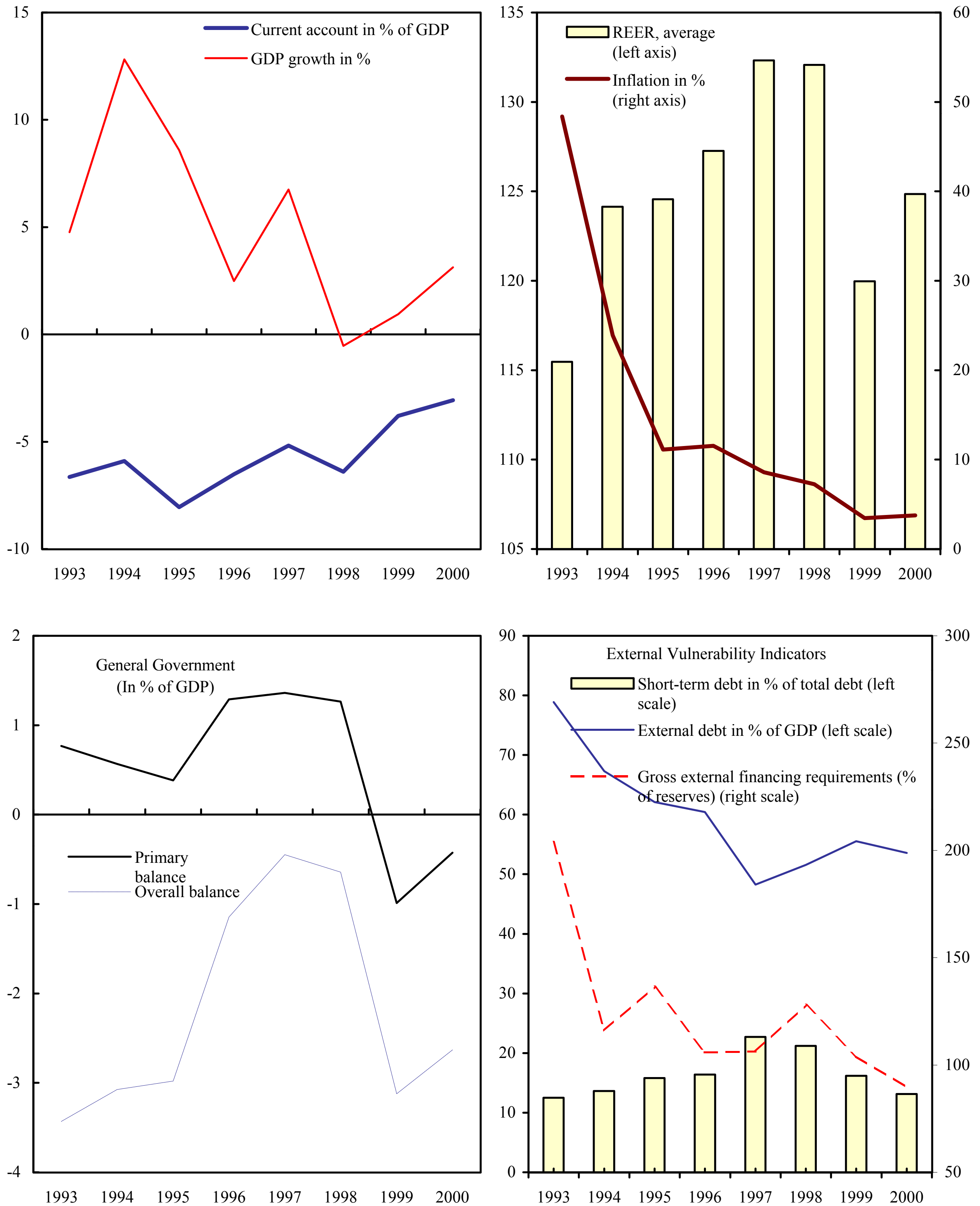
73. Apart from restructuring its commercial debt into Brady bonds in 1997, the government of Peru has not issued "new" international sovereign debt since the mid-1980s. The lack of sovereign bond issuance has several explanations, which arguably do not include a lack of market access. Continued fiscal consolidation in Peru, a considerable pool of domestic dollar financing due to the high dollarization of the economy (a private pension system was launched in 1993), the availability of government resources (in the form of U.S. dollar deposits at the central bank) originating from previous privatizations, and a stream of fungible external financing from IFIs, meant that external financing needs could be covered without issuing debt in international capital markets (Figure 24).

VII. Romania

A. The Mexican Crisis

74. Following the encouraging start in mid-1994, when Romania began to push through basic reforms essential for a market-oriented system, including a liberalization of the foreign exchange auction system and the introduction of a basic legislative framework that would strengthen the banking system, a major relaxation of economic policies during 1995–96, along with the adoption of an inflexible exchange rate policy, led to substantial macroeconomic imbalances (Figure 25).

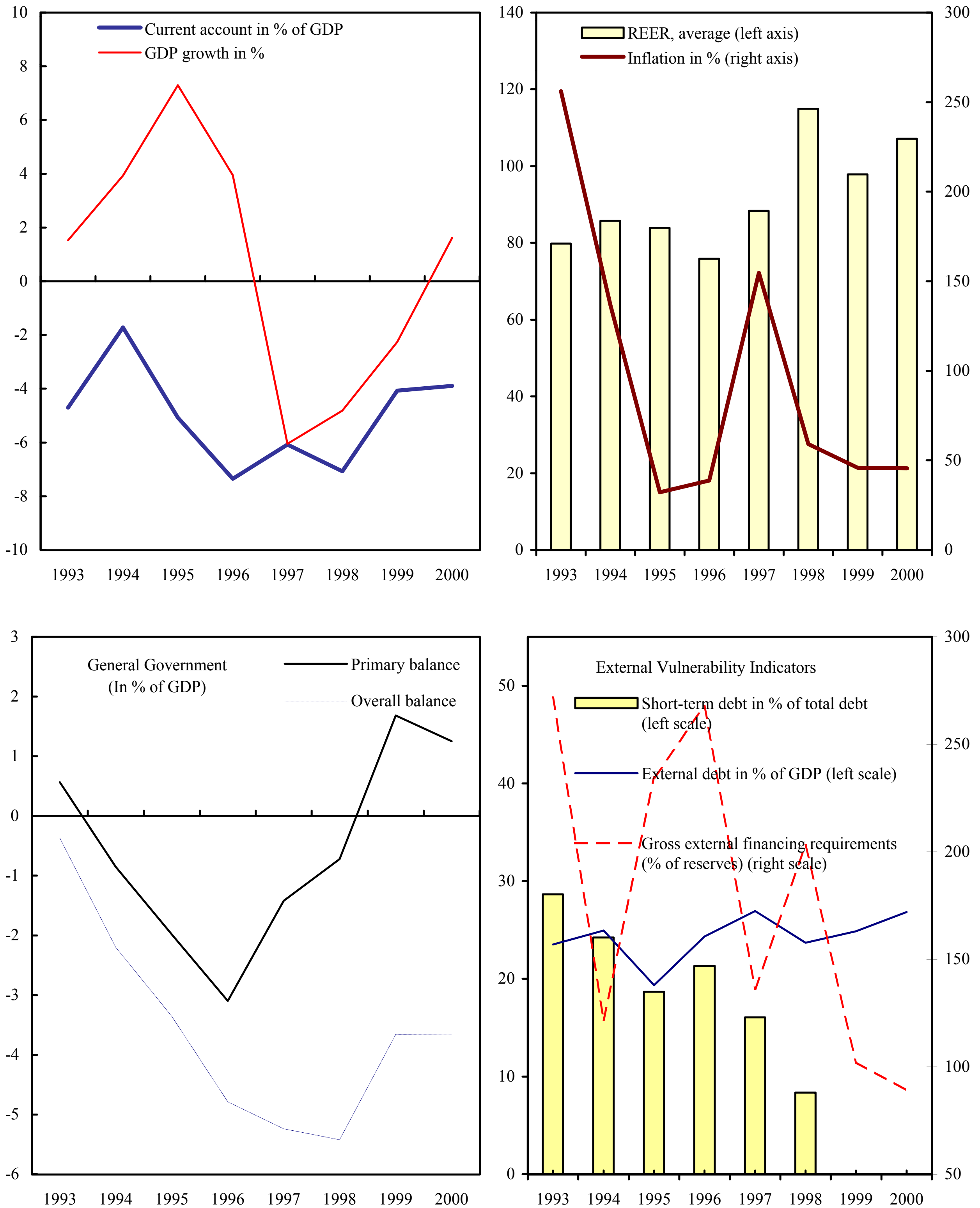
Figure 24. Peru: Fundamentals , 1993-2000 1/



Sources: IMF, International Financial Statistics; IMF, World Economic Outlook.

1/. The latest WEO data may not correspond exactly to the latest data from country staff reports.

Figure 25. Romania: Fundamentals , 1993-2000 1/



Sources: IMF, International Financial Statistics; IMF, World Economic Outlook.

1/. The latest WEO data may not totally correspond to the latest data from country staff reports.

75. Despite the macroeconomic imbalances and the slow pace of structural reforms, which led to the lack of agreement on a Fund-supported program, Romania successfully returned to international capital markets in late 1995–1996 when the National Bank of Romania (NBR) borrowed about US$1.5 billion from international capital markets (US$1.1 billion in bond placements at an average maturity of three years) (Figures 26–27). During the same period (late 1995–1996), Romania raised US$760 million through syndicated loans (both public and private), while equity flows were minimal. Romania's favorable access to capital markets under these conditions can be attributed to its debut assessment by credit rating agencies, a rebalancing of portfolios by investors following the Mexican crisis, a sharp expansion of international bond markets in 1995 which increased capital flows to transition economies, and an expansion of the yen-denominated market, triggered by the deregulation of the Japanese market starting in 1994.[10] [11]

76. Romania's access to capital markets in 1996, however, was rather expensive, with the Eurobonds being issued at relatively high spreads (about three times the EMBI+) and short average maturities (three years). These terms were particularly burdensome for Romania, which was falling further behind other Eastern European countries in its transition process.

B. The Asian Crisis and its Aftermath

77. Following the election of a reform-oriented government in November 1996 and a subsequent agreement on a Fund-supported program, Romania managed to secure reasonable access to international capital markets. Romania's state-owned commercial bank (BCR) was able to make a three-year bond placement of US$75 million in the first quarter of 1997 at a launch spread of 314 basis points. The state-owned electricity company, then called RENEL, issued a five-year US$135 million bond in the first quarter of 1997 with a put option due after three years and a launch spread of 275 basis points over Libor. Romania's Ministry of Finance also issued a five-year Eurobond of DM 600 million (about US$350 million) in June 1997 at a launch spread of 267 basis points. In the syndicated loan market Romania was able to raise only about US$150 million in 1997, while no equity flows materialized.

