Main Developments in the World Economy in 1997/98

The dominant developments in the world economy and for the IMF in 1997/98 were the Asian financial crisis and its repercussions. The crisis broke out in July 1997 in Thailand when, following several episodes of exchange market pressure and reserve losses, the authorities abandoned the peg of the baht to the U.S. dollar. The forced exit from the U.S. dollar peg, in turn, raised doubts about the viability of exchange rate arrangements elsewhere. Spillover effects were soon felt in other countries in the region, especially Indonesia, Malaysia, and the Philippines, exposing underlying structural weaknesses in these economies. Measures to tighten liquidity conditions in Indonesia failed to stem the growing exchange market pressures, and the Indonesian authorities allowed the rupiah to float in mid-August. The situation worsened markedly over the next two months and spillover effects spread to other countries. In Hong Kong SAR, strong pressures on the Hong Kong dollar in October led to a surge in interest rates, followed by a substantial equity market decline. In Korea, downward pressures on the won intensified in late October, following the attack on the Hong Kong dollar, and equity prices fell sharply, reflecting diminished confidence about economic prospects and the growing difficulties encountered by the financial sector in rolling over external loans. After making efforts to defend the won, the Korean authorities widened the daily fluctuation band from 4½ percent to 20 percent in late November, and subsequently requested financial support from the IMF (see Chapter V).

The unfolding crisis, which saw exchange rates and equity prices plunge dramatically (Figure 1), was one of the worst in the postwar period. It was centered in countries that had long pursued prudent fiscal policies and enjoyed high saving rates. What went wrong? The key elements, especially in Thailand, were a buildup of inflationary pressures, manifested in large external deficits and inflated property and stock markets; maintenance for too long of pegged exchange rate regimes, which came to be viewed as implicit guarantees of exchange value, encouraging unhedged external borrowing—often at short maturities; lack of timely and relevant data and information; lax enforcement of prudential rules, as well as weaknesses in the institutional structures of supervision in financial systems; government-directed lending practices that led to a sharp deterioration in the quality of banks' loan portfolios, in turn reducing the scope for raising interest rates; and problems of governance that, together with political uncertainties, worsened the crisis of confidence. External elements also played a role: foreign investors underestimated the risks associated with their search for higher yields during a period of sluggish economic growth in Japan and Europe and low international interest rates, and contagion effects of the crisis led to an excessive devaluation of the affected currencies.

Global Overview

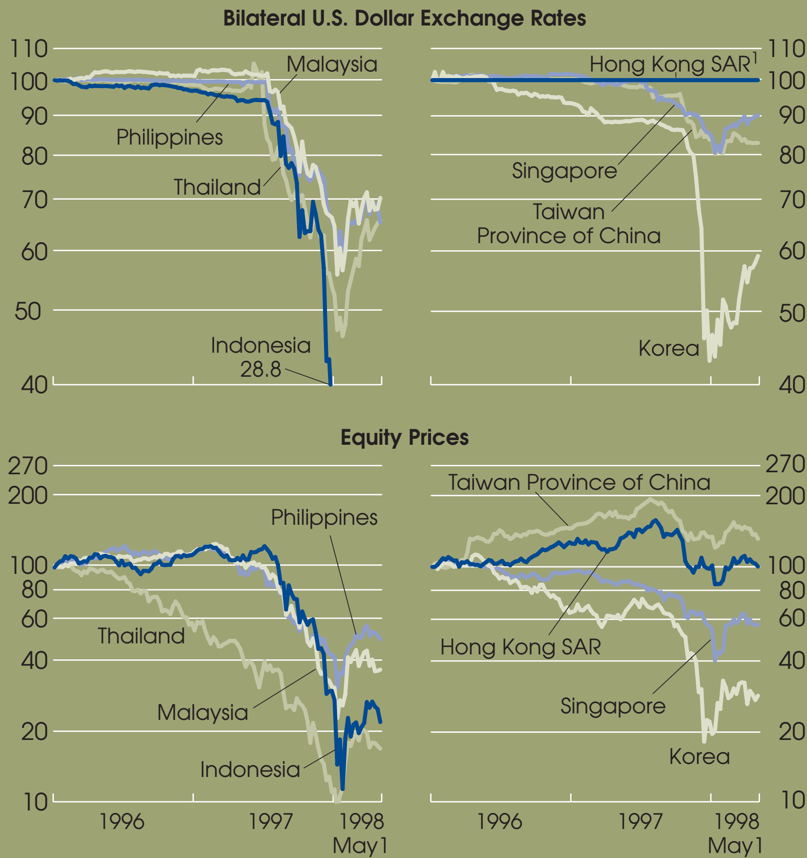
The financial turmoil that erupted in southeast Asia in mid-1997 quickly began to take its toll on demand and activity in the affected countries. It also began to have a dampening impact on global growth late in the year and in early 1998. In 1997 as a whole, however, world output growth continued at about 4 percent (Figure 2), with slower growth in Africa, Asia, and the Middle East offset by faster expansion in the industrial countries, the developing countries of the Western Hemisphere, and the countries in transition (Table 1). Growth in the volume of world trade rebounded in 1997 to 9½ percent, matching the expansion of 1995—the most rapid rate for two decades. The acceleration was widely shared between the advanced and developing country groups, but the growth in trade of the transition economies slowed somewhat.

