CHAPTER
I

Main Developments in the World Economy in 1998/99

In 1998/99, financial markets stabilized and economic activity bottomed out in the emerging market economies of Asia, with signs of an economic turnaround emerging in some cases by early 1999. During the year, external financing conditions facing emerging market economies deteriorated markedly following the Russian crisis in August, which also, for a time, gave rise to fears of a more widespread credit crunch. Conditions improved following a broad-based easing of monetary conditions among the industrial countries, although Brazil's crisis in January 1999 caused a temporary setback.

Economic activity in emerging market economies generally was adversely affected, not only by the difficult external financing environment but also by weaker external demand and falling prices for commodity exports. Among the industrial countries, the recession in Japan deepened during 1998 before a sharp rebound in activity in early 1999, and growth in the European Union (EU) waned during the period, but the expansion in the United States remained remarkably strong. World output growth slowed to 2½ percent in 1998 from 4¼ percent in 1997, with preliminary indications of some pickup in early 1999—although growth appeared to remain significantly weaker than during 1994–97 (Table 1 and Figure 1). This fourth global slowdown in a quarter century stemmed mainly from the crises in emerging markets and the Japanese recession.

Commodity prices fell across the board by amounts not experienced since the mid-1980s. Following some sharp declines in early 1998, oil prices lost further ground toward the end of the year—resulting in a decline of more than 30 percent in 1998 as a whole—but most of the 1998 drop was recovered following the announcement in March 1999 of planned production cuts and evidence of a turnaround in Asia. Prices of nonfuel commodities weakened steadily over the financial year, and by March 1999 they were more than 15 percent below a year earlier. This downward movement in commodity prices, while contributing to lower global inflation, also reduced real incomes and domestic demand in many commodity-exporting developing countries, with major negative effects on current account and fiscal positions in some cases. Partly reflecting low-cost imports from Asian emerging markets and falling commodity prices, consumer price inflation in the advanced economies eased further in 1998, to 1½ percent. In a number of emerging market economies, however—including Indonesia and Russia—inflation rose sharply following currency depreciations.

Associated with the financial turmoil in emerging market economies was a precipitous drop in private capital inflows. In the wake of the Russian crisis, most emerging market borrowers temporarily lost access to private financing as interest rate spreads reached levels not observed since the Mexican crisis of 1995, with Latin American countries most affected. A general flight to quality and liquidity also prompted a severe tightening of credit conditions and a sharp fall in equity prices in developed financial markets before tensions eased in late 1998. Net private capital flows to emerging market economies fell to about $65 billion in 1998, less than one-third the peak reached in 1996 and the lowest annual level of the decade (Table 2). The Brazilian crisis postponed the return of interest rate spreads and capital flows to levels observed before the Russian crisis, but by March and April 1999 emerging market borrowers, including some in Latin America, began to return to the market.

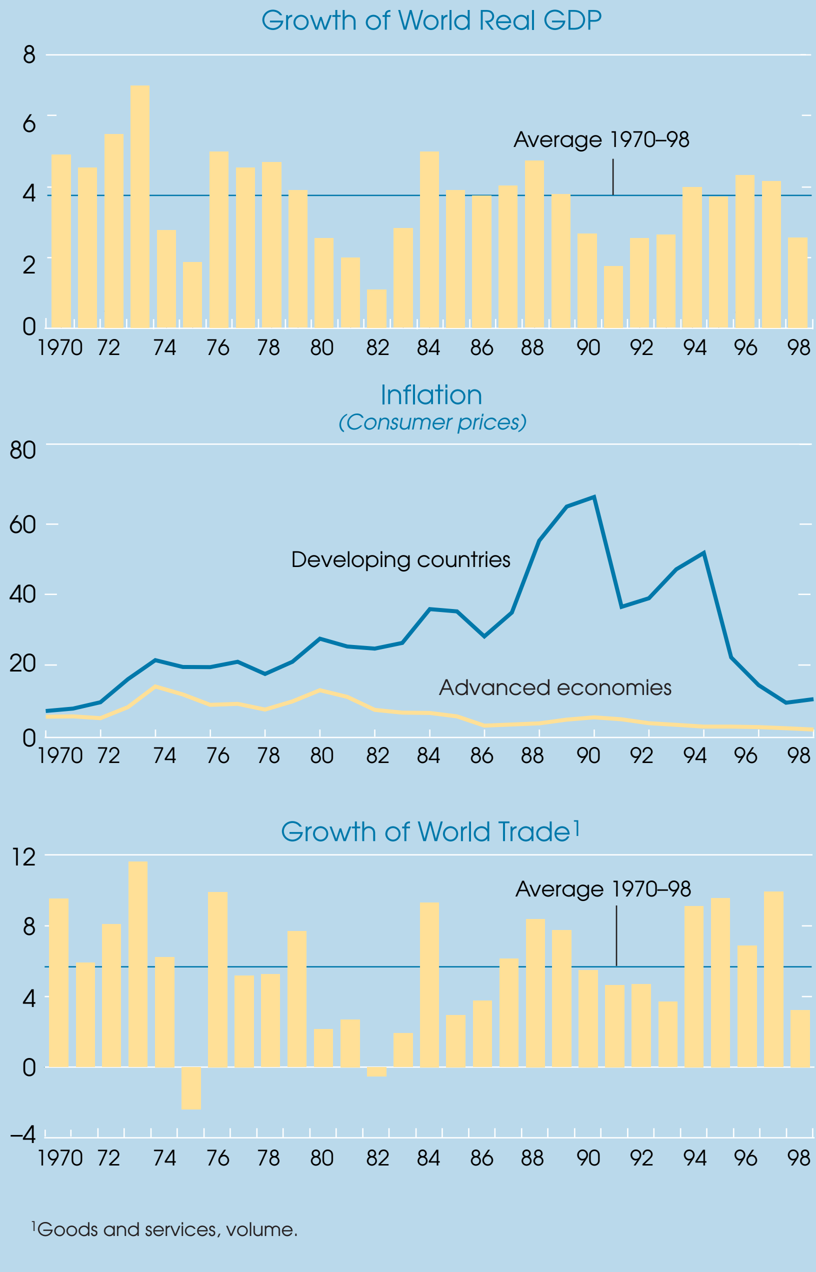
Slower output growth in all the main country groups in 1998 led to a sharp slowdown in the growth of world trade volume to an estimated 3¼ percent, the lowest annual growth rate since 1985. Furthermore, adjustment in the crisis-afflicted emerging market economies, the more difficult external financing environment, falling prices for commodity exports, and the uneven pattern of growth among the industrial countries contributed to substantial changes in regional and national trade and payments balances. The trade balances of the crisis-afflicted East Asian economies turned sharply positive in 1998, to the tune of almost $100 billion, as the severe import compression initiated in

Table 1
Overview of the World Economy
(Annual percent change unless otherwise noted)