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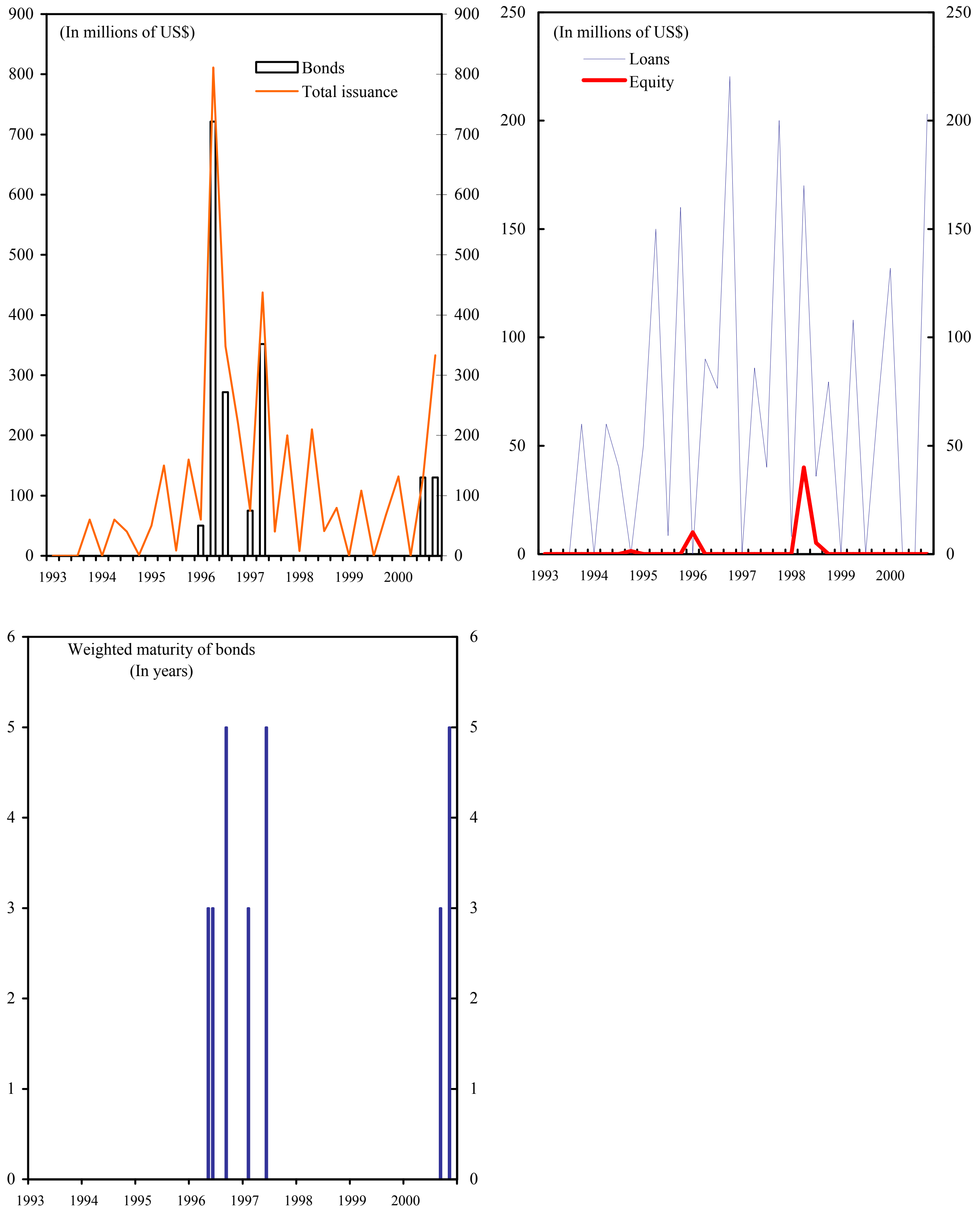
[10] Romania obtained its first non-investment grade rating of Ba3 from Moodys, BB- from Standard and Poors, and BB+ from the Japan Credit Rating Agency. Some of these ratings placed Romania in a similarly category to Argentina, Kazakstan, and Russia.

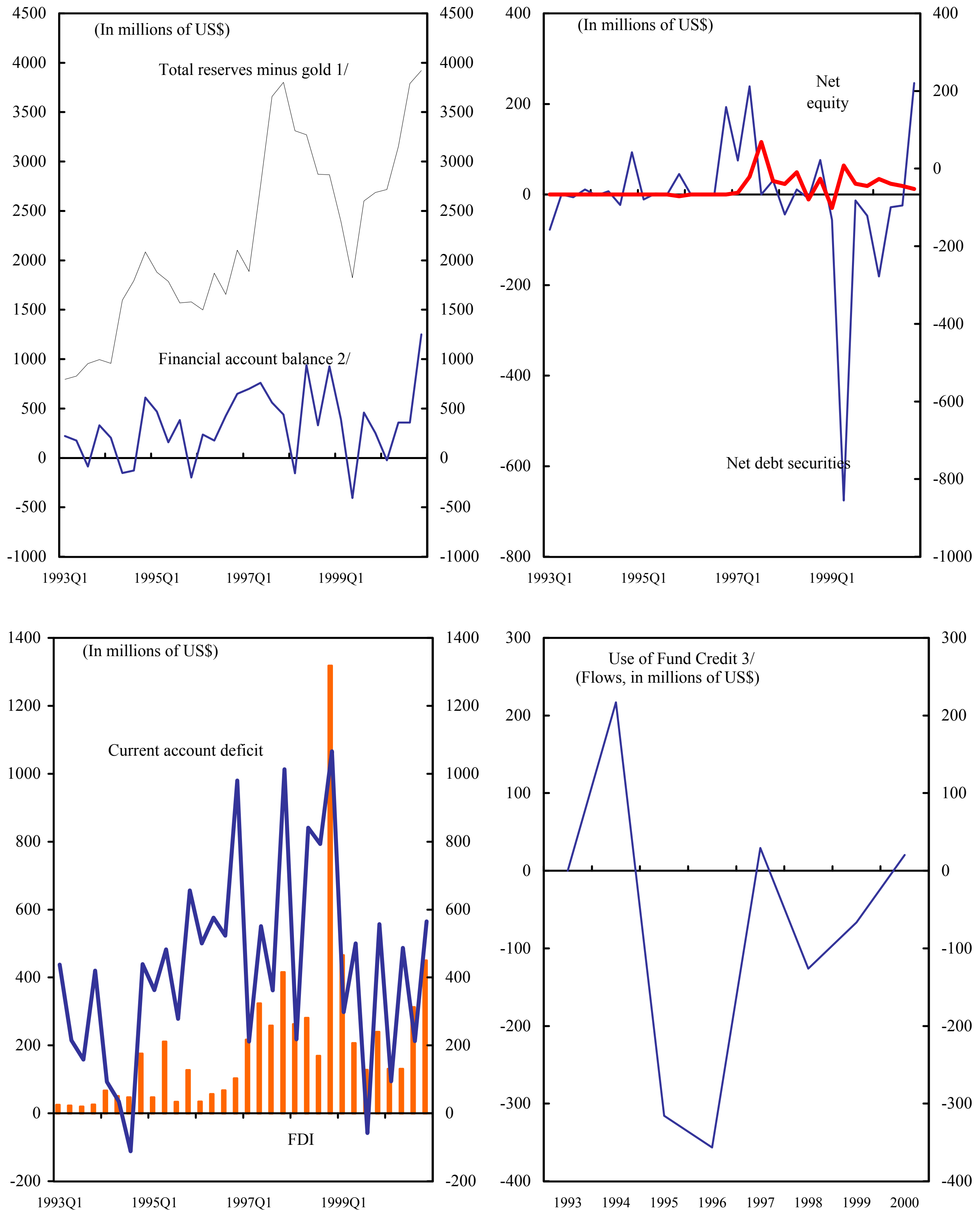
[11] Factors allowing greater access included the elimination in early 1994 of the 90-day lockup period by which Japanese investors could purchase, after initial placement, sovereign yen-denominated Eurobonds and the elimination on January 1, 1996, of the requirement for a minimum BBB credit rating to access the Samurai market.

Figure 26. Romania: Gross Issuance of Bonds, Loans, and Equity, Jan-1993 to Dec-2000



Sources: BEL database; Capital data Bondware; Loanware; and staff calculations.

Figure 27. Romania: Net Capital Flows, 1993-2000



Source: IMF, International Financial Statistics.

1/ Total reserves not adjusted for encumbered reserves.
2/ Excludes errors and omissions.
3/ Net.

78. During the second half of 1997, with macroeconomic policies deviating from the programmed path and slippages emerging in structural reform, including limited progress in privatizing or closing loss-making state-owned enterprises and rehabilitating ailing banks, the Fund-supported program went off track. Following the loosening of policies, economic performance deteriorated in the second half of 1997 and worsened further in 1998. The external current account deficit widened to US$3 billion (8 percent of GDP) in 1998 largely due to the NBR's pursuit of an unsustainable exchange rate policy leading to a sharp appreciation of the real exchange rate, while a slowdown in capital inflows, due in part to contagion from the Russian crisis, led to a loss of reserves to the tune of US$500 million in the second half of 1998 (Figure 28). By the end of the third quarter of 1998, exchange market pressure had begun to intensify, eventually forcing a correction in the exchange rate in 1999.

79. The worsening macroeconomic stance, in tandem with the deterioration in global financial conditions following the Asian crisis, resulted in Romania's losing access to international capital markets. The large and unsustainable current account deficit at end–1998, against the background of little progress in economic restructuring, inadequate macroeconomic policy response and a hump in debt service payments in 1999, worsened investor sentiment towards the country. Romania had no access to the Eurobond market between the third quarter of 1998 and the fourth quarter of 1999, but was able to secure US$290 million of syndicated loans, while equity flows amounted to about US$5 million.[12] In addition to the weak policy stance, reflected quite clearly in a series of downgradings by credit rating agencies (both Standard and Poors and Moody's), the absence of support from the Fund through early 1999 and from other key multilateral institutions further reduced investor appetite for Romanian paper.[13]

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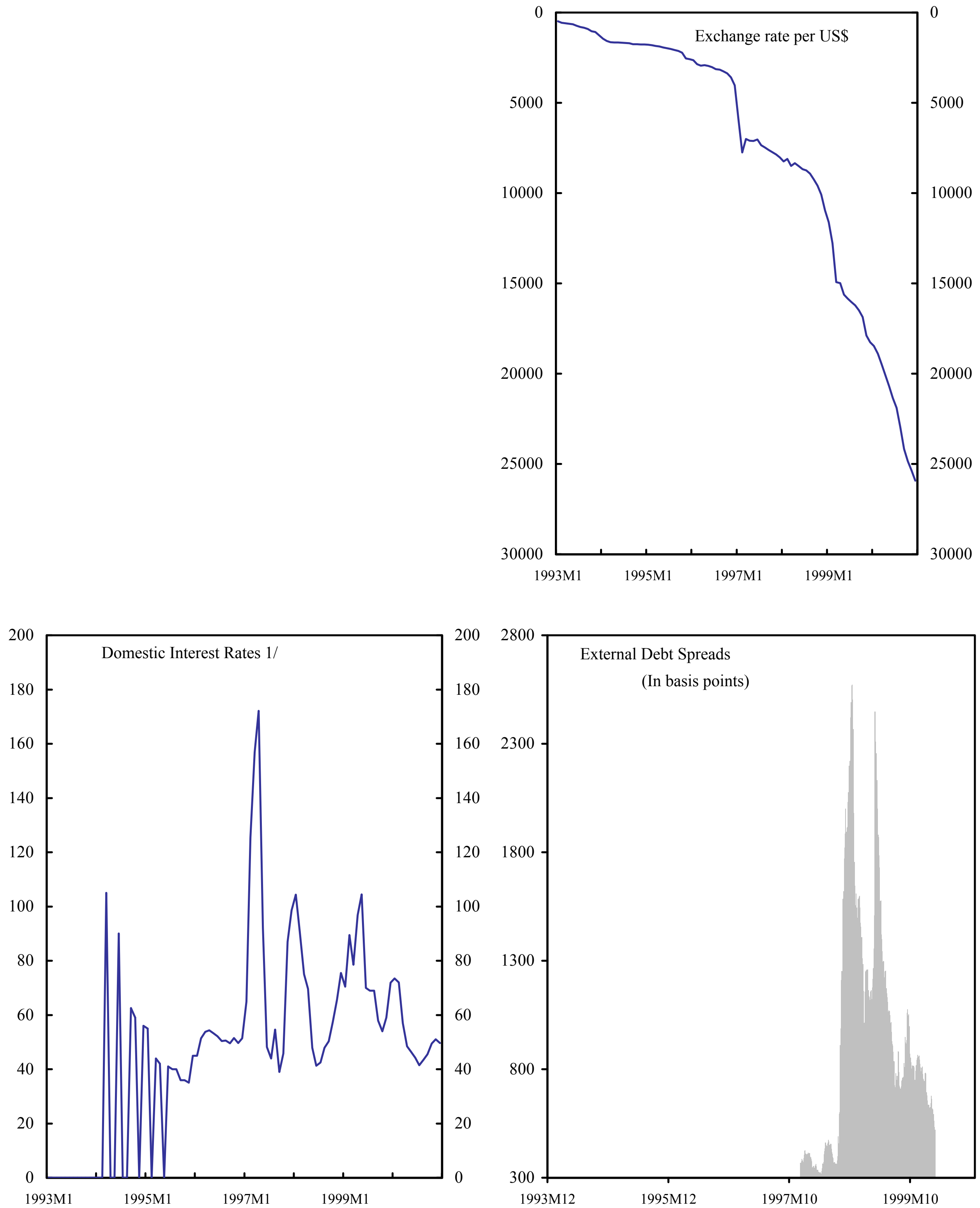
[12] As an element of the financing assurances for the 1999 stand-by arrangement, Romania sought to raise US$600 million of new money of at least two years maturity, but in practice, only managed to raise US$172 million of club loans from foreign commercial banks active in Romania with original maturity of one year and interest rates between 10–12 percent. A more detailed background analysis of private sector involvement in Romania's case can be found in EBS/99/194 and EBS/00/42.