Associated with the Asian crisis was a dramatic drop in net private capital flows to emerging market economies (Table 2). Such flows had reached a record $240 billion in 1996, with Asia attracting more than 40 percent of the total. After rising further in the first half of 1997, net flows fell steeply, as the crisis in Asia deepened, and for the year as a whole were about $70 billion less than in 1996. Net flows to the developing countries of Asia fell by more than $60 billion to about $40 billion—the lowest inflow since 1992. The devel-

Figure 1

Selected Asian Economies: Bilateral U.S. Dollar Exchange Rates and Equity Prices

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



Sources: Bloomberg Financial Markets, LP; International Finance Corporation; and Reuters.

[1]Pegged to U.S. dollar.

oping countries of the Middle East and Europe saw a smaller decline in inflows, while flows to the Western Hemisphere, Africa, and the countries in transition actually increased. In the first quarter of 1998, net capital inflows to emerging market countries remained close to their already reduced levels of late 1997.

The sharp declines in private capital flows to emerging market economies in Asia, although cushioned to some extent by an increase in official financing flows, required substantial adjustments in these countries' external positions. For the Asian developing countries, taken together, the current account deficit narrowed by almost $30 billion in 1997. And by early 1998, the countries most affected by the crisis—Indonesia, Korea, and Thailand—were each running current account surpluses. In 1997 as a whole, a widening of current account deficits among a number of Latin American countries, reflecting the increase in foreign direct investment in the region, was the main counterpart to the narrowing of deficits in the Asian emerging markets (Table 3). In late 1997 and early 1998, however, a number of advanced economies—most notably the United States—and the oil-exporting countries began to show signs of deteriorating current account balances.

Consumer price inflation declined further in each of the main country groups in 1997 (see Figure 2). The decline was helped by the weakness of primary commodity prices, including those for oil. In early 1998, oil prices fell further; indeed, by April 1998, in SDR terms, oil prices were about 31 percent lower than a year earlier, while non-oil commodity prices had fallen by 20 percent over the same period. To some extent, the declines reflected the reduced demand for commodities in the countries embroiled in the Asian crisis; the sharp depreciation of these countries' currencies may also have led to reductions in the foreign currency prices of their commodity exports.