	1991	1992	1993	1994	1995	1996	1997	1998
World output	**1.8**	**2.7**	**2.7**	**4.0**	**3.7**	**4.3**	**4.2**	**2.5**
Advanced economies	1.2	1.9	1.2	3.2	2.6	3.2	3.2	2.2
Major industrial countries	0.8	1.8	1.1	2.9	2.1	3.0	3.0	2.2
United States	–0.9	2.7	2.3	3.5	2.3	3.4	3.9	3.9
Japan	3.8	1.0	0.3	0.6	1.5	5.0	1.4	–2.8
Germany	5.0	2.2	–1.2	2.7	1.2	1.3	2.2	2.8
France	0.8	1.2	–1.3	2.8	2.1	1.6	2.3	3.1
Italy	1.1	0.6	–1.2	2.2	2.9	0.9	1.5	1.4
United Kingdom	–1.5	0.1	2.3	4.4	2.8	2.6	3.5	2.1
Canada	–1.9	0.9	2.3	4.7	2.6	1.2	3.8	3.0
Other industrial countries	2.9	2.5	2.0	4.6	4.4	3.8	4.2	2.1
Memorandum								
Industrial countries	0.8	1.7	0.9	2.9	2.3	3.0	3.0	2.5
Euro area	2.4	1.3	–1.0	2.7	2.3	1.7	2.5	2.9
Newly industrialized Asian economies	7.9	5.8	6.3	7.6	7.3	6.3	6.0	–1.5
Developing countries	4.9	6.7	6.5	6.8	6.1	6.5	5.7	3.3
Africa	1.8	0.2	0.7	2.2	3.1	5.8	3.1	3.4
Asia	6.6	9.5	9.3	9.6	9.1	8.2	6.6	3.8
China	9.2	14.2	13.5	12.6	10.5	9.6	8.8	7.8
India	1.7	4.2	5.1	7.2	8.0	7.4	5.5	5.6
ASEAN-4[1]	7.4	6.7	7.1	7.7	8.1	7.1	3.8	–9.4
Middle East and Europe	2.7	7.0	4.0	0.6	3.7	4.7	4.4	2.9
Western Hemisphere	3.9	3.3	3.9	5.2	1.3	3.6	5.2	2.3
Brazil	1.0	–0.5	4.9	5.9	4.2	2.8	3.5	0.2
Countries in transition	–7.4	–11.7	–6.4	–7.5	–1.1	–0.3	2.2	–0.2
Central and eastern Europe	–9.9	–8.5	–3.7	–2.9	1.6	1.6	3.1	2.4
Excluding Belarus and Ukraine	–10.7	–5.0	0.3	3.2	5.6	3.7	3.5	2.6
Russia	–5.0	–14.5	–8.7	–12.6	–4.1	–3.5	0.8	–4.8
Transcaucasus and central Asia	–7.0	–14.4	–9.6	–10.4	–4.4	1.6	2.4	2.0
World trade volume (goods and services)	**4.6**	**4.7**	**3.7**	**9.1**	**9.6**	**6.9**	**9.9**	**3.3**
Imports								
Advanced economies	3.4	4.8	1.7	9.7	9.1	6.5	9.1	4.7
Developing countries	9.7	11.1	8.7	7.2	11.5	8.2	11.2	–0.7
Countries in transition	–12.7	–25.7	8.9	5.5	15.3	9.6	9.3	1.2
Exports								
Advanced economies	5.8	5.2	3.4	8.7	9.1	6.3	10.3	3.2
Developing countries	6.2	10.7	8.2	13.1	10.5	9.2	11.4	2.2
Countries in transition	3.6	–21.3	8.0	2.8	11.5	6.6	6.2	4.1
Commodity prices in U.S. dollars								
Oil[2]								
In SDRs	–16.4	–4.5	–11.1	–7.3	1.8	23.7	–0.2	–31.2
In U.S. dollars	–15.7	–1.7	–11.8	–5.0	7.9	18.4	–5.4	–32.1
Nonfuel[3]								
In SDRs	–6.5	–2.8	2.7	10.6	2.3	3.3	2.0	–13.5
In U.S. dollars	–5.7	0.1	1.8	13.4	8.4	–1.2	–3.3	–14.8
Consumer prices								
Advanced economies	4.7	3.5	3.1	2.6	2.5	2.4	2.1	1.6
Developing countries	36.5	38.9	47.2	51.8	22.2	14.3	9.4	10.4
Countries in transition	94.1	646.4	602.0	266.9	126.9	40.6	28.2	20.8
Six-month LIBOR (in percent)[4]								
On U.S. dollar deposits	6.1	3.9	3.4	5.1	6.1	5.6	5.9	5.6
On Japanese yen deposits	7.2	4.3	3.0	2.4	1.3	0.7	0.7	0.7
On euro deposits	9.5	9.8	7.4	5.7	5.7	3.7	3.5	3.7

Source: IMF, *World Economic Outlook* (May 1999).
[1]Indonesia, Malaysia, the Philippines, and Thailand.
[2]Simple average of spot prices of U.K. Brent, Dubai, and West Texas Intermediate crude oil.
[3]Average, based on world commodity export weights.
[4]London interbank offered rate.

the second half of 1997 continued. Reflecting the incipient recovery in the East Asian crisis countries, their combined trade surplus began to narrow in late 1998 and early 1999. The main adjustment effort then shifted to those Latin American countries that were confronted with a more unfavorable external environment, and to major commodity-exporting developing countries that had initially relied on reserves and external borrowing to absorb the revenue shortfall from lower commodity prices. The improvement in trade balances of the emerging market economies as a group found its counterpart mainly in a number of industrial countries, where domestic demand growth exceeded output growth—especially in the United States, which accounted for about half of the growth in world demand in 1998. The combined trade balances of the industrial countries worsened in 1998 by almost $80 billion.



[1]Goods and services, volume.

Emerging Market Economies

Growth in the developing countries slowed to 3¼ percent in 1998 from 5¾ percent in 1997, with Africa the only region recording an increase, albeit limited, in growth (Figure 2). The East Asian crisis countries other than the Philippines suffered severe output declines.

Among the Asian crisis countries, financial markets in *Korea and Thailand* began to stabilize in the second quarter of 1998 and signs of a bottoming out of economic activity emerged later in the year, although output growth was negative for the year as a whole. In both countries, investor confidence strengthened significantly, allowing currencies to recover some of their losses, interest rates to fall, and equity markets to rebound. Expansionary fiscal policy also provided support for demand. Positive growth resumed in Korea in late 1998. In Thailand, output stabilized in the final months of 1998 before picking up in early 1999. The current account positions of both countries improved sharply in 1998, swinging into surpluses of 12–13 percent of GDP, owing largely to deep import compression. In *Indonesia,* where the currency came under further downward pressure in mid-1998 amid political unrest and uncertainties about policy implementation, confidence was slower to return and high interest rates had to be maintained longer to stabilize the exchange rate; output continued to decline through the end of 1998 before showing signs of recovery in early 1999.

Table 2
Emerging Market Economies: Net Capital Flows[1]
(In billions of U.S. dollars)

	1991	1992	1993	1994	1995	1996	1997	1998
Total								
Net private capital flows[2]	123.8	119.3	181.9	152.6	193.3	212.1	149.1	64.3
Net direct investment	31.3	35.5	56.8	82.7	97.0	115.9	142.7	131.0
Net portfolio investment	36.9	51.1	113.6	105.6	41.2	80.8	66.8	36.7
Other net investment	55.6	32.7	11.5	–35.8	55.0	15.4	–60.4	–103.4
Net official flows	36.5	22.3	20.1	1.8	26.1	–0.8	24.4	41.7
Change in reserves[3]	–61.5	–51.9	–75.9	–66.7	–120.2	–109.1	–61.2	–34.7
Memorandum								
Current account[4]	–85.1	–75.6	–116.0	–72.0	–91.0	–91.8	–87.1	–59.1
Africa								
Net private capital flows[2]	8.9	6.9	8.7	4.8	6.8	7.6	16.3	10.3
Net direct investment	2.0	1.7	1.9	3.4	4.2	5.5	7.6	6.8
Net portfolio investment	–1.5	–0.6	1.0	0.8	1.5	–0.2	2.9	3.5
Other net investment	8.4	5.8	5.8	0.7	1.2	2.3	5.8	0.0
Net official flows	7.8	10.5	7.8	14.0	10.8	3.7	–4.5	1.5
Change in reserves[3]	–2.5	0.8	0.8	–4.7	–1.7	–7.4	–12.3	2.9
Memorandum								
Current account[4]	–7.4	–10.4	–11.0	–11.8	–16.4	–5.7	–6.1	–18.1
Asia[5]								
Crisis countries[6]								
Net private capital flows[2]	26.8	26.6	31.9	33.2	62.5	62.4	–19.7	–45.3
Net direct investment	6.1	6.3	6.7	6.5	8.7	9.5	12.1	4.9
Net portfolio investment	3.4	5.3	16.5	8.3	17.0	20.0	12.6	–6.5
Other net investment	17.3	15.0	8.7	18.4	36.9	32.9	–44.5	–43.6
Net official flows	4.4	2.0	0.6	0.3	0.7	4.8	25.0	22.7
Change in reserves[3]	–8.3	–18.1	–20.6	–6.1	–18.3	–13.6	37.7	–39.1
Memorandum								
Current account[4]	–25.2	–16.1	–13.5	–23.2	–40.5	–53.4	–27.0	66.6
Other Asian emerging markets								
Net private capital flows[2]	7.2	–8.7	25.5	33.2	32.6	38.1	22.8	–9.6
Net direct investment	8.3	8.5	26.3	38.7	41.1	45.6	50.5	45.1
Net portfolio investment	–2.0	2.6	4.5	1.1	–6.1	–7.5	–11.8	–8.8
Other net investment	0.9	–19.7	–5.4	–6.6	–2.4	0.1	–15.8	–45.9
Net official flows	6.5	8.3	7.9	5.1	3.8	5.3	3.3	5.9
Change in reserves[3]	–31.4	–7.6	–17.2	–47.7	–26.2	–42.5	–46.3	–9.7
Memorandum								
Current account[4]	23.7	14.0	–8.5	17.1	9.4	17.0	37.5	30.5
Middle East and Europe[7]								
Net private capital flows[2]	68.6	35.1	33.7	15.4	10.1	6.8	16.7	26.5
Net direct investment	1.2	0.9	3.9	3.8	3.7	2.4	3.3	2.9
Net portfolio investment	22.3	13.5	21.8	13.6	9.4	4.1	4.3	8.8
Other net investment	45.1	20.7	8.0	–2.0	–3.0	0.4	9.1	14.7
Net official flows	3.9	–1.3	2.3	–1.3	–1.4	–0.7	–1.0	–2.2
Change in reserves[3]	–3.3	1.2	–4.8	–3.6	–12.7	–16.2	–20.4	–5.3
Memorandum								
Current account[4]	–64.2	–26.7	–31.1	–7.2	–5.2	5.4	2.9	–22.7
Western Hemisphere								
Net private capital flows[2]	24.1	55.9	62.6	47.5	38.3	82.0	87.3	69.0
Net direct investment	11.3	13.9	12.0	24.9	26.1	39.3	50.7	54.0
Net portfolio investment	14.7	30.3	61.1	60.8	1.7	40.0	39.7	33.0
Other net investment	–2.0	11.7	–10.6	–38.2	10.6	2.7	–3.1	–18.1
Net official flows	2.7	–1.7	0.6	–4.1	20.6	–13.7	–7.8	1.6
Change in reserves[3]	–17.4	–22.6	–21.3	4.2	–25.5	–28.3	–14.6	17.7
Memorandum								
Current account[4]	–16.9	–34.5	–45.7	–50.9	–35.9	–38.9	–65.1	–89.6