[13] In August, 1999, in their report on Romania, Standard and Poor's described the Romanian economy as: "A largely unrestructured economy, loss-making enterprises and a fragile banking sector remain a constant threat to macroeconomic stability, the budget deficit, the current account and the exchange rate." S&P's Sovereign Ratings Service Report, August 1999, page 1.

Figure 28. Romania: Financial Markets Developments, 1993-2000



Sources: IMF, International Monetary Fund; Bloomberg.

1/ Treasury bill rate

C. Market Reaccess in 2000

80. Romania's external adjustment in 1999 far exceeded projections elaborated in the Fund-supported program and the improvement continued in 2000.[14] Following the significant correction in the real exchange rate and the tightening of the fiscal stance, the current account deficit fell from 7.5 percent of GDP in 1998 to 3.5 percent of GDP in 1999. Consequently, gross official reserves improved significantly from their end-June 1999 nadir of about US$1.4 billion to about US$3.2 billion by end-October 2000.

81. In addition to improvements in the macroeconomic policy stance, there was some progress in structural reform during in 1999, particularly in strengthening the banking sector and privatizating state-owned enterprises. The views of rating agencies also began to improve in 2000. Specifically, on August 4, 2000, Standard and Poors changed the outlook on Romania's foreign currency rating (B-) from negative to stable. Moreover, Romania succeeded in broadening its investor base in Germany, Greece, Italy, Switzerland and the U.K.

82. After a three-year hiatus, Romania eventually returned to international capital markets in September 2000. Reaccess initially yielded a €100m three-year transaction, but was subsequently augmented to €150 million. Romania accepted a spread of 587 basis points over the corresponding German government bond. On November 6, 2000, Romania made another bond placement of €150 million with five-year maturity and priced to yield 668 basis points over the corresponding German government bond. Reflecting the diversification of the investor base, this issue attracted both institutional and retail intermediaries. In January 2001, Romania successfully tapped the markets for another €150 million.

VIII. RUSSIA

A. Market Access from the Early-1990s Until the Asian Crisis

83. Russia embarked on a path of wide-ranging economic reforms in the early-1990s. Initially, economic stabilization was only partial, and an exchange crisis occurred in October 1994. Due to the minimal exposure that Russia had gained to private capital markets by this point, the Mexican crisis did not significantly affect Russia. Renewed stabilization efforts, including the introduction of an exchange rate band, were launched in 1995, supported by a US$6.3 billion arrangement with the Fund. Although some program goals were achieved, fiscal problems persisted. A new medium-term macroeconomic program, supported by a US$10 billion EFF, was adopted in March 1996.

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[14] Market commentaries (Euroweek, September 15, 2000) referred to this stronger external adjustment in their analysis of Romania's recent return to international capital markets; in particular they mentioned the lower external financing needs.

84. Improvements in Russia's economic policy and financial position, together with a successful rescheduling agreement with the Paris Club in March 1996, encouraged sharp improvements in Russia's access to global capital markets during 1996.[15] The first issuance of "new" sovereign debt (as opposed to the repackaging of outstanding Soviet debt)[16] occurred in the form of a foreign-targeted tranche of 6-month ruble-denominated treasury bills (GKOs) in February 1996. Nonresident net purchases of GKOs and OFZs (longer-dated treasury securities) amounted to US$5.9 billion in 1996. Total external bond issuance was US$1.1 billion in 1996, of which US$1 billion represented sovereign debt (Figure 29). Gross loan flows to Russia during 1996 also were substantial and amounted to US$4.2 billion. Net equity flows totaled over US$2 billion, compared to virtually zero in 1995 (Figure 30).

85. Market access improved further in 1997 and extended beyond the federal government. The deficit in the nonsovereign capital account declined from US$19.1 billion in 1996 to US$13.5 billion in 1997, before widening again to US$14.7 billion in 1998. There was increased interest in equities and bonds issued by the Russian private sector, as well as in bonds issued by regional governments. Total external bond issuance was US$6.7 billion in 1997: US$3.6 billion sovereign, US$2.2 billion private, and US$900 million by non-federal public entities. External sovereign bonds were issued at launch spreads averaging roughly 350 basis points. In 1997, gross loan flows increased to US$14.4 billion, and FDI surged to US$6.2 billion, up from US$2.5 billion the year before. However, FDI remained considerably lower than in other transition economies, mainly due to shortcomings in the protection of property rights and the enforcement of contracts, and inadequacies in bankruptcy laws. At US$2.4 billion, portfolio inflows remained high in 1997. Net financing through GKOs/OFZs nearly doubled to US$10.9 billion in 1997.

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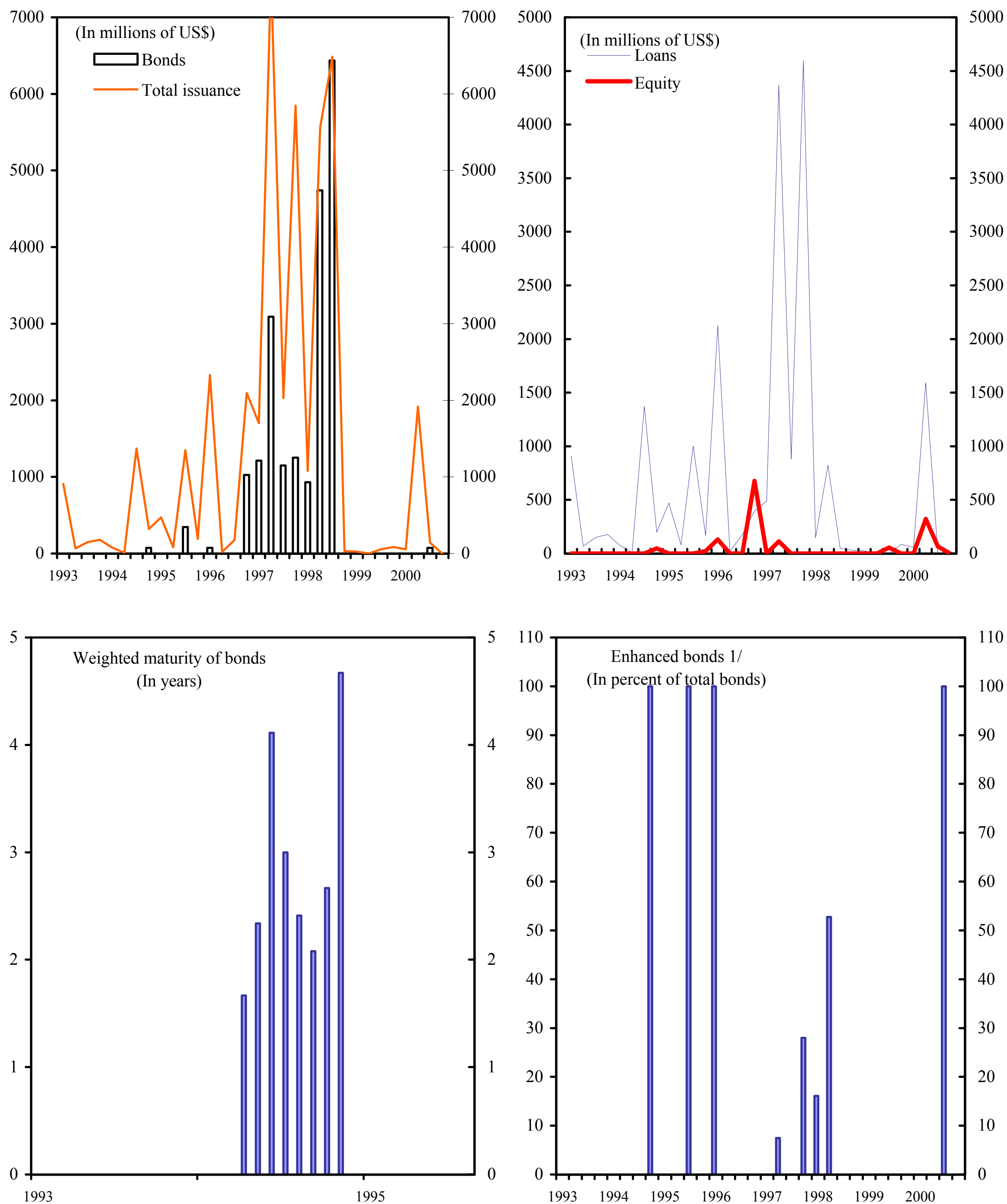
[15] Countering these large private capital inflows was heavy capital flight, which has been estimated as high as US$15-20 billion per year for 1994-98. A number of exchange control measures were introduced during the 1990s to combat capital flight, including a 100 percent repatriation requirement for hard currency earnings of Russian exporters and mandatory authorization for capital transfers by residents. These measures have not been notably successful in limiting capital flight.

[16] The Russian Federation inherited the external debt of the Soviet Union, which amounted to 60 percent of GDP at end-1993. It included over US$1.5 billion of Eurobonds as well as MinFin bonds, which were securitized foreign currency deposits in the banking system that were frozen by the authorities in 1991. Thanks to these two foreign-currency denominated instruments, Russia already had benchmark bonds in the market to assist in the pricing of new instruments.

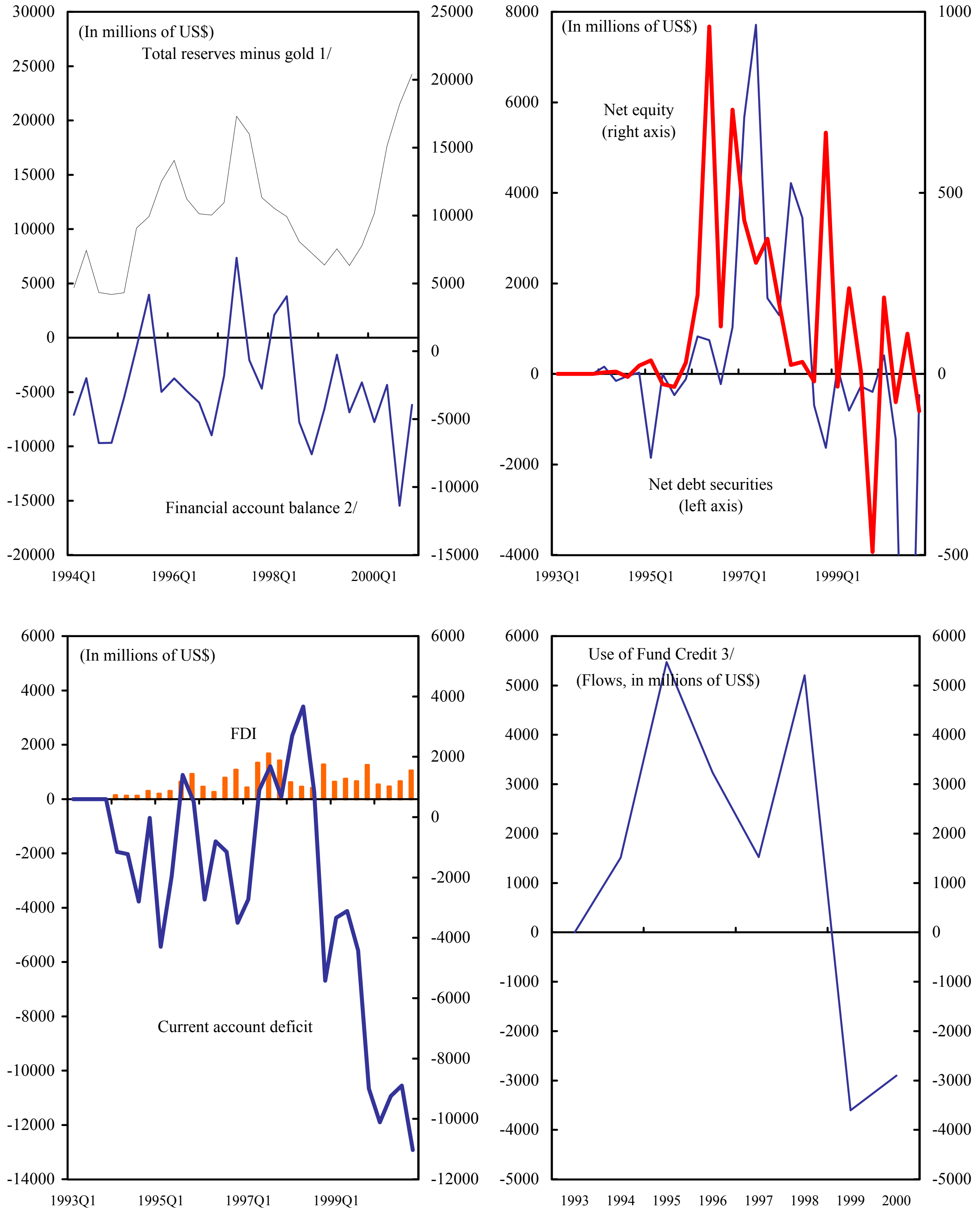
Figure 29. Russia: Gross Issuance of Bonds, Loans, and Equity, Jan-1993 to Dec-2000



Sources: BEL database; Capital Data Bondware; Loanware; and staff calculations.