The redirection of financial flows toward the mature markets following the onset of the crisis, together with prospects for lower inflation, contributed to significant declines in medium- and long-term interest rates in the industrial countries in late 1997 and early 1998—in some cases to 50-year lows. This easing of financial conditions, particularly in North America and in western Europe, contributed, in turn, to further gains in equity markets, with many indices reaching new peaks. These developments helped support the growth of domestic demand in industrial countries at the same time that net exports began to be adversely affected by the Asian crisis.

In foreign exchange markets, after considerable initial strengthening during 1997/98, the yen experienced strong selling pressures for most of the period, reflecting market concerns about progress in Japan's economic recovery. After falling to ¥127 per dollar at the end of April 1997, the yen rebounded sharply in May and early June to reach a high of ¥110. With the recov-

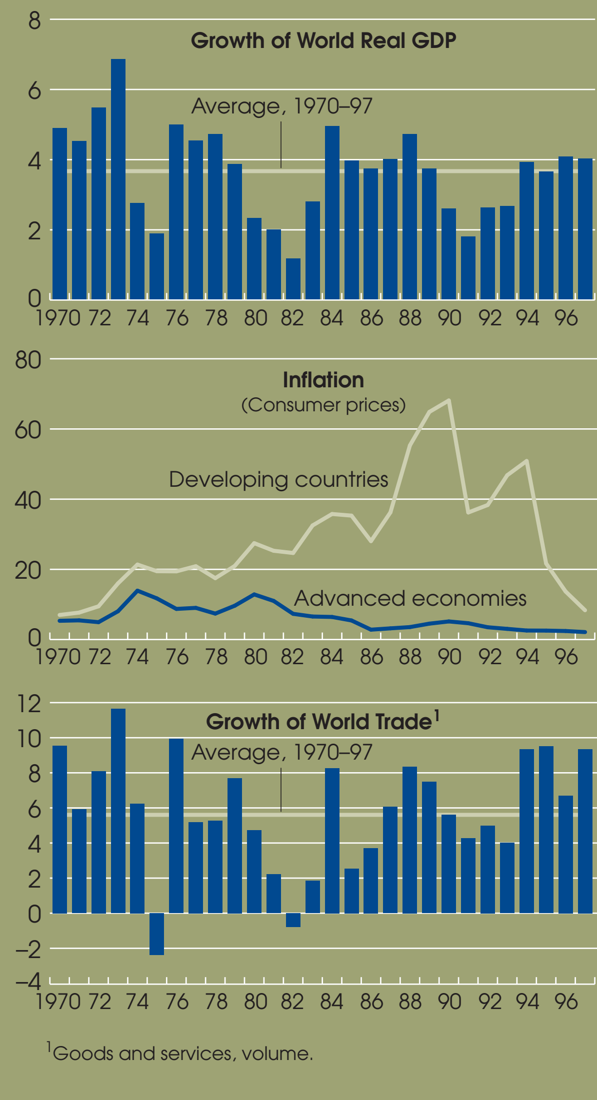
ery losing momentum by midyear and with concerns about the domestic financial sector, the yen subsequently weakened anew; by the end of April 1998, it had depreciated to ¥132 per dollar. Although the deutsche mark depreciated further against the dollar during 1997 and in early 1998, the depreciation in nominal effective terms was moderate. The pound sterling rose steeply in 1997 and in early 1998, owing mainly to short-term cyclical factors.

Advanced Economies

Cyclical divergences remained sizable among the advanced economies in 1997. Economic activity was strong in the United States and the United Kingdom, with both economies operating close to capacity and unemployment rates at their lowest in many years. The major economies of continental Europe saw a strengthening of growth in the second half of 1997 and in early 1998, but significant margins of slack remained in most of these countries. The Japanese economy faltered after the first quarter of 1997, then slipped into recession in the fourth quarter of the year, with output contracting in the first quarter of 1998 by 5.3 percent at an annual rate. The impact of the Asian crisis on the advanced economies varied depending on two main factors. The first was the importance of trade and financial links with the crisis economies; these links were generally closest in the Asia-Pacific region.[3] The second was the economy's starting position. The dampening effects of the crisis had a relatively large adverse impact on Japan, where activity and confidence were already weak; by contrast, these effects most likely helped contain inflationary pressures in countries facing the risk of overheating.