Table 2 *(concluded)*

	1991	1992	1993	1994	1995	1996	1997	1998
Countries in transition								
Net private capital flows[2]	–11.7	3.5	19.6	18.5	42.9	15.1	25.7	13.6
Net direct investment	2.4	4.2	6.0	5.4	13.4	13.5	18.5	17.4
Net portfolio investment	0.0	0.1	8.8	21.0	17.8	24.4	19.0	6.7
Other net investment	–14.1	–0.7	4.8	–8.0	11.7	–22.8	–11.9	–10.6
Net official flows	11.1	4.5	0.9	–12.2	–8.5	–0.2	9.3	12.2
Change in reserves[3]	1.3	–5.6	–12.8	–8.7	–35.8	–1.0	–5.3	–1.2
Memorandum								
Current account[4]	4.8	–1.7	–6.3	3.9	–2.4	–16.2	–29.3	–25.8

Source: IMF, *World Economic Outlook* (May 1999).

[1]Net capital flows comprise net direct investment, net portfolio investment, and other long- and short-term net investment flows, including official and private borrowing. Emerging markets include developing countries, countries in transition, Korea, Singapore, Taiwan Province of China, and Israel. Data for Hong Kong SAR are not available.

[2]Because of data limitations, "Other net investment" may include some official flows.

[3]A minus sign indicates an increase.

[4]The difference between the current account and the sum of net private capital flows, net offical flows, and change in reserves is the capital account and errors and omissions.

[5]Includes Korea, Singapore, and Taiwan Province of China. Data for Hong Kong SAR are not available.

[6]Indonesia, Korea, Malaysia, the Philippines, and Thailand.

[7]Includes Israel.

In *Malaysia,* after a period in which the authorities had responded to financial market pressures by tightening macroeconomic policy, there was a shift in August 1998 to expansionary monetary policies, with the exchange rate pegged and capital controls introduced in September 1998; some of the controls were relaxed in early 1999. As of the end of April 1999, the decline in activity bottomed out and signs of recovery emerged. The *Philippines* remained less affected by the crisis, but output nevertheless fell slightly in 1998, attributable mainly to a weather-related drop in agricultural production.

In other emerging market economies in Asia, *China's* real GDP grew by 7¾ percent in 1998, close to the official target of 8 percent, supported by a large increase in public investment outlays. Partly reflecting low levels of capacity utilization and a decline in import prices, consumer prices fell by about 1 percent. Activity in *Hong Kong SAR,* however, was hit hard by the Asian crisis, with output contracting by about 5 percent in 1998. Through the early part of 1999, activity remained weak, partly because of high real interest rates amid negative inflation and weak domestic demand. The regional crisis also affected *Singapore* despite its strong domestic fundamentals. Although accommodative monetary policies together with downward exchange rate adjustments limited the effects of the crisis on the economy, activity nevertheless weakened in the second half of 1998 before positive growth resumed in early 1999. Other emerging market economies in Asia proved more resilient to the financial turbulence in the region. These included India—whose economy is relatively closed—although growth failed to pick up after its slowing in 1997, partly reflecting a stalling of structural reforms and a deterioration in government finances.

The East Asian crisis contributed to increases in financing costs and declines in oil and other commodity prices that put severe pressure on emerging market economies in other regions. In *Russia,* structural weaknesses in the enterprise and banking sectors, persistent fiscal imbalances, and a buildup of short-term government debt (including to foreign investors) left the economy especially vulnerable, and mounting tensions in the foreign exchange and treasury bill markets led in August 1998 to a de facto devaluation and a unilateral restructuring of domestic debt. Reflecting the severe financial pressure during the run-up to the August crisis and the worsening of the overall economic situation in the postcrisis period, output declined, by 4½ percent in 1998 as a whole, and inflation accelerated to more than 100 percent on a 12-month basis in early 1999, with the currency remaining under pressure. A loss of access to private market financing following the crisis led to sharp import compression and a corresponding shift into current account surplus. Nevertheless, the authorities were forced to reschedule payment obligations on debt inherited from the former Soviet Union (see Chapter 4 for further discussion of Russian developments in 1998/99).

The Russian crisis had a strong adverse impact on economic activity in neighboring *countries in transition* and contributed importantly to currency depreciations in a number of them—including Ukraine—as well as

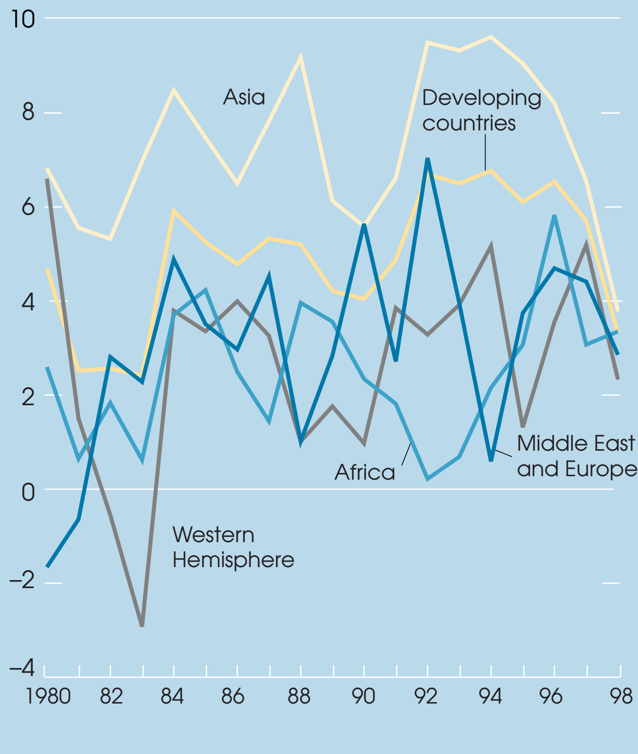


Figure 2
Developing Countries: Real GDP Growth
(Annual percent change)

further inflationary consequences. The *Baltic countries* were less affected; they maintained their exchange rate pegs and retained access to international capital markets, but still experienced a growth slowdown owing in part to reduced trade with, and banking sector exposure to, Russia. In the transition countries of *Central and Eastern Europe,* the Russian crisis had a mostly temporary impact: weakening demand in the export markets of western Europe was a more important negative influence on growth performance in late 1998 and early 1999. In the Czech Republic, in part reflecting a tightening of policies in 1997 and early 1998 that was needed to reduce external imbalances, output fell by 2¼ percent in 1998. In Hungary and Poland, growth was relatively robust, at about 5 percent in 1998, despite the year-end slowdown. Consumer price inflation in all three countries declined rapidly in late 1998 and early 1999, to single digits on a 12-month basis, reflecting falling commodity prices, past monetary policy tightening, and a weakening of economic growth.

In Latin America, most countries coped well with the financial pressures emanating from the Asian crisis, owing in part to actions to tighten macroeconomic policies. They were affected significantly by the Russian crisis, however, as interest rate spreads on their external debt soared and private capital inflows came to a virtual halt. *Brazil* came under particularly heavy pressure because of concerns about its large fiscal deficit and the sustainability of its exchange rate peg. In response, the Brazilian authorities raised official interest rates and, in late October 1998, announced a set of fiscal measures aimed at producing substantial primary surpluses, as part of a policy program supported by IMF financing. However, investor concerns about the authorities' ability to implement these fiscal measures and fears that interest rates were insufficiently high to stop continued capital outflows resulted in increasing pressure on the currency, which led the central bank in January to abandon its crawling exchange rate band and to allow the real to float. The currency initially depreciated by more than 40 percent against the U.S. dollar and, amid widespread domestic financial market volatility, it remained under pressure until early March, when moves to strengthen the fiscal adjustment program began to restore confidence in Latin American countries generally. (See Chapter 4 for further discussion of Brazilian developments in 1998/99.)