1/ Data on enhanced bonds from BEL is based on a strict definition of enhancement namely convertibles, secured, and put options.

Figure 30. Russia: Net Capital Flows, 1993-2000



Source: IMF, International Financial Statistics.

1/ Total reserves not adjusted for encumbered reserves.
2/ Excludes errors and omissions.
3/ Net.

B. The Asian Crisis

86. The Asian crisis had significant spillover effects on Russia: its terms of trade deteriorated 37 percent between January 1997 and December 1998, and in November 1997 alone sales of foreign exchange amounted to US$6 billion (over one quarter of gross reserves). The rise in interest rates necessary to defend the exchange rate (the ruble was trading in a fixed band) weakened commercial banks' balance sheets, in whose portfolios the share of federal government securities had increased to almost three quarters of ruble deposit liabilities at end-1997; in fact, government securities had been the main business for Russian banks since their issuance in 1996.

87. Starting in the latter part of 1997, Russia faced increasing difficulty in financing its deficit. This reflected in part the net sales of emerging market instruments by investors in a number of other emerging markets, including Brazil and Korea. Nevertheless, Russia was able to increase its issuance of external debt from US$3.6 billion in 1997 to US$9.6 billion in 1998, albeit at ever-increasing interest rates. However, US$5.9 billion of the 1998 bond issuance was accounted for by the swap of short-term ruble bonds into Eurobonds. Also indicative of investors' increasing reluctance to hold Russian debt is the fact that net nonresident purchases of GKOs/OFZs fell from US$10.9 billion in 1997 to US$2.8 billion in 1998.[17] This necessitated further foreign exchange market intervention by the CBR and increases in interest rates; the latter crippled commercial banks, which relied on their portfolios of treasury bills to manage liquidity, and also dramatically increased the government's debt service. Finally, large-scale support by the CBR to both banks and the government intensified the pressure on the ruble.

88. Pressure temporarily eased following the June 1998 announcement of a new modified Fund-supported program, and allowed a voluntary domestic debt exchange to take place: US$5.9 billion of GKOs were exchanged for 7- and 20-year Eurobonds, at the high spread of 940 basis points. But confidence was short-lived, and the government's cash-flow problems became increasingly acute, liquidity in the banking sector dried up, and interbank transactions virtually stopped. The CBR provided large credits to the government to meets its debt-service obligations, thus further fueling the loss of reserves.

C. The Russian Crisis

89. Between April and mid-August 1998, CBR intervention amounted to US$10.5 billion, or 40 percent of end-July base money. On August 17, in the face of unrelenting pressure on the exchange rate, the authorities were forced to: (i) widen the exchange rate band, from 5.3–7.1 rubles to 6.0–9.5 rubles per U.S. dollar; (ii) default de facto on T-bills maturing before end-1999, with the intention of launching a debt exchange for these instruments; (iii) declare a 90-

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[17] Over the summer months of 1998, the government had the equivalent of US$1 billion in domestic paper to refinance every week.

day standstill on the repayment of private external debt (excluding the payment of interest); and (iv) suspend secondary market trading in GKOs and OFZs.

90. The ruble depreciated considerably despite CBR intervention. On September 2, the band was lifted, and the ruble fell to 21 per dollar within one week (Figure 31). This, combined with the T-bill default, caused the collapse of a large number of banks that had invested heavily in GKOs/OFZs, even though many commercial banks did not fulfill a large share of forward foreign exchange contracts with foreign banks . At the outbreak of the crisis, non-residents held about US$17 billion of GKOs, and about US$15 billion of forward contracts used by investors to cover their currency exposure came due on September 15 (with more falling due during the August 17–November 17 moratorium period). Financial market activity ceased completely, and the payment system came to a virtual halt due to the breakdown in trust between banks, while a run on deposits ensued.

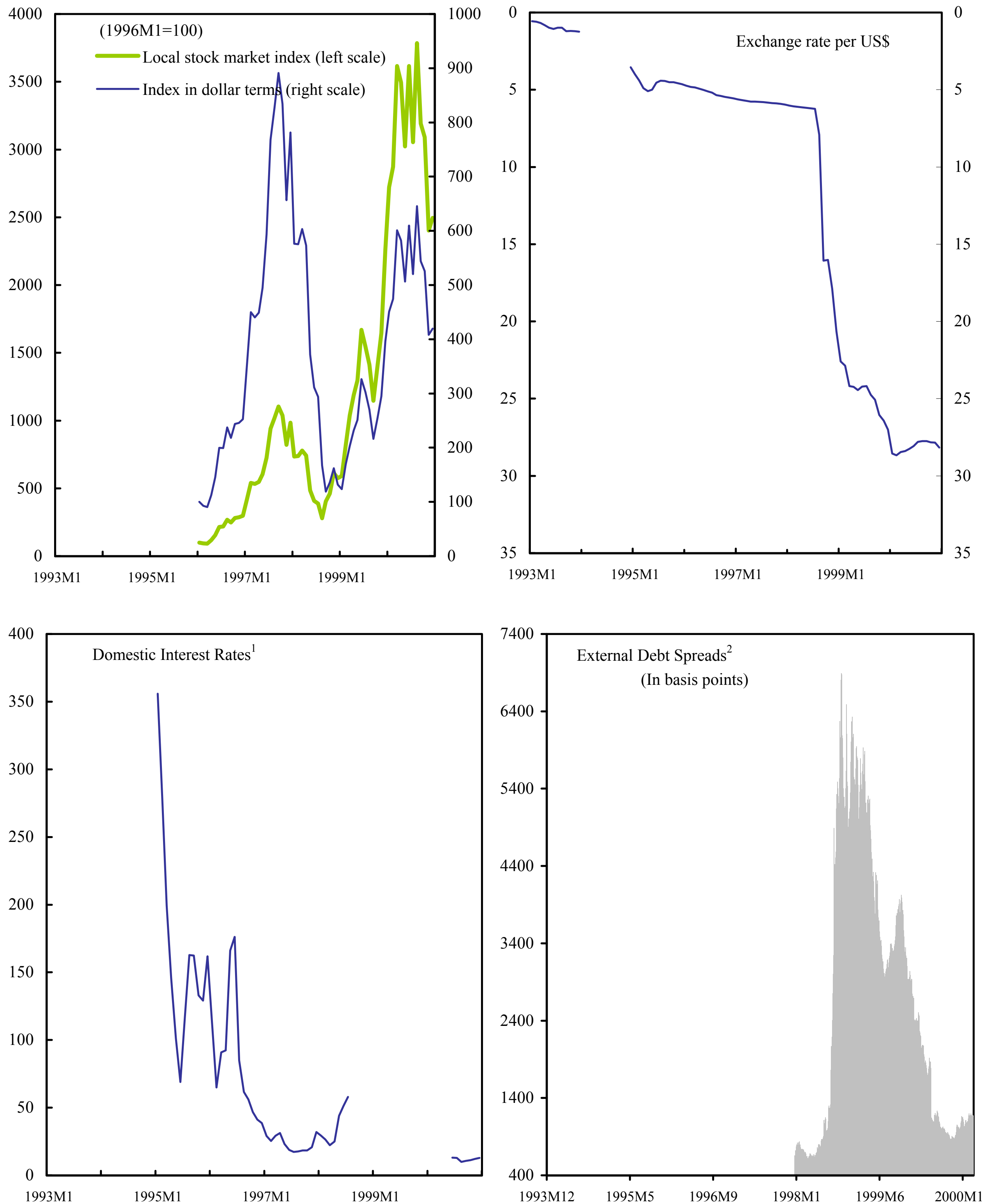
91. In the aftermath of the August financial crisis, the Russian government began accumulating arrears on its Soviet-era debt. A rescheduling agreement was reached with official creditors (Paris Club) on August 1, 1999, covering arrears and maturities falling due on Soviet-era debt in the period July 1999 to December 2000, estimated at US$8.1 billion. Successive bond exchanges were launched in the wake of the ruble crisis. In November 1999, an exchange was announced to reschedule the defaulted MinFin-3 bonds, and in February 2000, the London Club agreed to exchange the entire US$31.8 billion stock of commercial Soviet-era debt for US$21.2 billion in new Eurobonds issued by Russia. The new Eurobonds have a 30-year maturity with a 7-year grace period, thus significantly lengthening the maturity profile of Russia's external debt (the old instruments had a remaining maturity of 15-20 years). The agreement is estimated to have achieved an NPV reduction of over 40 percent at a minimal cost in terms of up-front payments (US$250 million). One of the reasons for Russia's success in obtaining such a high NPV reduction is that the new instruments, issued by the government of the Russian Federation, carry more seniority than the old instruments, which had been issued by Vnesheconombank. Another reason is that the macroeconomic outlook at the time, before the sustained and significant hike in oil prices, looked gloomy (Figure 32).

IX. THAILAND

A. Prior to the Asian Crisis

92. Thailand achieved remarkably high growth rates that often exceeded 10 percent a year in the late 1980s and the first half of the 1990s, accompanied by equally high growth in private fixed investment (rising at 9 to 13 percent in real terms in 1993–96) while consumption grew at 6–8 percent real rates (Figure 33). In 1993–96, Thailand was the recipient of significant net capital inflows that averaged an annual 10 percent of GDP, including bond placements that

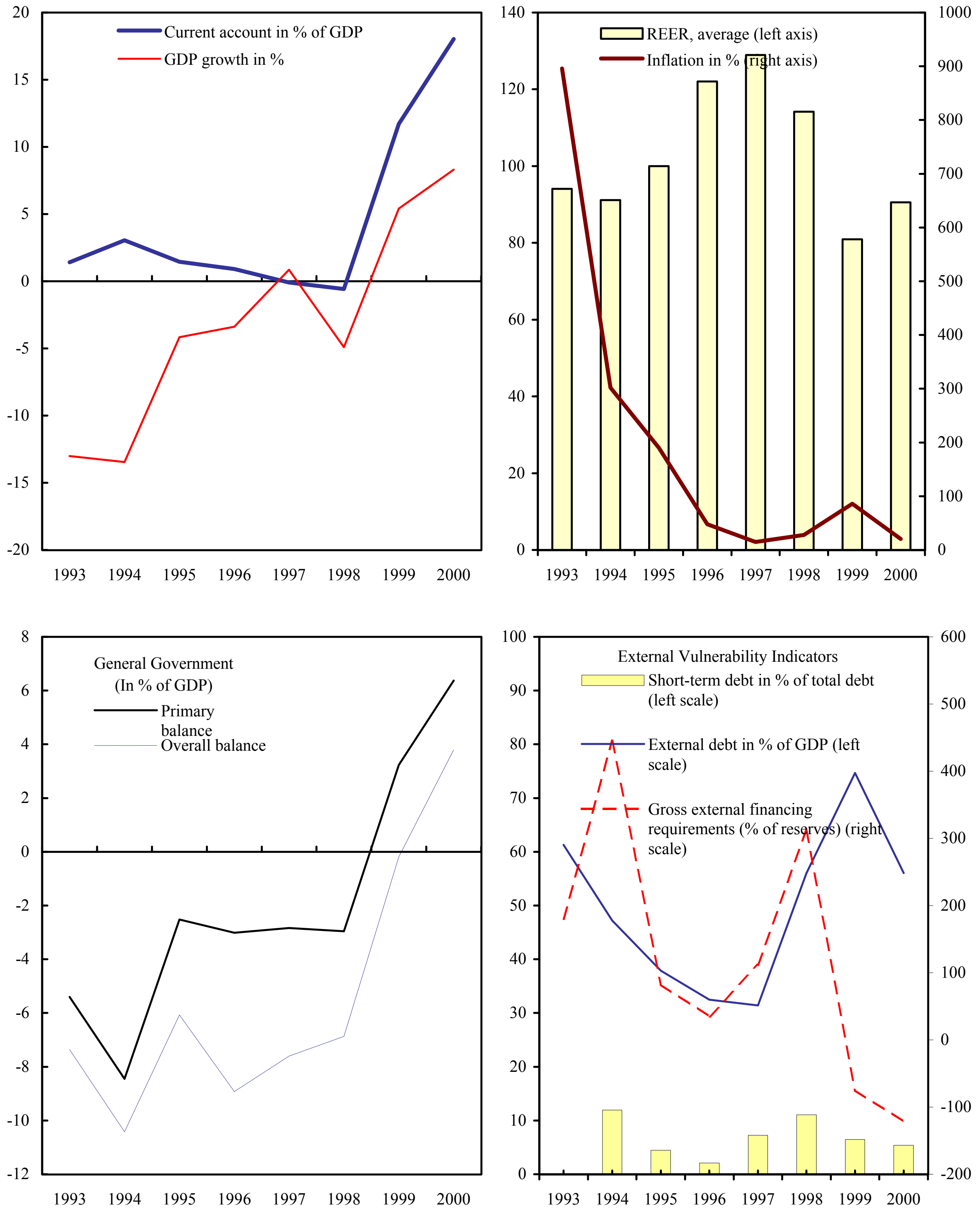
Figure 31. Russia: Financial Markets Developments, 1993-2000