After a strengthening of growth in 1996 following four years of weak recovery, self-sustaining growth seemed to be taking hold in Japan in the early part of 1997. But activity declined sharply in the second quarter and picked up only weakly during the remainder of the year. The loss of growth before the middle of the year was attributable primarily to domestic factors, including an increase in the consumption tax in April 1997, cuts in public spending, and financial sector fragility. In the latter part of the year, concerns about the Asian crisis and about the domestic financial sector, together with a renewed softening of equity prices, contributed to continued weakness in domestic spending. For the year as a whole, GDP grew by ¾ of 1 percent. The Japanese authorities responded to these developments by announcing a large fiscal stimulus package in April 1998 and by taking steps to address

Figure 2
World Indicators
(Annual percent change)



[1]Goods and services, volume.

banking problems, including making public money available to strengthen deposit insurance and boost bank capital. Nevertheless, uncertainties remained about how the banking sector measures would be implemented. In July 1998, the Japanese authorities announced a series of further banking sector initiatives in a Comprehensive Plan for Financial Revitalization, including a "bridge bank" facility intended to facilitate the resolution of failed institutions and measures to strengthen bank supervision and increase transparency.

In the other advanced economies in the Asia-Pacific region, cyclical positions were generally stronger than in Japan when the Asian crisis erupted. In Australia,

[3]For example, in 1996, trade with the Asian newly industrialized and developing economies represented 5 percent of GDP in Japan, compared with 1½ percent to 3 percent in the major industrial economies of Europe and North America.

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

	1994	1995	1996	1997
World output	**3.9**	**3.6**	**4.1**	**4.1**
Advanced economies	3.1	2.5	2.7	3.0
Major industrial countries	2.8	2.0	2.5	2.8
United States	3.5	2.0	2.8	3.8
Japan	0.6	1.5	3.9	0.9
Germany	2.7	1.8	1.4	2.2
France	2.8	2.1	1.5	2.4
Italy	2.2	2.9	0.7	1.5
United Kingdom	4.3	2.7	2.2	3.3
Canada	3.9	2.2	1.2	3.8
Other advanced economies	4.5	4.3	3.8	4.0
Memorandum				
Industrial countries	2.9	2.1	2.5	2.9
European Union	2.9	2.5	1.7	2.6
Newly industrialized Asian economies	7.6	7.3	6.4	6.1
Developing countries	6.8	6.0	6.6	5.8
Africa	2.5	3.0	5.5	3.2
Asia	9.6	9.0	8.3	6.7
ASEAN-4[1]	7.7	8.1	7.1	3.9
Middle East and Europe	0.7	3.6	4.9	4.4
Western Hemisphere	5.1	1.2	3.5	5.0
Countries in transition	–7.6	–1.3	–0.1	1.7
Central and eastern Europe	–3.0	1.4	1.5	2.7
Excluding Belarus and Ukraine	3.0	5.3	3.6	3.1
Russia	–12.6	–4.0	–2.8	0.4
Transcaucasus and central Asia	–10.2	–4.3	1.5	2.2
World trade volume (goods and services)	**9.3**	**9.5**	**6.6**	**9.4**
Imports				
Advanced economies	9.7	8.9	6.4	8.6
Developing countries	7.1	11.9	9.3	12.1
Countries in transition	7.8	18.3	7.6	5.4
Exports				
Advanced economies	8.8	8.8	5.9	9.8
Developing countries	13.2	10.6	8.7	10.8
Countries in transition	8.3	12.3	4.9	3.5
Commodity prices				
Oil[2]				
In SDRs	–7.8	1.9	24.3	–0.9
In U.S. dollars	–5.5	8.0	18.9	–6.0
Nonfuel[3]				
In SDRs	10.8	2.1	3.1	1.6
In U.S. dollars	13.6	8.2	–1.3	–3.7
Consumer prices				
Advanced economies	2.6	2.5	2.4	2.1
Developing countries	50.7	21.7	13.7	8.5
Countries in transition	268.4	124.1	41.4	27.8
Six-month LIBOR (in percent)[4]				
On U.S. dollar deposits	5.1	6.1	5.6	5.9
On Japanese yen deposits	2.4	1.3	0.7	0.7
On deutsche mark deposits	5.3	4.6	3.3	3.4