The Brazilian devaluation had relatively limited and mostly temporary effects on financial markets in *other Latin American countries* but is having more significant trade-related spillover effects on Brazil's partners in the MERCOSUR trade agreement (Argentina, Paraguay, and Uruguay). Growth in Latin America had already slowed sharply in the second half of 1998. This slowdown reflected partly the less favorable external financing environment that developed in the aftermath of the Russian crisis, but also significantly lower commodity prices, and—in most cases—tighter monetary and fiscal policies. In Argentina, after three years of vigorous recovery from the Mexican crisis, growth turned negative in the latter part of 1998, and the downturn was worsened by the trade effects of Brazil's recession. Venezuela, hit hard by the decline in oil prices, suffered from an unsustainable fiscal situation and its recession deepened starting in the fourth quarter of 1998. In Ecuador, also heavily dependent on oil export revenues, a severe exchange rate and banking crisis erupted in February 1999. Growth was better sustained in Mexico than in most countries in South America, partly reflecting its closer links to the strongly growing U.S. economy. Elsewhere in the Western Hemisphere, the economies of several Central American countries—especially Honduras and Nicaragua—were afflicted by Hurricane Mitch in October 1998.

Economic growth in *Africa* remained subdued in 1998, at about 3½ percent, attributable mainly to the further weakness in commodity prices and, in South Africa where little growth was recorded, to unfavorable conditions in international financial markets. Although the effects of lower commodity prices, including oil, on the terms of trade and growth of Africa as a whole were

relatively modest, fiscal positions and external accounts in many instances came under pressure, and large terms of trade losses entailed significant real income reductions. In particular, lower oil prices led to a growth slowdown in the oil-producing countries of Africa and the *Middle East.* Slower growth was also recorded in Turkey, where output expanded by 2¾ percent in 1998—down from 7½ percent in 1997—as contagion from the Russian crisis showed up in high real interest rates and reduced access to international financial markets. In the group of developing countries in the Middle East region and Europe, growth slowed to 3 percent in 1998 from 4½ percent in 1997, owing mainly to developments in the oil-producing countries and in Turkey.

Advanced Economies

Divergences in economic performance among the advanced economies grew more pronounced in 1998 as the recession in Japan deepened, the strengthening of growth in the euro area waned toward the end of the year, and growth continued strong in the United States.

The *Japanese* economy contracted by 2¾ percent in 1998, but in early 1999 output recovered sharply to a level slightly above that of early 1998, though still below the 1997 levels. Consumer prices remained broadly unchanged through the period, while prices at the wholesale level fell, contributing to concerns about deflation. The deepening of Japan's recession in 1998 stemmed primarily from weakness in private demand, accounted for in turn by declining confidence and weaknesses in the financial sector, but also from the weakening demand in the emerging market economies of East Asia. In response, the authorities undertook additional fiscal stimulus and also eased monetary policy further, lowering a key policy rate (the overnight call rate) virtually to zero by March 1999. Moreover, to address persistent weaknesses in the financial sector, legislation was approved in October 1998 that put in place a comprehensive framework for dealing with banking problems. These measures helped boost activity and improve financial market sentiment in early 1999.

In Europe, Stage 3 of European Economic and Monetary Union began successfully on January 1, 1999, with 11 member countries of the EU adopting the euro as their currency and the European Central Bank (ECB) assuming responsibility for monetary policy in the *euro area*. Through 1998, short- and long-term interest rates in the area continued to converge toward the levels prevailing in Germany, France, and other core countries; in a coordinated move in early December, official short-term interest rates were lowered to 3 percent. The ECB held its repurchase ("repo") rate at this level until early April 1999, when the rate was lowered to 2½ percent. Growth in the euro area, which had strengthened in 1997, with momentum largely maintained through mid-1998, slowed significantly in late 1998, reflecting weaker external demand and an associated deterioration in business confidence, before recovering partially in early 1999. Inflation remained well under control in the area as a whole, with 12-month consumer price inflation at 1.1 percent at the end of the period, partly reflecting weak commodity prices. Unemployment in the euro area remained high, at 10½ percent in April 1999, compared with 11 percent a year earlier.

Among the major euro-area countries, the growth slowdown in late 1998 was most apparent in *Germany* and *Italy* but less pronounced in *France*. France recorded above-potential growth in 1998 as a whole, but in Italy output expanded by only 1½ percent for the second successive year. Elsewhere in the euro area, Ireland (again the fastest growing economy in Europe), the Netherlands, Portugal, and Spain continued to record robust growth in 1998, despite some slowdown toward year-end. In these countries, inflation remained somewhat above the euro-area average, because of relatively strong demand pressures.

Outside the euro area, growth in the *United Kingdom* declined further during 1998 and in early 1999, owing to the weakening of external demand, the strength of sterling, and past fiscal and monetary tightening. Overheating was thereby forestalled. Inflation held close to the 2½ percent target in the second half of 1998 and early 1999, and official U.K. interest rates (repo rates) were lowered to 5¼ percent from 7½ percent between October and April. The deteriorating external environment also dampened growth in some of the *smaller European countries,* including Denmark, Norway (particularly affected by the fall in oil prices), and Switzerland.

In the *United States,* the economy continued to grow strongly, expanding by almost 4 percent in 1998, with domestic demand boosted by strong gains in equity prices and declines in interest rates. Vigorous employment growth cut unemployment to a 29-year low of 4¼ percent in early 1999. Net external demand, however, weakened during 1998, reflecting developments in the emerging market economies of East Asia and Latin America, as well as the strong dollar, with the effects being felt mainly in the industrial sector. During September–November 1998, monetary policy was eased in response to severe financial market pressures that emerged in the wake of the Russian crisis and the near collapse of a major hedge fund. Inflation was broadly stable, dampened by further declines in import prices and the absence of significant wage pressures. Reflecting the benefits of past fiscal adjustment and strong economic growth, the federal budget swung into a surplus of nearly 1 percent of GDP in 1998.

In *Canada,* economic activity slowed in 1998 as a whole as income, output, and the external balance were adversely affected by falling commodity prices and lower demand in a number of Canada's overseas markets. The pace of growth, however, picked up again toward the end of the year. Core inflation held steady, at the lower end of the 1–3 percent official target range, despite the depreciation of the Canadian dollar during the year. Growth in *Australia* accelerated in 1998 despite the East Asian recessions, with demand boosted by an easing of monetary conditions, including through depreciation of the Australian dollar; strong growth continued in early 1999. In *New Zealand,* by contrast, the economy went into recession in the first half of 1998, but growth resumed in the second half as business and consumer confidence rebounded, supported by looser monetary policy. In both countries, annual inflation remained broadly stable, at about 1½ percent.

In *foreign exchange markets,* exchange rates among the major currencies were again subject to significant fluctuations in 1998/99. In mid-July 1998, the U.S. dollar reached its highest level in nominal effective terms since December 1986, buoyed by strong domestic demand growth, interest rate differentials favoring U.S. dollar-denominated assets, and safe-haven demand in the face of deteriorating sentiment toward emerging markets. The dollar's nominal effective rate fell sharply in early September and early October, as the yen's weakness was reversed in a large-scale unwinding of yen-denominated exposures. The dollar rebounded in late 1998 and early 1999, however, in light of the continued relative strength of the U.S. economy and an associated widening of interest differentials in favor of dollar-denominated assets. After reaching an eight-year low of more than ¥145 to the U.S. dollar in mid-June 1998, the yen appreciated in the following six months by about 25 percent against the dollar, and by 20 percent in nominal effective terms. Following an easing of Japanese monetary policy, the yen fell back by about 5 percent in effective terms in February–April 1999. During August–December 1998, the currencies of the prospective euro-area countries strengthened against the U.S. dollar, and also in effective terms. The euro itself began to depreciate shortly after its introduction; by the end of April, it was more than 9 percent below its initial value in dollar terms, and more than 6 percent lower in effective terms. Elsewhere in Europe, movements in the pound sterling were affected partly by changing expectations regarding U.K. monetary policy. Sterling traded in a relatively narrow range in 1998 but tended to depreciate in effective terms in the second half of the year. In the first part of 1999, however, sterling appreciated in effective terms as the euro weakened. Lower commodity prices contributed to downward pressure on the Canadian dollar, which depreciated to record lows against the U.S. dollar in August 1998. The currency recovered, however, following an increase in official interest rates in August 1998 and continued to appreciate while interest rates subsequently declined.