Sources: IMF, International Monetary Fund; Bloomberg.

1/ Treasury bill rate. No treasury bills were issued between August 1998 and June 2000.
2/ EMBI Russia subindex.

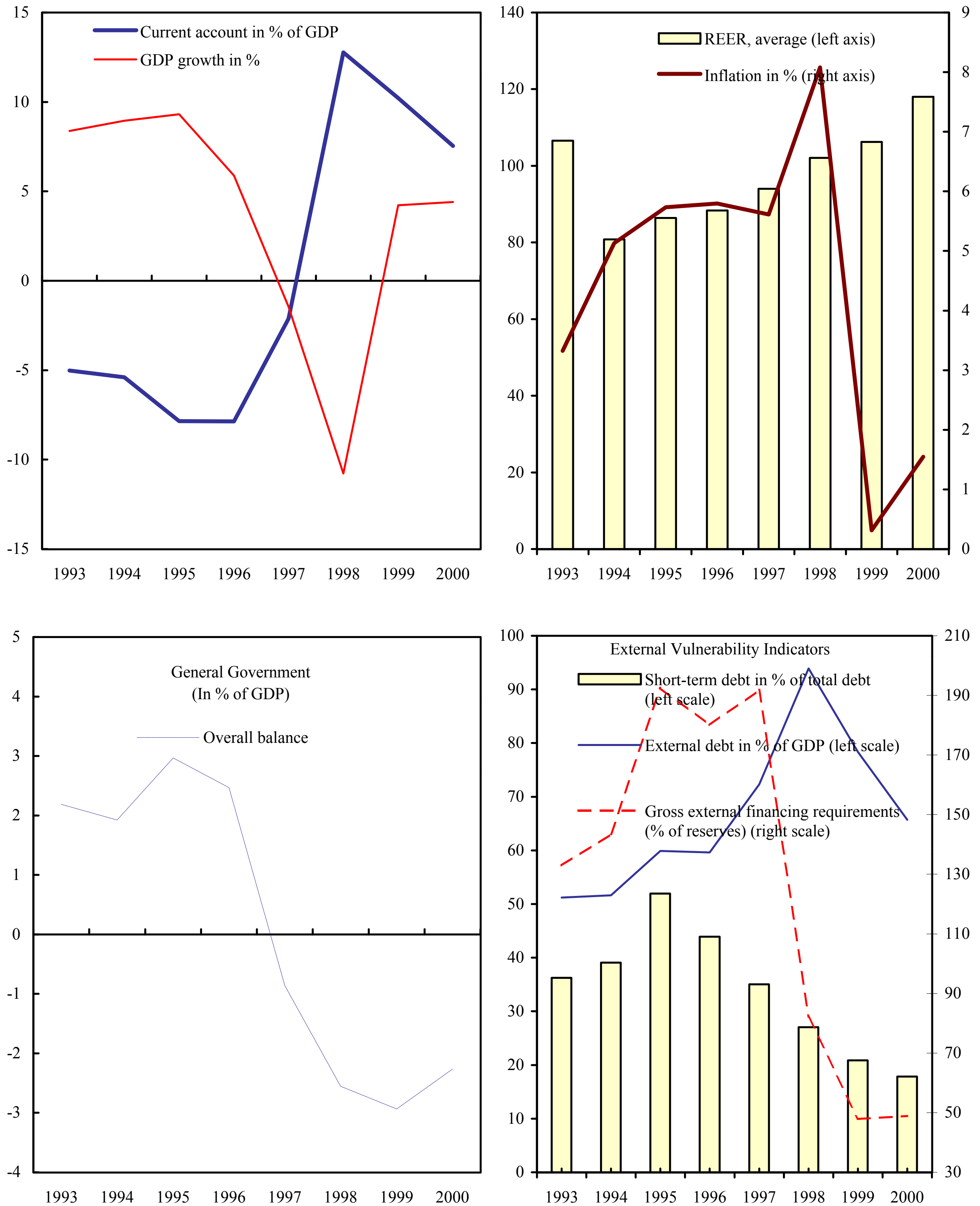
Figure 32. Russia: Fundamentals , 1993-2000 1/



Sources: IMF, International Financial Statistics; IMF, World Economic Outlook.

1/. The latest WEO data may not totally correspond to the latest data from country staff reports.

Figure 33. Thailand: Fundamentals , 1993-2000 1/



Sources: IMF, International Financial Statistics; IMF, World Economic Outlook.

1/. The latest WEO data may not totally correspond to the latest data from country staff reports.

averaged US$3 billion and loans averaging US$6.5 billion per year over the same period (Figures 34-35). The inflows were facilitated by the relaxation of capital controls, cheap labor costs, and the favorable interest rate differential coupled with exchange rate and price stability. There was only sporadic sovereign borrowing from the international capital markets since the budget surpluses eliminated the substantive need for the sovereign to borrow: the sovereign used to borrow mainly in Yen at spreads well below 100 basis points. Overall, private bond placements accounted for about 80 percent of total bond issuance. A significant part of the debt was short term, which at end–1996 amounted to about US$40 billion. Contracting external debt was encouraged by the establishment of the BIBF, a tax-exempt entity specializing in borrowing from abroad and on-lending in the domestic market.

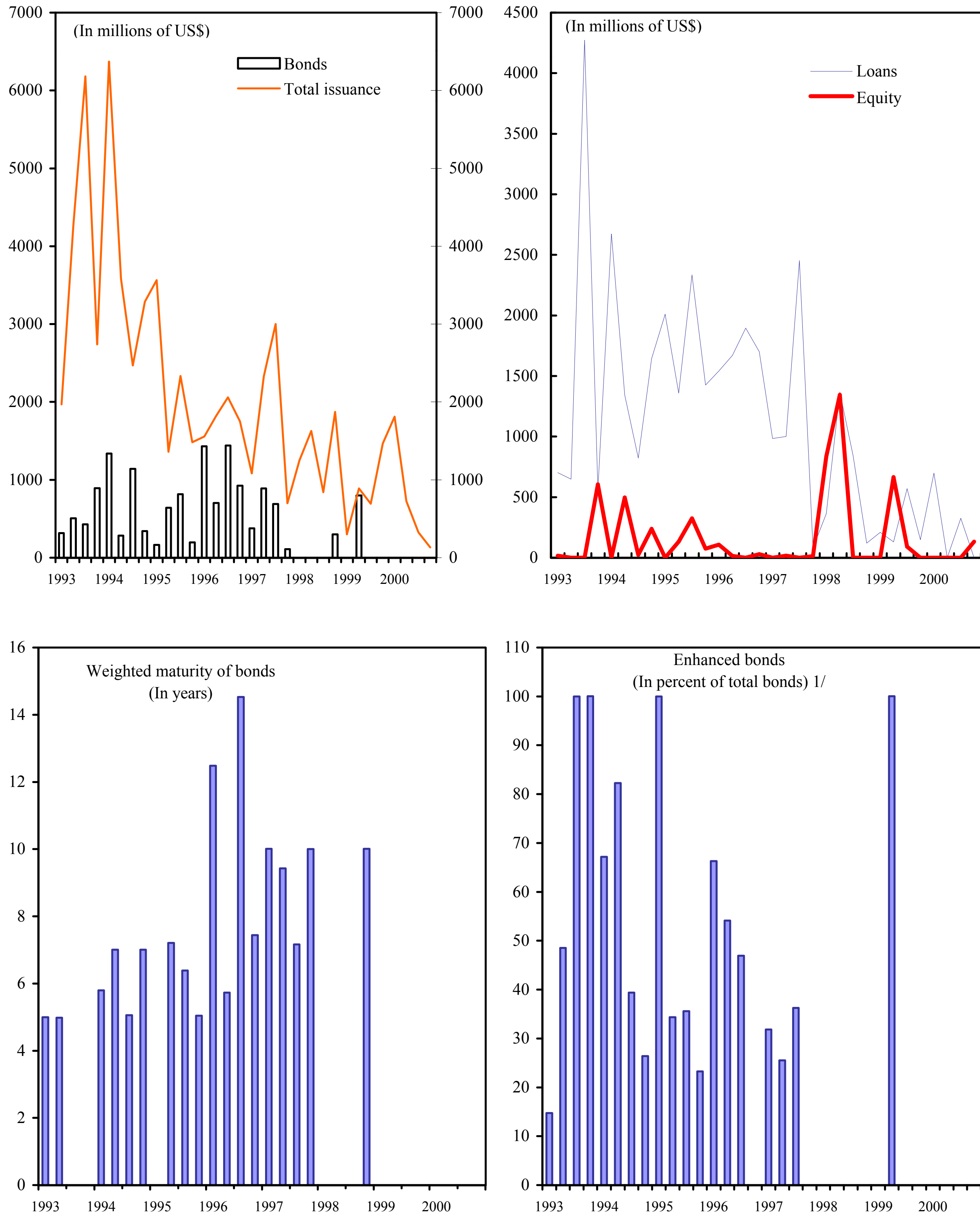
93. Weaknesses began to accumulate in 1995–96. These were related to the inflexible exchange rate policy and an overvalued exchange rate, excessive overseas borrowing, a highly-leveraged corporate sector, and unsustainable domestic credit expansion. There was also a deterioration in the average quality of banks' portfolio, in part due to the problem of the asset price bubble, which underscored the weaknesses in banking supervision. Exports that had been the engine of growth for many years lost steam in 1996 as a result of the worldwide slowdown in semiconductor industry and a loss of competitiveness. The economy fell into a recession while the current account deficit soared to 8 percent of GDP in 1996.

B. The Asian Crisis

94. As the economy slowed down, the real estate bubble burst sending shockwaves through finance companies. In the spring of 1997 the Bank of Thailand (BOT) started secretly to provide liquidity support at below market interest rates to troubled finance companies. However, a weak banking sector combined with weakening macroeconomic fundamentals (a high-current account deficit and weakening growth) rapidly changed investors' perception of the country, which became a primary target for a currency attack as speculation concerning an imminent devaluation arose.