[1]Indonesia, Malaysia, the Philippines, and Thailand.
[2]Simple average of spot prices of U.K. Brent, Dubai, and West Texas Intermediate crude oil. The average price of oil in U.S. dollars a barrel was $19.18 in 1997; the assumed price is $14.59 in 1998 and $15.94 in 1999.
[3]Average, based on world commodity export weights.
[4]London interbank offered rate.

growth strengthened during 1997 against a background of subdued inflation, a budget near balance, and a reduced current account deficit. Partly as a result of the Asian crisis, however, the Australian dollar depreciated substantially against the currencies of other industrial countries late in the year. In Hong Kong SAR, by contrast, competitiveness deteriorated as a result of regional currency depreciations, and interest rates rose sporadically to relatively high levels in the face of intermittent pressures on the currency. These developments, together with the effects of the regional crisis on trade and confidence, rapidly reduced the overheating pressure that had emerged in early 1997 and led to a sharp contraction of activity in early 1998. As in Hong Kong SAR, a strong financial sector helped limit the contagion of the regional crisis in Singapore and Taiwan Province of China, although in both significant currency depreciation and marked increases in domestic interest rates occurred.

The advanced economies of North America and Europe were less adversely affected by the Asian crisis. U.S. economic performance in 1997 was exceptionally strong, with GDP growing at 3¾ percent, the fastest growth in nine years. Furthermore, inflation in terms of the GDP deflator was the lowest in 32 years, unemployment fell to its lowest level in 24 years, and the federal budget was virtually in balance for the first time since the early 1970s. The strength of the U.S. economy provided essential support for global growth in the face of the Asian crisis. The weakening of external demand associated with the Asian crisis, and the strength of the U.S. dollar, dampened potential inflationary pressures in the U.S. economy and shifted the balance of arguments against monetary tightening in late 1997 and early 1998. Canada also experienced strong growth in 1997, but with significant slack remaining, inflation eased further. A considerable widening of the current account

Table 2
Net Capital Flows to Developing Countries, Countries in Transition, and Newly Industrialized Economies[1]
(Billions of U.S. dollars)