The *current account balance of the industrial countries* as a group deteriorated by more than $80 billion in 1998. The deterioration was unevenly distributed among the industrial countries, reflecting differences in domestic demand conditions and reliance on commodity imports and exports, as well as the strong exchange rate fluctuations among their currencies. The United States—where export growth slowed sharply but domestic demand and imports remained buoyant—accounted for the bulk of the adjustment, with the U.S. current account deficit widening by about $75 billion in 1998, to $230 billion or 2¾ percent of GDP. Japan, by contrast, recorded a further increase in its current account surplus, to 3½ percent of GDP, attributable partly to the weakness of domestic demand. In the euro area, the current account surplus of 1½ percent of GDP changed little in 1998, owing to a weakening in domestic and import demand, the competitiveness effect of past currency depreciations, and lower import prices offsetting the decline in export volumes to emerging markets. Other industrial countries—including Australia, Canada, and Norway, which all saw their commodity export revenues decline—accounted for much of the remaining adjustment.

CHAPTER 2

World Economic Outlook

As part of its responsibility for surveillance over the exchange rate policies of member countries and of the international monetary system, the Executive Board periodically reviews global economic developments, based on World Economic Outlook reports prepared by the staff. The reports, usually published twice a year—but published more frequently if rapid changes in economic conditions require it—feature a comprehensive analysis of prospects for the world economy, individual countries and regions, and an examination of various topical issues.

During 1998/99, the Board met on three occasions to discuss staff analyses of the World Economic Outlook: in September 1998, December 1998 (to discuss an update to the September assessment by the staff), and April 1999.[3] These discussions focused on the turbulence in financial markets stemming from the recession in Asia, the crisis in Russia, and, subsequently, the financial turmoil in Brazil.

In September 1998, Directors agreed that the near-term outlook had deteriorated considerably, as the recession in Asia deepened and the crisis in Russia helped trigger a sell-off in equity markets worldwide. The crises underscored the vulnerability of economies with policy shortcomings to abrupt shifts in capital flows. Although signs were encouraging that policy programs in Korea and Thailand, and even Indonesia, had begun to restore financial market confidence, emerging market economies both in Asia and other regions faced a risk of setbacks. Downside risks to the world economy attested to the widening prevalence and intensity of contagion and its major role in driving financial crises in an increasingly globalized world economy. Directors pointed out that, while contagion effects were most evident in those countries with weak policies and inadequate institutions, some countries with reasonably well-managed economies, better fundamentals, and limited trade or financial linkages to crisis countries had not been spared.

In their December 1998 discussion, Directors agreed that the turbulence in mature markets from mid-August through early October had in many ways been unprecedented. The Board observed, however, that a measure of calm had returned to financial markets after mid-October. This was attributable largely to helpful policy actions, such as the easing of interest rates by the U.S. Federal Reserve, which was followed by other industrial country central banks, including those of the future euro area; strengthened policies in Japan to stimulate demand; commitments by Brazil to address its fiscal imbalances and the subsequent agreement on a support package by the international community; continued progress with stabilization and structural reform in Asia; and progress toward increasing the IMF's financial resources and thereby strengthening the international community's ability to assist countries in financial crisis. Several Directors also emphasized that countries' adjustment efforts in response to such developments as reduced access to capital markets and the effects of declining commodity prices deserved the support of the international community.

With the mitigation of market turbulence after mid-October, earlier fears of a global recession had diminished. Directors generally agreed with the staff's projection of a modest downward revision to the outlook for world output growth in 1999.

The Board stressed that a number of positive developments had occurred since it had discussed the fall World Economic Outlook. Growth was expected to remain relatively solid in continental Europe in 1999, although at a slower pace than in 1998. Directors saw the anticipated moderate slowdown in the U.S. economy in 1999 as suggesting a soft landing, which would help reduce the risk of a sharper slowdown at a later stage. Notwithstanding these developments, Directors felt it was premature to conclude that the danger had passed because conditions in financial markets

[3]The three reports were published as IMF, *World Economic Outlook* (Washington, October 1998 and May 1999), and *World Economic Outlook and International Capital Markets: Interim Assessment* (Washington, December 1998).

remained volatile and fragile and the supply of funds to most emerging market economies was still sharply reduced. The balance of the risks to the projections remained predominantly on the downside. If private capital flows fell short of the levels assumed in the projections, greater trade adjustment through demand compression and perhaps exchange rate adjustment was likely to be needed in emerging market economies. Directors warned, further, that some of these countries might have difficulty meeting their debt-service obligations if private financing did not recover. They also questioned whether the impact of the recent declines in commodity prices had been fully reflected in the projections. Weaker commodity prices, if sustained, coming on top of reduced access to international capital markets, would call for further adjustments in many commodity-exporting countries.

In their April 1999 discussion, Directors concurred that, while the global economic slowdown was likely to continue in 1999, the risk of a global recession had receded and a moderate pickup in growth was projected for 2000. They saw signs of the beginning of economic recovery in Asia's crisis-afflicted emerging market economies, the broad-based easing of monetary conditions in the industrial countries, and the continued strong growth of the U.S. economy. They also acknowledged that the baseline projections rested on a number of favorable developments—particularly the realization of a soft landing for the U.S. economy; a pickup in growth in the euro area, despite a somewhat unfavorable external environment; and a bottoming-out of the recession in Japan in 1999. Directors also felt that the Brazilian crisis, despite its limited contagion effects, had imparted a new contractionary impulse to the world economy and that financing conditions for many emerging market countries were likely to remain extremely tight.

The uneven pattern of growth among the United States, the euro area, and Japan since the beginning of the decade had increased global payment imbalances, which, in the view of many Directors, posed a worrisome risk to the outlook. Directors argued that the imbalances—in particular the U.S. external deficit that had aided global adjustment in the wake of the emerging market crises—might give rise to destabilizing movements in exchange rates among the major currencies and further increase protectionist pressures. Several Directors pointed to the challenge of restoring global growth to near potential in a period when domestic demand growth in the United States would probably have to slow to allow some narrowing in the U.S. current account deficit. This, they argued, highlighted the priority that should be attached to policies aimed at generating early recovery in Asia, including Japan, and at countering and reversing the recent slowdown in much of continental Europe.

United States, Japan, and Europe

The continued momentum of the U.S. expansion was remarkable for its length and the absence of inflation. Directors attributed the long expansion to fiscal consolidation, prudent and responsive monetary policies, and flexible labor and product markets. Declining energy and other commodity prices had contributed to maintaining low inflation. But Directors also concurred that the run-up in equity prices, which in part reflected falling inflation expectations and lower bond yields, had helped sustain demand. Possible sharp corrections in the equity market and the exceptionally low rate of household savings posed important downside risks to the outlook.

The strength of the U.S. economy was beginning to present a dilemma for U.S. policymakers, according to many Directors. If domestic demand growth did not slow to a more moderate pace at an early stage, several Directors felt that an early monetary tightening might be needed to guard against the risks of overheating. These and other Directors were apprehensive that current and projected private sector and external imbalances were unsustainable in the long run, and that past evidence suggested that the longer they continued, the greater were the chances of a sharp and painful correction. Abrupt reductions in U.S. imports, as well as potentially disruptive swings in exchange rates, equity markets, and monetary conditions, could transmit adverse consequences of such a correction to other countries. Most other Directors, however, preferred a wait-and-see approach, arguing that preemptive monetary tightening was not needed, because monetary conditions in the United States were already quite tight, taking into account the low level of inflation and the strength of the dollar, and that such action could jeopardize recoveries elsewhere, especially in countries emerging from crisis. Regarding fiscal policy, Directors urged the United States to resist pressures to spend current and prospective fiscal surpluses in order to meet longer-term financial needs and to create room for fiscal policy to be used temporarily for stabilization if the need were to arise.

The continued weakness of activity in Japan was of special concern to the Board. Most Directors felt that room for additional fiscal stimulus was limited, given the estimated deficit of more than 10 percent of GDP at fiscal year-end in March 1999, but that the full implementation of the previously planned stimulus to support demand was critical at both the central and local government levels. With regard to monetary policy, many Directors agreed that the deflationary forces in the economy justified maintaining short-term interest rates as low as possible, as well as measures to ensure adequate growth of liquidity through open market operations.