95. Significant capital outflows started in the spring of 1997, culminating in a major attack on the baht during mid-May 1997. The baht was sold en masse in the spot and forward markets. The BOT intervened and defended the de facto dollar peg. As was revealed later, the BOT entered into swap and forward contracts of close to US$30 billion. The authorities had hoped that the central bank would regain a comfortable level of reserves before the forward liabilities came due. The BOT asked banks to refrain from providing liquidity to offshore banks, with the intention of squeezing short sellers. Meanwhile, sales of bonds and stocks by foreign investors became significant, adding to the exchange rate pressure. Eventually, in early July 1997, the authorities abandoned the peg and let the baht float. With little reserves to support it and in light of weak supporting policies, the baht depreciated by 20 percent against the dollar in July only (Figure 36). The government asked for support from the U.S. and Japan, started consultation with the Fund, and tried to introduce measures to prevent further depreciation, particularly to shore up the fragile financial sector. To stabilize bank funds and prevent bank runs, the BOT extended a blanket guarantee for depositors and creditors while it

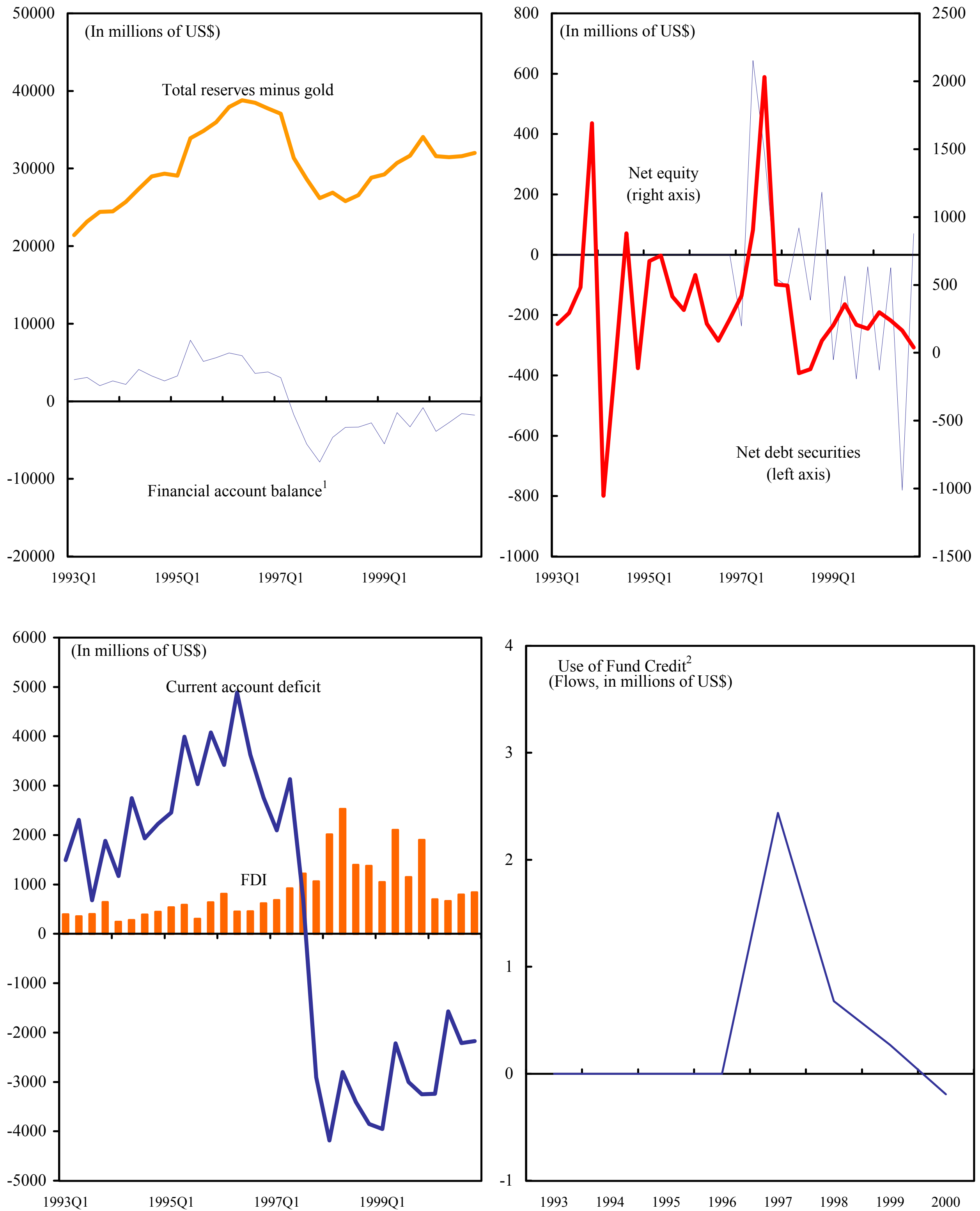
Figure 34. Thailand: Gross Issuance of Bonds, Loans, and Equity, Jan-1993 to Dec-2000



Sources: BEL database; Capital Data Bondware; Loanware; and staff calculations.

1/ Data on enhanced bonds from BEL is based on a strict definition of enhancement namely convertibles, secured, and put options.

Figure 35. Thailand: Net Capital Flows, 1993-2000

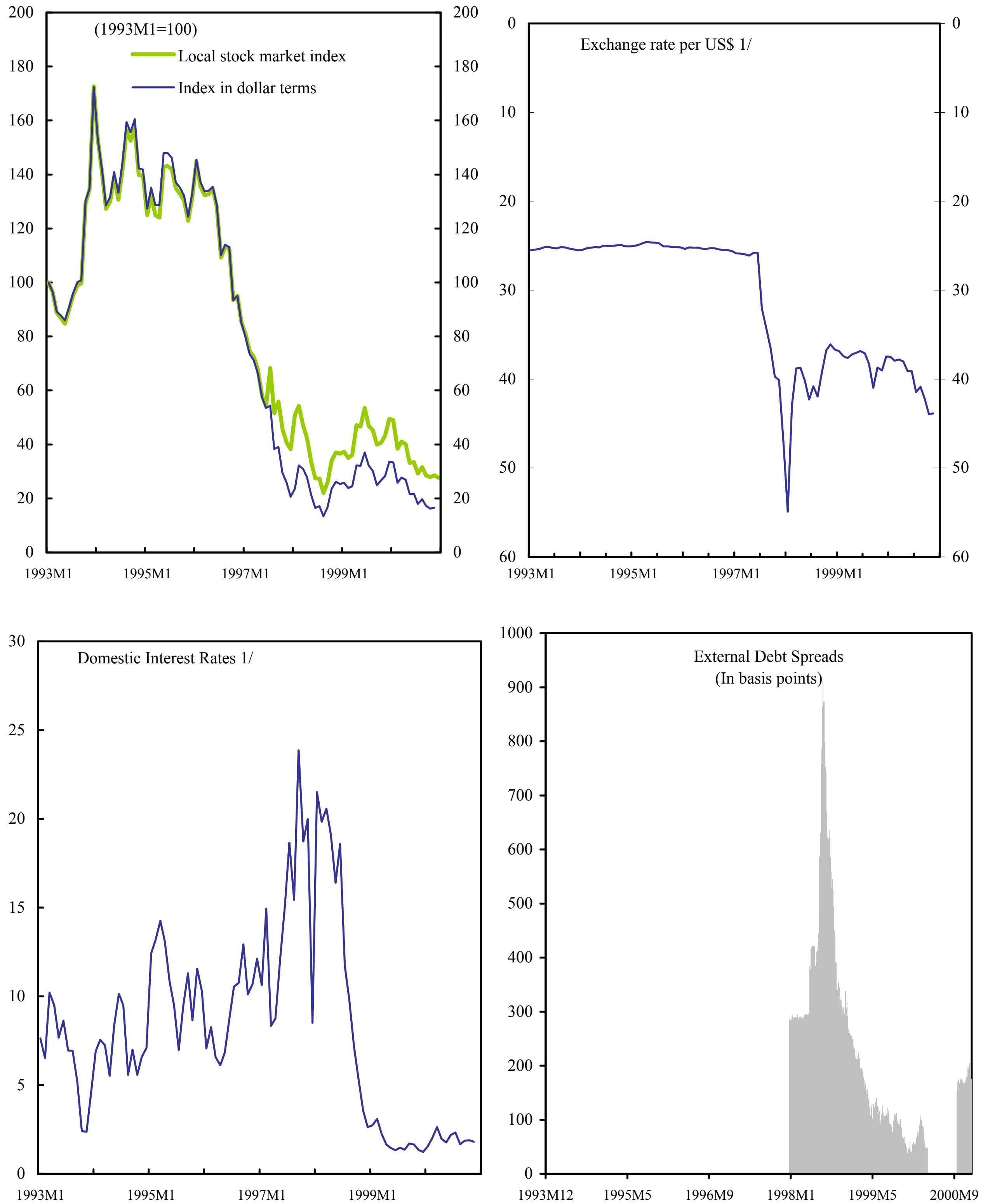


Source: IMF, International Financial Statistics.

[1]Excludes errors and omissions.

[2]Net.

Figure 36. Thailand: Financial Markets Developments, 1993-2000



Sources: IMF, International Financial Statistics; Bloomberg.

1/ Money market rate.

suspended the operations of 16 finance companies to stop the liquidity drain. These measures failed to calm the markets, as there was uncertainty over the extent of the guarantees.

96. To arrest the continuing pressures, a three-year Stand-By Arrangement of SDR 2.9 billion (505 percent of quota) was announced in August, as part of a US$17.2 billion assistance package with participation from the World Bank, Asian, and interested countries. The program included measures to restructure the financial sector, fiscal adjustment, and a continuation of a floating exchange rate system. The program was supported by informal understandings that Japanese banks would maintain their exposure to Thai borrowers.

97. The reforms encountered many obstacles and required modifications in light of the rapidly deteriorating situation due to a simultaneous threat from a currency crisis and a loss of confidence in financial institutions. The emergence of a regional crisis and deteriorating confidence in the government exacerbated this situation. The agreed financing package was also deemed too small. Capital outflows also continued as non-Japanese banks sought to reduce their exposure. The turning point came in late-October–early-November with a change in government and more decisive action. The economic program was strengthened and several emergency decrees were approved by the cabinet to facilitate financial sector restructuring and the closure of 56 finance companies.

98. Market conditions remained difficult in December and January as investor sentiment was dampened by spillovers from Indonesia and South Korea. Market access was largely lost and new inflows from bonds and loans in the six-month period from October 1997 to March 1998 reached a trickle of less than US$0.5 billion combined. Difficulties in the banking sector continued, and the BOT had to take over weak institutions in the first quarter of 1998. However, a gradual return of confidence started in early 1998, following improvements in the policy setting and an upturn in regional markets. Contracting domestic demand contributed to a sharp reduction in imports and a large current account adjustment. During February-May 1998, the baht appreciated by 35 percent.

99. Thai companies borrowed about US$1.3 billion from the syndicated loan market in the second quarter of 1998, and an additional US$0.8 billion in the third quarter. The first private placement in the bond market came in October 1998. However, external borrowing remained sporadic, as only few companies had maintained their ability to borrow externally. The revival of credit hinged largely on progress with the corporate and bank restructuring. The sovereign has abstained from issuing bonds since the crisis and has covered its financing needs through official loans and domestic borrowing.

C. The Russian and Brazilian Crises

100. Thailand was relatively little affected by these crises. Spreads on the 10-year Yankee bond increased to 900 basis points in August 1998 (from 450 basis points at end-December 1997) but declined to 700 basis points in December 1998 and below 300 basis points after January 1999. In the first quarter 1999, debt rollover ratios fell to below 60 percent,

but this was largely offset by other private capital inflows. The stock market index increased by about 30 percent between September 1998 and March 1999. The exchange rate remained stable, while the BOT continued its purchases of foreign exchange in the market and gross reserves reached about US$30 billion at end-March. Despite the turmoil in the financial markets, the country's credit ratings remained stable. In the 12 months from August 1998 to July 1999, Thailand raised about US$1.1 billion from two bond placements and US$1.0 billion from syndicated loans, amounts substantially below the pre-crisis levels.