	1984–89[2]	1990–96[2]	1994	1995	1996	1997
Total						
Net private capital flows[3]	15.2	148.1	160.5	192.0	240.8	173.7
Net direct investment	12.9	63.1	84.3	96.0	114.9	138.2
Net portfolio investment	4.7	54.1	87.8	23.5	49.7	42.9
Other net investment	–2.5	30.9	–11.7	72.5	76.2	–7.3
Net official flows	23.9	15.3	–2.5	34.9	–9.7	27.3
Change in reserves[4]	–13.8	–81.2	–77.2	–120.5	–115.9	–54.7
Developing countries						
Net private capital flows[3]	18.2	131.2	136.6	156.1	207.9	154.7
Net direct investment	12.1	56.8	75.4	84.3	105.0	119.4
Net portfolio investment	4.2	49.3	85.0	20.6	42.9	40.6
Other net investment	1.9	25.1	–23.8	51.2	60.0	–5.3
Net official flows	25.8	15.6	9.1	27.4	–3.4	15.8
Change in reserves[4]	5.8	–55.7	–42.4	–65.6	–103.4	–55.2
Africa						
Net private capital flows[3]	3.6	4.4	10.6	13.8	4.5	8.9
Net direct investment	1.1	2.9	3.6	4.2	5.3	7.7
Net portfolio investment	–0.8	–0.2	0.5	1.4	–0.3	2.6
Other net investment	3.3	1.6	6.5	8.1	–0.6	–1.3
Net official flows	5.1	7.1	8.1	5.2	6.5	6.7
Change in reserves[4]	0.2	–1.9	–4.4	–1.4	–6.4	–11.3
Asia						
Net private capital flows[3]	13.0	55.9	63.1	91.8	102.2	38.5
Net direct investment	4.5	32.2	43.4	49.7	58.5	55.4
Net portfolio investment	1.5	6.8	11.3	10.8	10.2	–2.2
Other net investment	7.0	16.9	8.3	31.3	33.5	–14.7
Net official flows	7.7	8.4	6.2	5.1	9.3	17.7
Change in reserves[4]	–2.1	–29.0	–39.7	–29.0	–48.9	–17.2
Middle East and Europe						
Net private capital flows[3]	1.7	25.2	15.5	14.8	20.7	16.1
Net direct investment	1.1	3.0	4.2	5.1	4.3	5.1
Net portfolio investment	4.4	12.8	12.5	8.4	7.9	6.8
Other net investment	–3.8	9.4	–1.2	1.3	8.6	4.2
Net official flows	4.8	–1.8	–1.2	–4.8	–5.8	–1.3
Change in reserves[4]	7.2	–6.4	–3.1	–9.4	–21.2	–14.3
Western Hemisphere						
Net private capital flows[3]	–0.2	45.7	47.4	35.7	80.5	91.1
Net direct investment	5.3	18.7	24.3	25.3	36.9	51.2
Net portfolio investment	–0.9	29.9	60.6	–0.1	25.2	33.5
Other net investment	–4.6	–2.8	–37.5	10.5	18.5	6.5
Net official flows	8.2	1.8	–4.0	22.0	–13.4	–7.3
Change in reserves[4]	0.5	–18.4	4.7	–25.9	–27.0	–12.3
Countries in transition						
Net private capital flows[3]	–1.0	12.8	18.4	29.8	21.3	34.5
Net direct investment	–0.2	6.3	5.4	13.2	13.1	18.2
Net portfolio investment	—	2.0	4.1	2.9	2.2	7.3
Other net investment	–0.8	4.6	8.9	13.6	5.9	9.0
Net official flows	0.2	0.5	–11.0	8.4	–5.5	0.8
Change in reserves[4]	–3.6	–7.8	–8.5	–35.9	0.4	–6.2
Newly industrialized economies[5]						
Net private capital flows[3]	–2.0	4.1	5.5	6.1	11.7	–15.4
Net direct investment	1.0	0.1	3.5	–1.5	–3.2	0.6
Net portfolio investment	0.5	2.8	–1.2	0.0	4.6	–5.0
Other net investment	–3.6	1.2	3.2	7.6	10.3	–11.1
Net official flows	–2.0	–0.8	–0.6	–0.9	–0.8	10.7
Change in reserves[4]	–16.0	–17.7	–26.3	–19.0	–12.9	6.7

[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.
[2]Annual averages.
[3]Because of data limitations, “other net investment” may include some official flows.
[4]A minus sign indicates an increase.
[5]Hong Kong SAR, Korea, Singapore, Taiwan Province of China, and Israel.