Directors also emphasized the need for structural reform in key areas to reinvigorate growth and job cre-

ation over the medium term. They considered bank reform to be essential and welcomed the commitment of public funds to recapitalize the banking system. They cited progress in strengthening major banks, resolving insolvent institutions, establishing legislation to facilitate the disposal of nonperforming assets, and improving disclosure and supervision, and urged the Japanese authorities to press forward with the financial stabilization program, especially where acute problems remained. Some questioned whether the reforms under way or planned went far enough. These Board members particularly stressed the growing need for corporate restructuring, as underscored by excess capacity in some sectors and troublesome corporate debt burdens, which complicated resolving banking sector difficulties. More generally, Directors saw the need to reduce further inefficiencies in the economy and to remove obstacles to the creation of new enterprises. Deregulation initiatives in some sectors had already helped increase competition and reduce costs, but many restrictions remained in agriculture, distribution, transportation, and construction, and these impeded growth and job creation.

Turning to Europe, the Board welcomed the start of the third stage of European Economic and Monetary Union (EMU), but cautioned that euro-area policymakers continued to face formidable challenges. Since late in 1998 indications had increased that growth in the euro area had been slowing, mainly because of the weakening external environment, but also because of weak business confidence. Growth in the area was expected to be below its potential rate in 1999, and while recovery was expected in 2000, Directors worried about downside risks. Although medium-term requirements remained important, it was at the same time essential that policies be adequately attuned to supporting the domestic demand needed to close the sizable output gap and absorb the cyclical component of unemployment. Many Directors also underscored the importance of the euro area playing a greater role in supporting global growth, not only through domestic demand, but also through structural reform. In light of these considerations and the limited room for maneuver in fiscal policies—and with inflation recently below the middle of the target range—a number of Directors argued that the case was strong for further monetary easing. Early action carried few risks but held significant benefits to both the euro area and the world economy more generally. It was important that those euro-area countries experiencing relatively strong growth respond to further monetary easing by taking countercyclical fiscal actions to prevent overheating. A number of other Directors, however, were not convinced about the case for further monetary easing, pointing to the strength of consumer confidence and the weakness of the euro. Nonetheless, all Directors agreed that the European Central Bank should act decisively to lower interest rates if it appeared that the slowdown was persisting. (Soon after this discussion, in early April, the ECB reduced its leading interest rates.)

Directors also agreed that success in labor and product market reforms would be central to enhancing growth and employment prospects in Europe, especially in the medium term. Indeed, those countries that had achieved the most progress showed considerable evidence of the positive effects of labor market reforms. Poor labor market performance had imposed a heavy burden on many European economies in terms of the hardship borne by the unemployed, the fiscal impact of forgone revenues and transfer payments, and, more generally, through the impact of output and welfare losses.

Directors recognized that, although conditions differed across countries with regard to both the extent and the specific nature of the problems to be addressed, the overall thrust of the required action was clear: to remove obstacles to job creation and disincentives for the nonemployed to work. This would require easing job protection legislation, reducing excessive tax burdens on labor, and minimizing the disincentive effects of unemployment benefits and other social transfers. As many labor and product market rigidities tended to reinforce one another, comprehensive reforms were more likely to succeed than partial or piecemeal actions.

Crisis-Afflicted Economies

The Executive Board agreed that public sector imbalances had been at the root of the crisis in Brazil. The growing fiscal imbalance had also contributed to a widening of the external deficit, making Brazil highly vulnerable to changes in investor sentiment and adding to a widespread perception that the country's crawling peg was unsustainable. Some Directors noted that the recent Brazilian experience had highlighted anew the importance of strong macroeconomic policies to support the credibility of a pegged exchange rate regime. Moreover, several Directors pointed to the need for a determined tightening of monetary policy in the early stages of an economic crisis, while others underscored the importance of sufficient exchange rate flexibility. Looking ahead, Directors thought that the Brazilian economy would begin to recover in 2000, as the crisis did not appear to be rooted in structural problems outside of the fiscal area and the financial system was relatively robust. The pace of recovery would depend crucially on how quickly the authorities addressed the fiscal deficit and on their success in containing inflation expectations and stabilizing exchange markets. Directors were encouraged by early signs that inflation was contained, but emphasized that strong implementation of the recently approved program was crucial to restoring confidence and allowing monetary conditions to ease gradually.

Although Directors cautioned that the recession in Brazil might have a significant regional impact, they were heartened by its moderate effect on financial markets elsewhere in Latin America. Most economies of the region appeared to be well placed to withstand spillover effects, a reflection of the considerable strengthening of the region's economic fundamentals over the past decade. Nonetheless, the required economic adjustments and the risks of further contagion called for determined policy discipline and reinvigorated reform efforts, especially in those countries suffering from fiscal and external imbalances that had been exacerbated by commodity price weaknesses and unfavorable financial market conditions. In a number of cases, financial sector fragilities required particular attention.

Directors expressed deep concern about the deterioration in Russia's economic performance since the August 1998 financial crisis, with a sharply increased inflation rate and the dangers of a prolonged recession and significant adverse spillovers in neighboring economies. They cited recent indications of the Russian authorities' efforts to address the underlying fiscal and structural problems and underscored that a strong commitment to reform was required to arrest and reverse the serious problems facing the country. Directors emphasized particularly the need for a strong fiscal adjustment program to limit the need for central bank financing of the budget and stop the accumulation of budget arrears. They also stressed the importance of reinvigorated structural reform efforts in those areas where implementation had been unsatisfactory, of reversing the setbacks that had occurred since August 1998, and of addressing the additional financial sector problems that had emerged following the crisis.

Directors were encouraged by signs that economic recovery was set to begin or already under way in the Asian emerging market economies that had suffered deep contractions following the financial crises in the second half of 1997. The turnaround appeared to be most advanced in Korea, followed by Thailand. Improvements in external payments positions and investor confidence, stronger exchange rates, a resumption of capital flows, and improved financial market conditions underpinned the recoveries in these and other crisis countries. The return of confidence assisted the recovery. A turnaround in activity in Indonesia might begin emerging in the second half of 1999, although delays in reform and continued political instability had hindered a return of confidence. In considering the steps required to transform the nascent recoveries in the region into sustainable growth, Directors strongly emphasized the need for banking and corporate sector restructuring and reforms aimed at fostering well-functioning markets and a more efficient allocation of resources.

Other Emerging Economies

China, India, and some African countries appeared to have weathered the recent financial crises relatively well in 1998. To varying degrees, the resilience of these countries reflected limited trade links with the crisis countries, relatively low reliance on private capital inflows, or limited integration with international financial markets. It was encouraging that the Chinese economy achieved a strong growth performance in 1998. At the same time, several Directors noted the problems in the financial and state-owned-enterprise sectors and encouraged the authorities to continue their efforts at strengthening the financial sector and reforming state-owned enterprises. Directors agreed that, in the areas of macroeconomic and exchange rate policy, China had steered an appropriate course in maintaining the stability of the renminbi and providing stimulus for the economy, which had played an important role in regional economic adjustment and recovery. The repercussions from the Asian crisis had been relatively modest in India, although the country's medium-term growth prospects continued to be constrained by serious fiscal and structural weaknesses.

With regard to Africa, improved policy implementation had helped a number of countries strengthen their economic performance and reduce their vulnerability to adverse external developments. At the same time, recent declines in the prices of oil and other commodities had led to significant falls in real income in many exporting African countries, although the growth of economic activity was affected only slightly. Several Directors considered that more external-debt-reduction options and continued international financial assistance were necessary to support the adjustment and reform efforts of these countries. Some Directors also suggested that industrial countries needed to improve market access for developing country exports, particularly agricultural products. Directors were also concerned about the severe economic and social costs of the armed conflicts in several parts of the continent and called for adequate provision of international assistance to the affected countries.

Oil price declines had also led to substantial shortfalls in export earnings and fiscal revenue among Middle Eastern oil exporters. These countries met the shortfalls partly by drawing on official reserves and through increased external borrowing. Directors encouraged these countries to build on adjustment efforts already under way to safeguard macroeconomic stability, especially if export price weakness continued.

Preventing Contagion

Financial crises in emerging market countries in recent years had in some cases spread among countries with apparently limited trade or financial links and in the absence of a significant common shock. Directors

agreed that this unusual phenomenon might be partly the result of increased globalization of financial markets, which, while providing benefits of access to external financing, made economies more vulnerable to sudden, sharp changes in investor sentiment. In fact, the increased globalization of financial markets had meant that balance of payments crises involved the capital account more than in the past, which tended to make crises less predictable. While financial contagion helped explain the increased incidence of crises, contagion was not indiscriminate. The crises were usually associated with common weaknesses in economic fundamentals—especially with regard to the external position or vulnerabilities in the financial system, including those arising from excessive exposure to short-term external liabilities.