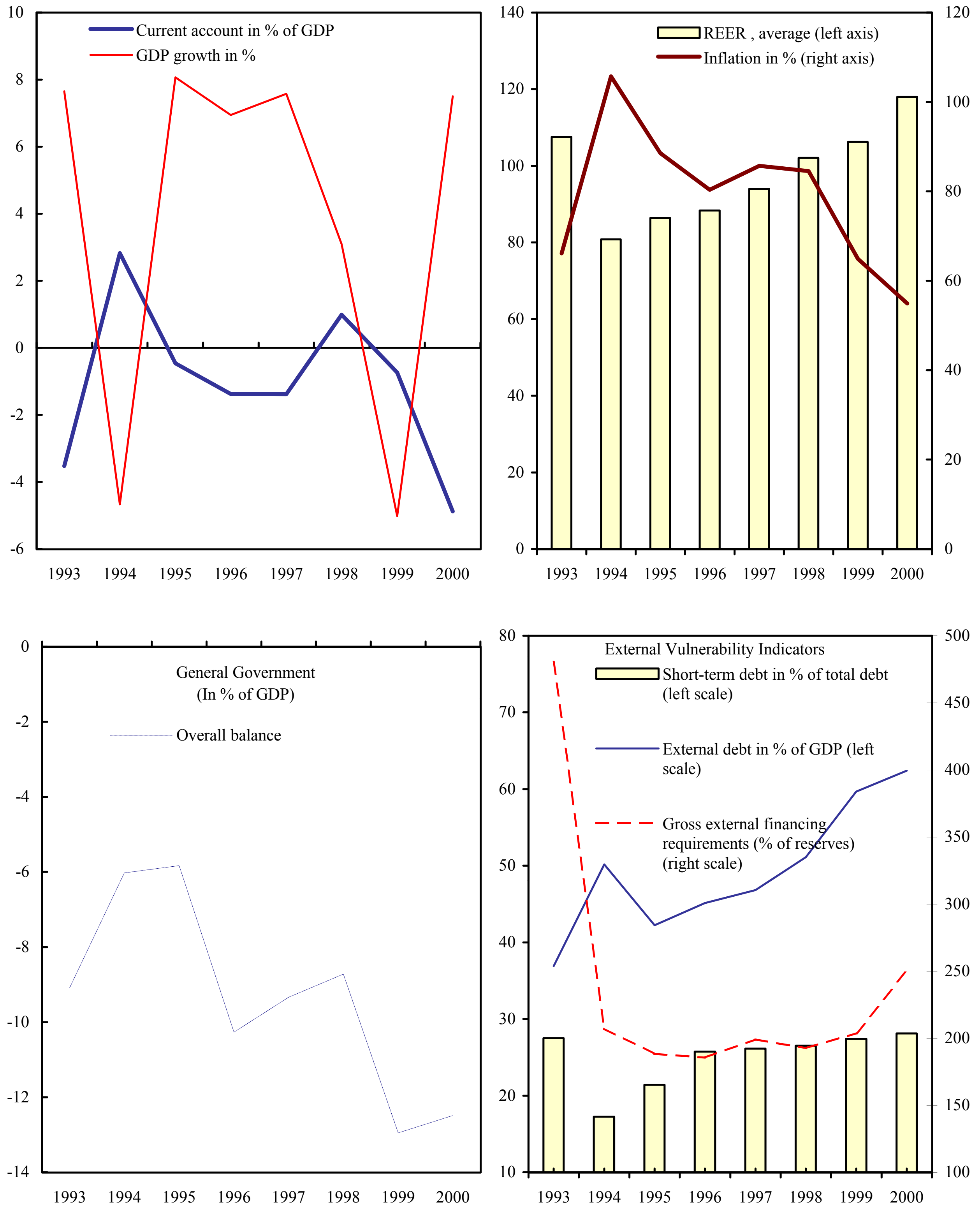
X. TURKEY

A. The Turkish and Mexican Crises, 1994–1995

101. Following years of market-oriented reforms in the late 1980s (including liberalization of the current account and most capital flows), Turkey earned an investment grade rating and good access to international capital markets. However, mounting fiscal imbalances triggered a severe financial crisis in early 1994 (Figure 37). The domestic crisis and policy setbacks in the second half of 1994, followed by a series of credit downgrades (to B+) and a deterioration in the external environment, resulted in Turkey's losing market access for a prolonged period. Total gross issuance (bonds, loans, and equities) dried up in April-May 1994, and even trade financing was badly disrupted (Figure 38). Likewise, net capital flows declined in the first quarter of 1994 to US$800 million from a quarterly average of US$2.2 billion in 1993 and turned negative in the second quarter of 1994 and remained so for the year (Figure 39). The bond market was the first to dry up, with only one small issue between December 1993 and March 1995. External spreads on dollar debt rose by about 200-300 basis points, to 400–500 basis points. Equity issuance also froze during January 1994-April 1995. Loans, a major source of funding for Turkish banks, contracted sharply (77 percent year on year) in April-June 1994. These loans were mostly one-year, pre-placed, pre-export financing facilities for first-tier banks, with spreads and fees more than double the pre-crisis levels.

102. The April 1994 stabilization program, supported by a 14-month Fund Stand-By Arrangement (SBA) of SDR 610.5 (80 percent of quota) entailed sharp fiscal adjustment, tight monetary policy aimed at reducing inflation, structural reforms to underpin the medium-term fiscal position, and a blanket household deposit guarantee to stop bank runs. Confidence waned in late 1994 due to an attempt to lower interest rates, political uncertainties, and concerns regarding the sustainability of fiscal adjustment (structural reforms were not being implemented). Although the current account and the fiscal position improved markedly, inflation reached record levels. In 1995, an exchange rate crawl was adopted. However, inflation was higher than programmed, the current account deteriorated, and structural reforms were not implemented. The SBA went off track shortly after the collapse of the government in September 1995.

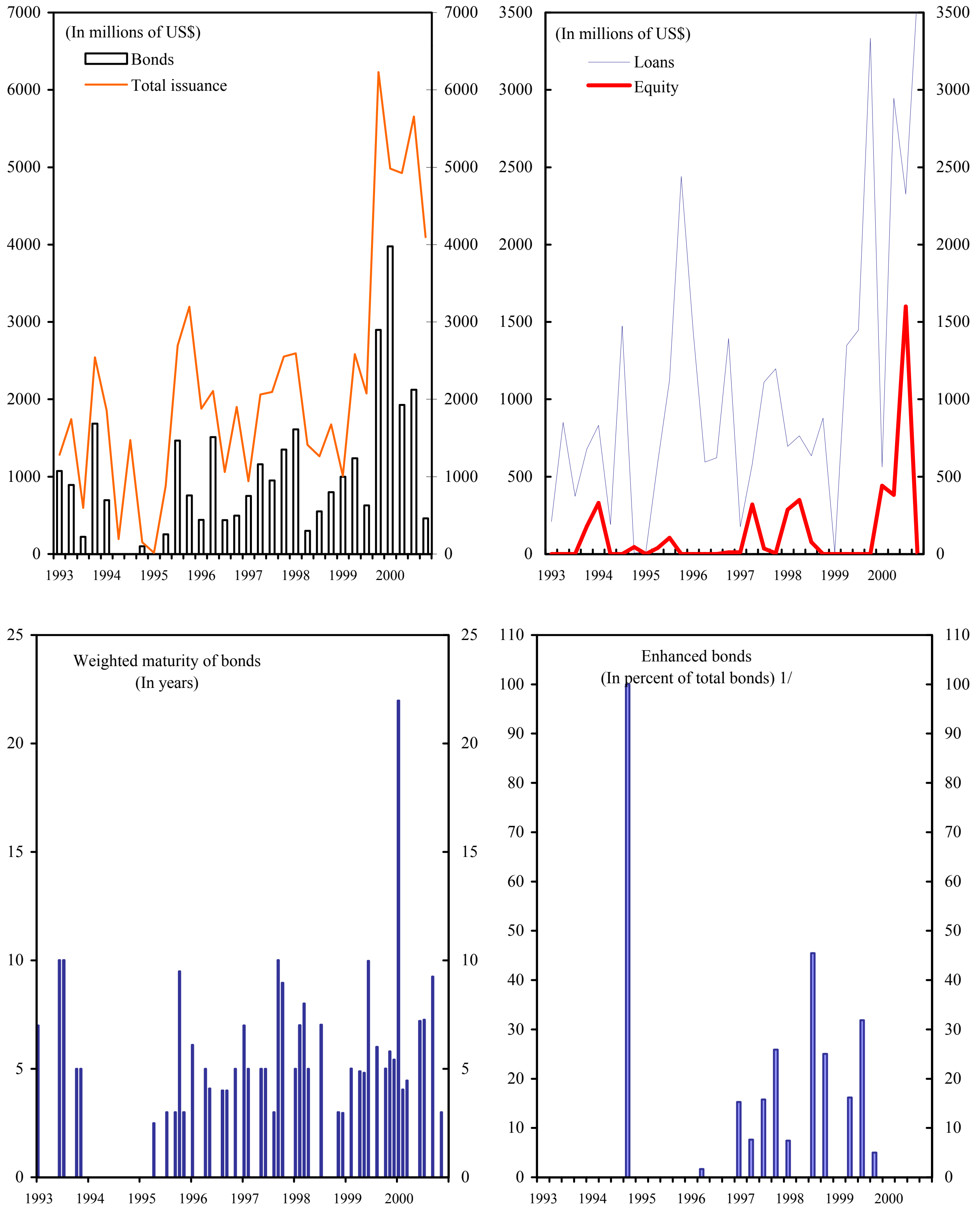
Figure 37. Turkey: Fundamentals , 1993-2000 1/



Sources: IMF, International Financial Statistics; IMF, World Economic Outlook.

1/. The latest WEO data may not totally correspond to the latest data from country staff reports.

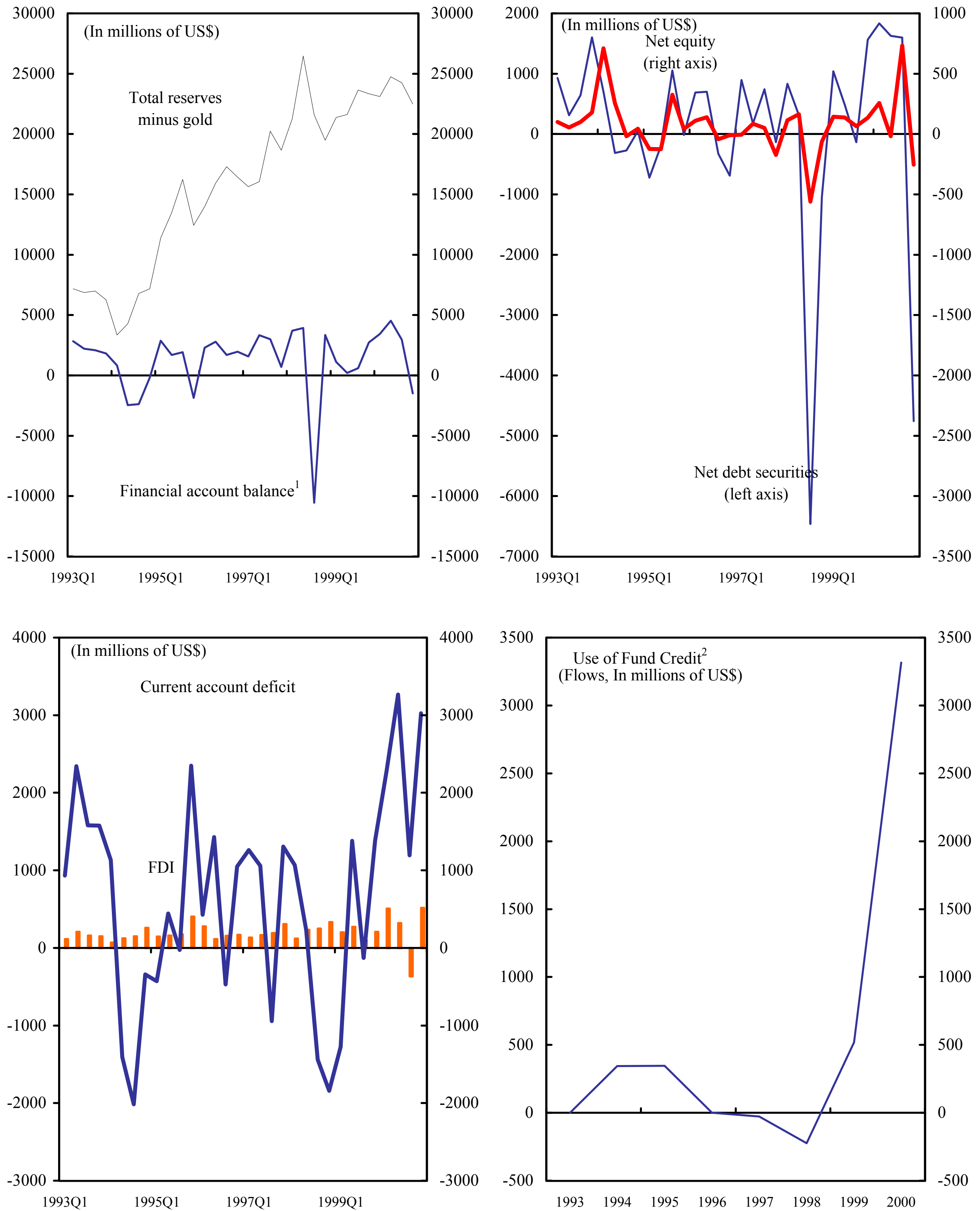
Figure 38. Turkey: Gross Issuance of Bonds, Loans, and Equity, Jan-1993 to Dec-2000



Sources: BEL database; Capital Data Bondware; Loanware; and staff calculations.