Table 3
Selected Economies: Current Account Positions
(Percent of GDP)

	1995	1996	1997
Advanced economies			
Major industrial countries			
United States	–1.8	–1.9	–2.1
Japan	2.2	1.4	2.2
Germany	–1.0	–0.6	–0.3
France	0.7	1.3	2.7
Italy	2.3	3.2	2.9
United Kingdom	–0.5	–0.1	0.3
Canada	–1.0	0.4	–2.0
Other advanced economies			
Australia	–5.6	–4.0	–3.4
Austria	–2.0	–1.8	–1.8
Finland	4.1	3.8	5.3
Greece	–2.1	–2.6	–2.9
Hong Kong SAR[1]	–3.9	–1.3	–1.5
Ireland	2.8	2.0	1.8
Israel	–5.6	–5.6	–3.4
Korea	–2.0	–4.9	–2.0
New Zealand	–3.7	–4.0	–7.0
Norway	3.3	7.1	5.5
Singapore	16.8	15.7	15.2
Spain	0.2	0.3	0.5
Sweden	2.1	2.5	3.1
Switzerland	6.9	7.3	8.3
Taiwan Province of China	2.1	4.0	2.6
Memorandum			
European Union	0.6	1.1	1.4
Developing countries			
Algeria	–5.3	2.7	6.7
Argentina	–1.5	–1.9	–3.8
Brazil	–2.5	–3.1	–4.1
Cameroon	–0.4	–2.4	–1.3
Chile	–2.1	–5.4	–5.3
China	0.2	0.9	2.4
Côte d'Ivoire	–6.0	–4.8	–4.5
Egypt	2.3	–0.3	0.3
India	–1.6	–1.2	–1.5
Indonesia	–3.3	–3.3	–2.6
Malaysia	–10.0	–4.9	–4.8
Mexico	–0.5	–0.6	–1.8
Nigeria	–3.7	2.4	0.4
Pakistan	–3.4	–6.5	–6.0
Philippines	–4.4	–4.7	–5.2
Saudi Arabia	–4.2	0.2	0.2
South Africa	–2.0	–1.3	–1.5
Thailand	–8.0	–7.9	–2.0
Turkey	–0.6	–1.5	–1.7
Uganda	–2.5	–1.8	–0.9
Countries in transition			
Czech Republic	–2.7	–7.6	–6.3
Hungary	–5.7	–3.8	–2.2
Poland[2]	3.3	–1.0	–3.2
Russia	1.3	0.5	–0.3

[1]Includes only goods and nonfactor services.
[2]Based on data for the current balance, including a surplus on unrecorded trade transactions, as estimated by IMF staff.

deficit, in part owing to weak global commodity markets, contributed to downward pressures on the Canadian dollar. Official interest rates were raised in late 1997 and in January 1998, mainly to offset the consequences of the currency depreciation for monetary conditions.

European countries' cyclical positions continued to diverge notably in 1997 and early 1998. In the United Kingdom, output grew by 3¼ percent in 1997, and unemployment fell by year-end to 5 percent—a 17-year low. In Germany, France, and Italy, growth strengthened moderately in 1997 after faltering in the two preceding years. Unemployment rates remained high in all three countries but declined somewhat in France beginning in mid-1997 and in Germany in early 1998. In Germany, growth was driven mainly by continued buoyancy in exports; however, machinery and equipment investment and, subsequently, demand for consumer products picked up. The recovery in France, which also relied heavily on exports, became better balanced, with a pickup in domestic demand emerging in the second half of 1997. Despite a large fiscal correction, growth in Italy also firmed in 1997, with the pickup sustained by a recovery of private consumption, a strengthening of export growth, and a replenishment of inventories. Inflation was less than 2 percent in Germany, France, and Italy in 1997.

Elsewhere in continental Europe—Denmark, Finland, Ireland, Luxembourg, the Netherlands, Norway, Portugal, and Spain—economic growth continued strong in 1997after periods of sluggishness; more convincing expansions emerged in Austria, Belgium, and Sweden. In some of these cases, important structural reforms adopted in earlier years underpinned growth, especially with respect to promoting greater flexibility of labor markets. Subdued growth in Switzerland continued a period of stagnation that has spanned almost five years, but activity picked up in the first quarter of 1998. Inflation in these countries remained fairly uniformly low.