Although efforts to strengthen the international financial architecture were essential both for crisis prevention and crisis management, the problem of contagion also had to be addressed at the country level. Directors, therefore, stressed the central role of domestic economic policies in preventing crises in the first place and in reducing a country's vulnerability to contagion. In particular, they noted the importance of avoiding significant exchange rate overvaluation and of pursuing fiscal and monetary policies to that end. Directors also emphasized that policies to address weaknesses in financial systems were crucial in any effective crisis prevention strategy. To guard against liquidity crises, governments had to pay attention to the maturity structure and currency composition of banks' debt and the corporate sector. The maturity structure of public debt had also to be managed carefully, because a change in investor sentiment could make it difficult for the government to roll over a large stock of short-term debt. Directors also emphasized the need in many countries to enhance the effectiveness of prudential regulation and supervision of banks and other financial institutions. Some referred in particular to the importance of prudential standards regarding short-term foreign currency borrowing by banks. In this regard, some Directors pointed to the need to improve the regulatory oversight, on the supply side, of the highly leveraged activities of financial institutions.

Because many emerging market crises in recent years had occurred in countries with pegged exchange rates, several Directors questioned the viability of pegged but adjustable regimes under conditions of increased globalization of financial markets. They emphasized that in many cases a greater degree of exchange rate flexibility might help make domestic and foreign investors more aware of exchange rate risks. Other Directors argued that a fixed exchange rate could be especially useful as a nominal anchor and help rein in high inflation. A currency board could be an attractive option in some cases, but Directors acknowledged that such a regime was particularly demanding in its requirements—in terms of the adequacy of reserves, financial system soundness, market flexibility, and fiscal performance. Directors agreed that the optimal exchange rate arrangement varies across countries and that, irrespective of the regime chosen, economic policies must support the arrangement and foster macroeconomic stability to guarantee its success.

CHAPTER
3

International Capital Markets

At the end of July 1998, Executive Directors conducted their annual review of developments in, and prospects for, international capital markets. At that time, the financial crises in emerging markets had been largely confined to Asia. Soon afterward, the outbreak of the debt crisis in Russia and, later, the near-collapse of a highly leveraged hedge fund, Long-Term Capital Management, ushered in another period of unusual financial turbulence, escalating fears that the economic slowdown might continue to widen and deepen in 1999.

Consequently, in mid-December 1998, the Board discussed an update of the fall World Economic Outlook assessment, as well as updated developments in international capital markets, their impact, and their implications for financial sector and stabilization policies[4] (see also Chapters 2 and 5).

Annual Review

At their July 1998 discussion of capital markets, Directors emphasized the lessons from the Asian crisis, the risks and challenges facing policymakers, and issues raised by the then-forthcoming introduction of the euro.

Asian Crisis and Other Emerging Market Developments

Directors viewed the deep-seated problems in banking systems and financial sectors—including weak supervisory and regulatory systems, poor internal risk management, and governance problems—as significant factors, although not the only ones, that had led to the Asian crisis. Several felt that inadequate domestic market discipline, owing to the availability of extensive national safety nets, had encouraged excessive risk taking in a number of countries. The financial sector weaknesses implied that the large capital inflows before the crisis had not been efficiently intermediated and—together with excessive reliance on formal or informal exchange rate pegs—had led to significant unhedged exposures to currency and interest rate risk, liquidity mismatches, and poor credit quality.

Regarding the role of different investors during the crisis, attempts by domestic agents to hedge or unwind unhedged currency exposures—as well as, in some cases, capital flight—had been an important source of pressure in exchange markets; Directors differed, however, about the role that international investors and hedge funds had played. The Board noted that the very large exchange rate depreciations during the crisis had been exacerbated by an especially perverse set of market dynamics related to the drying up of liquidity in foreign exchange markets, growing counterparty risk, and interactions with weak domestic financial institutions. Several Directors noted that the extent of spillovers and contagion across countries did not appear to be fully accounted for by the growing trade and financial linkages between countries. Several Board members suggested that contagion had been aggravated by deficiencies in information and a lack of transparency that made it difficult for investors to discriminate among emerging markets, contributing to the severity of the market reaction after the crisis had begun.

A number of Executive Directors noted that the Asian crisis raised fundamental questions about the functioning of international capital markets. The capital inflows before the crisis had created enormous difficulties for emerging market policymakers, given the size of the inflows and the potential for sharp reversals when sentiment changed. Some Directors felt the Asian crisis was as much a reflection of weaknesses in international investor behavior as of problems in the emerging markets. Some considered that the sharp decline in nominal interest rates in mature markets had stimulated the search by global investors for higher yields.

In this regard, a number of Board members noted, as an important feature of the crisis, cross-border interbank lending—especially at short maturities—which had facilitated capital inflows and posed new challenges

[4]The background papers were published as IMF, *International Capital Markets: Developments, Prospects, and Key Policy Issues* (Washington, September 1998), *World Economic Outlook and International Capital Markets: Interim Assessment* (Washington, December 1998).

for managing risk. A number of Directors supported changes to bank capital requirements that would better reflect the risks of short-term interbank lending. Some underscored the need to find ways to improve the pricing of risks by foreign creditors and called for better supervision of creditor banks.

Several Directors noted that key international credit-rating agencies had failed to foresee the Asian crisis and then aggravated it when they subsequently moved to sharply lower the credit ratings of countries. A number of others, however, indicated that these agencies were not alone in failing to see the crisis coming, or in missing the extent of the vulnerabilities in the Asian crisis countries. Notwithstanding these concerns, Directors felt it was inevitable that the trend toward increased capital account liberalization would continue. Most believed that a certain degree of volatility was unavoidable; policymakers had to work to make their economies more resilient to the shocks that did occur and had to give much greater attention to ensure the orderly and well-sequenced liberalization of the external capital accounts.

The Board pointed to a number of lessons that national authorities should take from the Asian crisis. Most important was that weak financial policies and systems could overwhelm sound macroeconomic policies. A number of Directors suggested that exchange rate flexibility could play a key role both in helping to adjust to capital inflows and in encouraging appropriate hedging. Some Directors reiterated that the timing of exiting from an exchange rate peg was crucial. In particular, the risks of switching to a flexible system in the midst of the crisis were higher when banking, financial, and corporate sectors were weak. A few Directors argued that other options in the context of the Asian crisis might have been to adjust the exchange rate within the framework of the existing anchor or to move to another nominal anchor.

The Board agreed that strengthening banking sector supervision and infrastructures, including through the adoption of the principles set out by the Basle Committee, was key to avoiding future crises. Some Directors favored Chilean-type taxes on short-term capital inflows as a prudential measure applying to both bank and nonbank sectors. Several others, however, considered that, while such controls had helped discourage potentially destabilizing short-term flows in certain cases, they tended to lose effectiveness over time. Such controls had, however, helped gain time for countries in the process of building up their supervisory frameworks and strengthening market discipline. In any event, controls on short-term capital inflows should not be considered a substitute for strong fundamentals, including the requisite banking sector reforms. Some Directors pointed to the important role of foreign direct investment as a more stable source of financing. And several Board members commended efforts by a number of countries to facilitate the development of local capital markets, especially bond markets, to reduce the importance of banks in intermediating capital flows.

On the issue of moral hazard, some Directors agreed that the prospect of IMF support had probably not been a consideration in lenders' and borrowers' decisions prior to the Asian crisis. Several Board members noted, however, that the provision of IMF support, together with government guarantees on external liabilities, could have affected the behavior of market participants. In this context, they called for measures to minimize moral hazard, including by involving the private sector early on, to bring about a fair burden sharing between the private and public sectors.

With respect to then-recent developments in the emerging markets, the Board was concerned about the sharp output declines in the Asian crisis countries and the continued fragility of private market financing provided to the emerging markets. Directors agreed that the priority for the Asian crisis countries was to accelerate financial and corporate restructuring, including providing adequate bankruptcy procedures; this could be facilitated in some cases by the judicious use of public funds to recapitalize weak but viable financial institutions. More generally, the Board urged policymakers in the emerging market countries to continue their efforts to reduce their vulnerabilities to external shocks, including through addressing domestic macroeconomic and financial weaknesses and, in the case of commodity exporters, adjusting appropriately to the softness in commodity prices.

Mature Market Countries

The continued weaknesses in a number of emerging markets, especially in Asia, contrasted sharply with the relatively favorable performance of many of the industrial countries. Most Directors felt that the performance of the industrial countries in North America and Europe (as of the July 1998 discussion) reflected strong macroeconomic conditions and policies in many of these countries, generally low and stable inflation, and manageable exposures of many banking systems to the Asian emerging markets in crisis. Moreover, several industrial countries had benefited to some extent from the favorable inflation implications of lower commodity prices and weaker Asian economic activity. On the other hand, growing domestic weaknesses in Japan had been worsened by—and were contributing to—the Asian crisis, given close trading and financial linkages with the Asian emerging markets.