1/ Data on enhanced bonds from BEL is based on a strict definition of enhancement namely convertibles, secured, and put options.

Figure 39. Turkey: Net Capital Flows, 1993-2000



Source: IMF, International Financial Statistics.

[1]Excludes errors and omissions.

[2]Net.

103. An improved external position compared to that prevailing in the pre-crisis period and a better global financial environment allowed Turkey to re-enter the international bond market in the second quarter of 1995 and regain broader access in mid-1995. In the second half of 1995, total gross issuance rose to a monthly average of US$1 billion, significantly higher than prior to the crisis. Investor concerns regarding Turkey's external vulnerability were eased by several factors, including (i) Turkey remained current on all external payments; (ii) rapid current account adjustment rebuilt reserves to above pre-crisis levels; and (iii) the repatriation of funds by residents and Turkish expatriates. In April 1995, the government arranged a US$500 million three-year (two-year average life) club loan among 18 international banks. The 350 basis points spread over Libor was higher than pre-crisis bond spreads, while maturity was considerably shorter than pre-crisis. The syndicated loan market for Turkish banks also picked up starting in the second quarter of 1995. Furthermore, in 1995, a few banks obtained medium-term financing, for example via A/B loan structures (see footnote 8).

104. The sovereign issued a DM Eurobond (US$400 million) and a Euro-yen bond (US$800 million) in July and August 1995, respectively. Turkish Eurobonds had typically sold well in Germany to savings banks, finding their way into retail portfolios. Turkey had also built up a strong presence in the Samurai market, which accounted for some 60 percent of its bond issues in 1993-94. Both post-crisis bonds had a 3-year maturity, substantially shorter than pre-crisis tenors. However, spreads at 300 basis points for the Yen deal and 294 basis points for the DM transaction were not high. In September 1995, Turkey returned to the dollar market with a US$300 million bond at a 300 basis points spread with a three-year maturity. In November the government privately placed a US$144 million instrument amidst a very unsettled political context. Equity issuance restarted in the period May-August 1995, but quickly dried up again. Net flows turned positive in the first quarter of 1995, with short-term capital attracted by high real domestic interest rates. However, as the weak fiscal position had been at the root of the 1994 crisis, international investors penalized the sovereign most: net public external debt flows remained negative through 1999.

B. The Asian Crisis

105. Despite adverse political developments and poor economic management, Turkey retained reasonable market access throughout 1996 and most of 1997 (average monthly gross issuance of US$600 million), because of a benign external environment. The turmoil of October 1997 had only a short-lived impact on Turkey's market access. Although there was no bond or equity issuance in November-December 1997, net capital flows in the fourth quarter of 1997 remained positive and in the first half of 1998 attained a record quarterly average of US$3.8 billion, partly due to high and declining local interest rates. The sovereign was able to place two-thirds of its annual issuance needs, and second-tier banks obtained syndications. Equity issuance was also robust.

106. In June 1997, a new government coalition embarked on a three-year disinflation program, which from June 1998 onwards was supported by a Fund staff-monitored program (SMP). Key elements of the program were a sharp fiscal adjustment, a revival of the

privatization program, closer coordination between monetary and fiscal policies, and forward-looking indexation of public prices. Beginning in the first quarter of 1998, the budget position improved sharply, sizable privatizations were completed, inflation eased, a tax reform was passed, reserves rose sharply, and Turkish asset prices rallied strongly. However, domestic interest rates did not decline in line with inflation, due to a credibility deficit as a result of insufficient structural reforms.

C. The Russian and Brazilian Crises

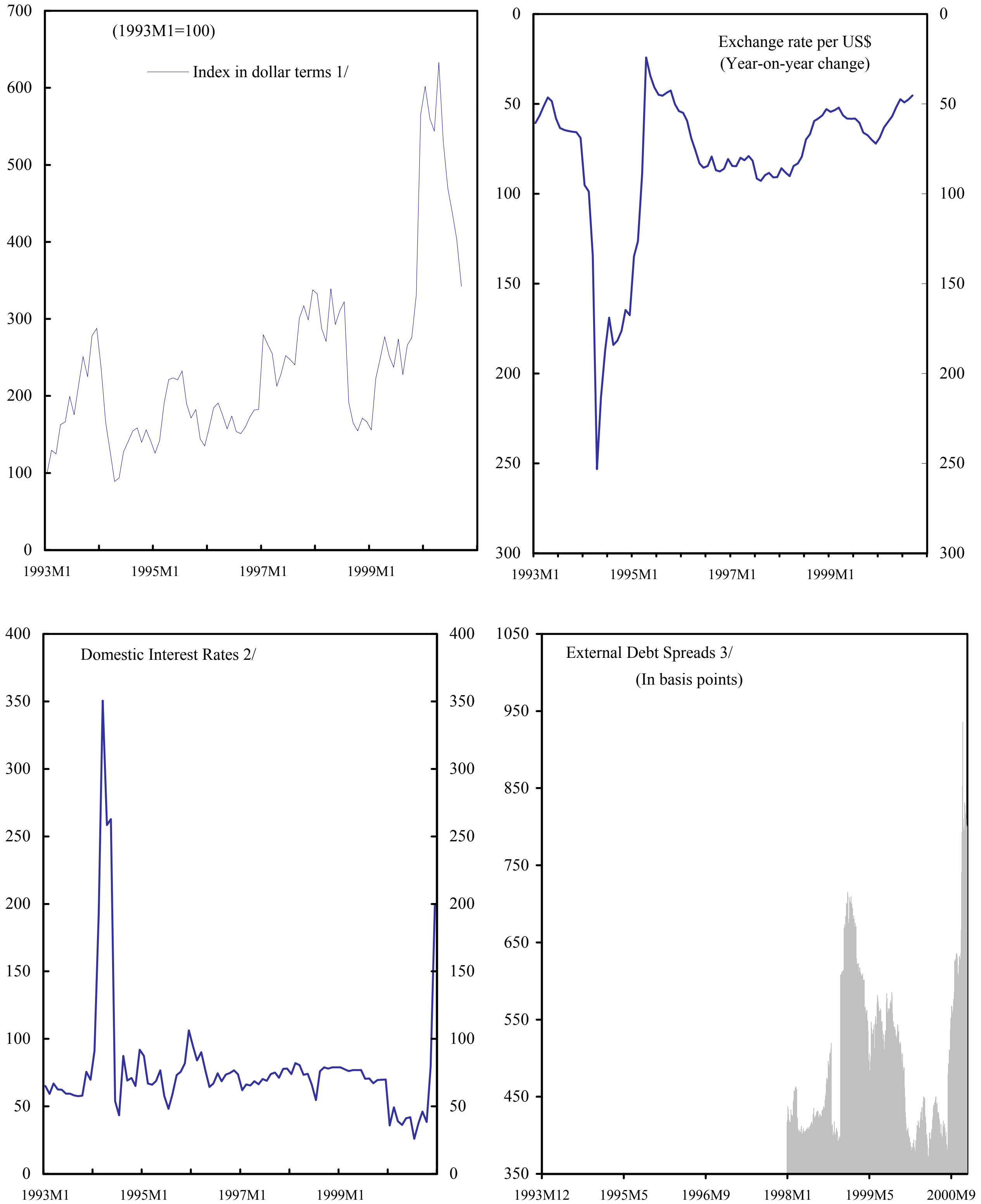
107. The Russian crisis sparked a sharp reversal of capital flows to Turkey, with US$11 billion leaving the country in the third quarter of 1998. Bond and equity issuance ceased in the period August-October 1998, and loans averaged only US$200 million a month with rollover rates falling below 50 percent. Equity issuance did not resume until February 2000. Financial markets registered severe losses in the third quarter of 1998: external debt spreads rose sharply from about 450 basis points to over 700 basis points and domestic interest rates shot up from about 70 percent to over 100 percent (Figure 40). The policy response focused on allowing interest rates to rise sharply to defend the exchange rate. However, the Central Bank expanded net domestic assets in order to ease the sharp liquidity squeeze faced by banks, and the target agreed under the SMP was missed.

108. Turkey regained access to bond markets in November 1998 after spreads had started to tighten, but while domestic interest rates were still rising. Total gross monthly issuance averaged US$600 million in November 1998–February 1999 with bonds accounting for over 75 percent of issuance. The DM market, with its attraction to retail investors, accounted for 84 percent of issuance; maturities were shorter (three years) than those of the 1996–1997 issues (5–10 years), and spreads significantly higher than prior to the crisis. Re-opening of issues was also an important avenue for market access during this period. In contrast with the past, most lead banks took a book-building approach and did not underwrite deals. The rollover rate of syndicated loans, which had been below 50 percent in August and September, rose to about 75 percent in December; however, second-tier banks remained cut off from the market.

109. At the time of the Brazilian crisis, Turkey's financial markets had started to recover, thanks to improving international sentiment, and the impact of the crisis was short-lived. Gross issuance was low only in March 1999, but resumed at reasonable levels from April onwards. Net capital flows remained positive in the first quarter of 1999, reflecting the expectation that the April 1999 elections would usher in a strong government capable to take on bold economic reforms.

110. The pattern of market re-access in early 1999 differed from earlier re-access episodes. Although bonds took center stage, this was likely due to the fact that bank loans coming due in early 1999 were not top-tier credits. In February 1999, right after the Brazilian crisis, the Republic issued its first euro-denominated Eurobond. The deal was increased to €1 billion in three re-openings, and was issued at a spread of about 600 basis points. Until April 1999,

Figure 40. Turkey: Financial Markets Developments, 1993-2000



Sources: IMF, International Monetary Fund; Bloomberg.

1/ Data series prior to January, 1996 rebased for devaluation effect.
2/ Overnight rate.
3/ EMBI Turkey subindex.

access was limited to the Euro market. The first dollar deal of 1999 was a reopening of the 2008 bond. The syndicated loan market improved markedly in April, but net issuance only turned positive in the second half of 2000. Spreads were at times more than 100 basis points higher than before the Russian crisis, but the increase in funding costs for first-tier banks was closer to 50 basis points.

111. In July 1999, after passage of a new banking law , the Fund extended the SMP for six months, with the expectation that a regular stand-by arrangement would follow thereafter. Despite a devastating earthquake in August 1999, a critical social security reform and new legislation on international arbitration were approved. In the second half of 1999, Turkey's gross monthly issuance was a record US$1.3 billion. This level of issuance was heavily influenced by the expectation that Turkey was embarking on a bold economic stabilization program.

112. Turkey's three-year stand-by arrangement, approved in December 1999, aimed to reduce inflation to 15 percent by 2001 and to 7 percent by 2002. It entailed strong fiscal adjustment, wide-ranging structural reforms, and a pre-announced crawling exchange rate peg, operating under quasi-currency board rules, with a gradual exit strategy. The program's early success was reflected in strong rallies in all Turkish asset markets and large capital flows evidenced by US$7.5 billion in Eurobond issuance. However, in the fourth quarter of 2000, the tightening of conditions in international markets, combined with policy implementation delays and a widening current account deficit, led to a severe liquidity crisis, resulting in banking difficulties and the loss of market access. In December 2000, the SBA was augmented by SDR 5.8 billion under the Supplemental Reserve Facility (600 percent of quota) with a strengthened policy package. In December 2000, Turkey obtained a US$1 billion one-year Club loan, but did not issue international bonds until February 2001. Furthermore, a voluntary agreement was reached with international creditor banks to maintain interbank credit lines and trade-related credits.