The Board welcomed the growing confidence in the then-forthcoming successful launch of the euro at the beginning of 1999, and the high degree of macroeconomic convergence achieved by the 11 countries that

were to make up the initial euro area. This was seen as contributing importantly to intra-European exchange rate stability and the effective convergence of long-term interest rates at low levels.

A number of not-insignificant risks in the mature economies, however, made the outlook uncertain. Most notable, Japan's failure to address decisively its financial sector problems had contributed to domestic economic weakness, downward pressure on the Japanese yen, and adverse spillovers, in particular, to neighboring emerging markets and the world economy. Directors therefore strongly urged the Japanese administration to move quickly to address the long-standing weaknesses in the banking sector through a rigorous accounting of the size of the bad loan problem, recapitalization and restructuring of viable banks, and improvements in the prudential framework to ensure that any use of public funds in assisting the banking sector would result in a sustained improvement in the safety and profitability of the banking system. A number of Board members noted that Japan's "Big Bang" reforms underscored the urgency of action, since the reforms would place additional pressure on banks and contribute to further downward pressure on the yen by making it easier for Japanese savings to be invested abroad.

A number of Directors were concerned about the risk of a significant correction in the then-high equity valuations in the United States, particularly in view of the apparent slowdown in U.S. earnings growth, the likelihood of further fallout from Asia, and the possibility of an increase in U.S. interest rates. Most Directors believed that the strong economic fundamentals in the United States—together with improvements in the financial market infrastructure since the 1987 stock market crash—meant that a modest correction would be manageable from a domestic perspective. They expressed concern, however, about spillovers, especially to emerging equity markets, and possible adverse implications for confidence in the then-unsettled global environment.

The European Economic and Monetary Union process had highlighted a number of supervisory and regulatory issues for the European countries that were also, to varying degrees, faced by other countries. The acceleration of financial sector restructuring likely to be facilitated by the introduction of the euro would pose a number of challenges for European policymakers. Directors expressed a range of views on the preparations for crisis management within EMU and, in particular, on lender-of-last-resort support. Some noted that such support was the responsibility of national authorities. Others thought it was essential for a central bank, and, in particular, for the European Central Bank, to be lender of last resort, and for it to play a central role in coordinating supervision across pan-European institutions and markets. Some Directors also pointed to the importance of such financial safety nets as deposit insurance schemes and liquidity consortia. Some Directors acknowledged, by referring to the European System of Central Banks (ESCB) Statute, that the ESCB had the tools necessary to fulfill a liquidity support role and could step in to provide liquidity if and when needed. Some supported the IMF staff's suggestion that it was important to clarify further the sharing of responsibilities between the ECB and national central banks and the flow of information between national supervisory bodies and the ECB.

The Board welcomed the ongoing efforts in multilateral forums and in many mature market countries to improve supervision and regulation through improvements in accounting and disclosure; clearer understandings on the responsibilities of "home" and "host" supervisors; and an increased focus on consolidated, risk-based supervision, such as the Basle Committee's guidelines on market risk capital requirements for banks, issued on January 1, 1998.

The Board concluded by noting that developments since its last review of international capital markets had underscored the importance of timely and comprehensive IMF surveillance of international financial markets.

Interim Review

At the Executive Board's December 1998 interim assessment—an update of the summer assessment of international capital market developments and fall World Economic Outlook—Directors considered the possible causes of the financial market turbulence, its likely impact on the global economy, and the implications for financial sector and stabilization policies. They emphasized the triggering role of Russia's unilateral debt restructuring, which was followed by a number of sharp global market corrections, a broad-based reassessment of the risks associated with emerging market investments, and a large-scale portfolio rebalancing across the full range of financial markets. The Board focused on the turbulence in mature markets; the widening of interest rate spreads after a period of unusual compression; the effects on highly leveraged investment positions; the heightened concern about a lack of liquidity in some of the world's deepest financial markets; and the sharp correction in the yen-dollar exchange rate in early October 1998.

Although a measure of calm had returned to financial markets since mid-October, the Board stressed the wide margin of uncertainty about the significance of the turmoil, in particular its implications for economic activity. Several Directors saw reason to expect that the turbulence would have only a limited economic impact. They emphasized the rapid rebound in equity markets in most industrial countries, reductions in bond spreads for most creditworthy borrowers and the ability of cor-

porate borrowers to draw on bank credit lines after the contraction in the U.S. commercial paper market, and a lack of evidence of a credit crunch in Europe. Directors were also encouraged by further declines in interest rates in the Asian crisis countries and by evidence of some renewed access for emerging market economies with stronger economic fundamentals to global financial markets.

On the other hand, many Board members were deeply concerned by signs that the crisis could have more long-lasting effects, especially for emerging market economies. Among the most important of these were a widening of yield spreads, increased selling pressures in equity markets, and indications of renewed capital outflows. Some of these were in reaction to delays in implementing the needed fiscal reform in Brazil.

Factors Behind Markets' Response

In light of the severity of the then-recent turbulence, the Board identified several elements that helped explain the markets' reassessment of risks and, together with the rebalancing of mature market portfolios, the disproportionately severe market reactions in response to disturbances of relatively limited magnitude:

- The Russian unilateral debt restructuring challenged underlying assumptions of many investors about the risk of sovereign default. Several Directors commented that the Russian experience had served to change perceptions of risk by demonstrating to markets that official support would not be disbursed unless economic policy requirements were met.
- Highly leveraged investment exposures in both emerging and mature markets had to be rapidly unwound or hedged as risks were reassessed. The subsequent rapid liquidation into falling markets added to the intensity of selling pressure.
- A large number of the world's leading commercial and investment banks—and not just hedge funds—were involved in the kind of highly leveraged investment positions that were vulnerable to the unexpected widening of interest rate spreads.
- Risk management models used by these institutions did not prevent the buildup, and modern portfolio management appears to have worsened the unwinding, of these leveraged financial positions. A disorderly unwinding and deleveraging of Long-Term Capital Management's portfolio would have posed additional systemic risks in international financial markets, which justified the role of the U.S. authorities in helping organize a private sector rescue operation. Several Directors noted that the reassessment of risk and portfolio adjustments were, in and of themselves, broadly appropriate, reflecting in large part a correction of the previous underestimation of risks of certain investments, in mature as well as in emerging markets. The concern, rather, was the speed and breadth with which the adjustments had occurred and the systemic risks they posed to financial markets and economic growth.

Directors underscored the limitations of private risk and portfolio management, banking supervision, and financial market surveillance in the face of rapid globalization of financial markets and increasing financial innovation. They identified, as a source of systemic concern, the apparent lack of understanding by both private and official market participants of the growing financial imbalances and vulnerabilities in the run-up to the events during August–October 1998. Several Directors questioned whether models of risk management were capable of adequate warnings and safeguards against low-probability but high-cost events, such as those that had shaken global markets in 1998. They observed that the international financial system itself, including the highly integrated nature of institutions and markets and their linking within and across national boundaries, contributed to the turbulence and unpredictability of financial market risks. Some Directors concluded that management control systems and practices within financial institutions would have to be reassessed and risk models subjected to more stress testing, to cope better with the risks inherent in modern financial markets.

Role of Public Policy

The Board also considered the role of public policy, especially as financial vulnerabilities had been allowed to accumulate until it was too late to prevent their adverse consequences. Directors called for urgent consideration, as a critical element in efforts to strengthen the architecture of the international financial system and domestic financial sectors, of possible measures to reduce the systemic risk associated with financial market turbulence. Such measures included stricter capital requirements for off-balance-sheet activities, a reexamination of the adequacy of current prudential supervision and regulation of the largely unregulated hedge fund industry and other highly leveraged institutional investors, and stronger oversight of bank lending to hedge funds.

Several Directors called for a further discussion of the systemic impact of highly leveraged positions of financial institutions generally. To reduce the systemic dangers posed by high-risk operations of hedge funds and other large financial institutions, stronger efforts were also needed on the supply side. Private financial institutions, with the help of supervising authorities, had to address the shortcomings in private risk and portfolio analysis and management, and the international community had to strengthen its efforts on financial supervision and regulation and financial market surveillance in the mature economies to better

identify and prevent the emergence of systemic risks. Directors generally thought that financial supervision and regulation could be enhanced only if national supervisors had more information and analysis on the buildup of balance-sheet and off-balance-sheet positions, leverage, and both the aggregate amount and distribution of risk taking in national and international markets.

Some Directors also stressed that the August–October 1998 episode of market turbulence underscored yet again the importance of capital account liberalization being orderly and well-sequenced—and preceded or accompanied by the establishment of effective prudential regulations and supervision. Market-based measures to discourage excessive short-term inflows and encourage foreign direct investment might also be desirable in the liberalization process. Pointing to the risks arising from increasingly volatile and large capital flows, Directors called for an effective system to manage and monitor them.