In March 1998, the European Commission determined that 11 of the 15 EU member states had qualified to participate in European Economic and Monetary Union (EMU) in 1999. The Commission based its recommendation (which included as input the European Monetary Institute's convergence report) on its assessment of the countries having met the convergence criteria for 1997 as outlined in the Maastricht Treaty for inflation, public finances, interest rates, and exchange rates. Of the other four EU countries, Denmark, Sweden, and the United Kingdom had indicated that they did not wish to participate immediately in EMU; the Greek government aimed to join EMU in 2001. In March 1998, the drachma joined the exchange rate mechanism (ERM) of the EU, with an announced central parity against the European cur-

rency unit (ecu) that implied a depreciation of 12½ percent; at the same time, the Irish pound was revalued by 3 percent in terms of its central parity.

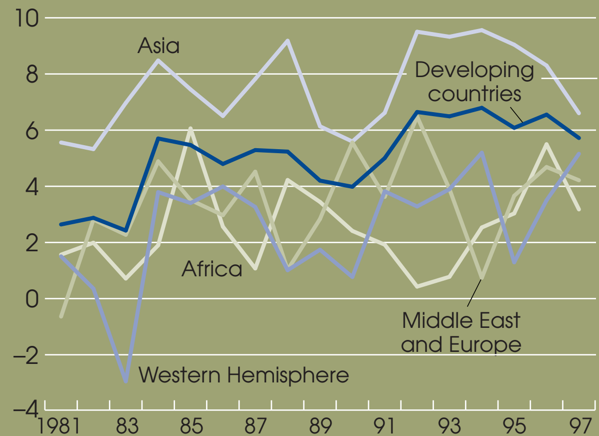
Developing Countries

A number of developing countries experienced contagion in their financial markets from the Asian crisis during 1997, and many others began to feel other economic effects from the crisis around the turn of the year, including generally higher risk premiums on foreign credits. These influences aggravated a number of other problems limiting growth, such as loss of competitiveness, lower commodity prices, and domestic and external imbalances. In the developing countries as a group, economic growth slowed to 5¾ percent in 1997 from about 6½ percent in 1996. The slowdown was significant in Asia, but most marked in Africa (Figure 3). In the developing countries of the Western Hemisphere, in contrast, growth in 1997 was actually stronger than in the previous two years but weakened in the first quarter of 1998. The slower growth was the result of spillovers from the Asian crisis and policy measures to reduce vulnerability to adverse shifts in investor sentiment and to widening current account deficits.

In the Asian region, financial markets in China remained relatively immune to the contagion effects of the crisis, reflecting the country's appropriate macroeconomic policies undertaken since 1993, the fact that its capital inflows consisted mainly of direct investment with limited vehicles for financial speculation, and its large foreign exchange reserves. While China's real exchange rate appreciated somewhat as a result of the currency depreciations of its Asian trading partners, its trade position remained strong and the current account continued in surplus. The authorities remained committed to not devaluing the renminbi, a policy critical to restoring stability in the region. Also, inflation remained low following the sharp drop in 1997. In India, output growth declined to about 6 percent in 1997 from about 7½ percent in 1996. The rupee weakened against the dollar in late 1997, partly because of spillovers from the regional crisis, but its exchange value was little changed on a real multilateral basis. In Pakistan, the government adopted a program to strengthen macroeconomic policies and implemented structural reforms following the widening of macroeconomic imbalances and the threat of a foreign exchange crisis in late 1996 and early 1997.

In Latin America, consumer price inflation declined in Brazil to 4¼ percent in 1997, while output growth at 3 percent remained much the same as in the previous year. In response to spillovers from Asia, the authorities tightened monetary and fiscal policies significantly in October and November 1997, and thereby restored confidence and halted the drain of foreign exchange reserves. In Argentina, output grew by a robust 8½

Figure 3
Developing Countries: Real GDP Growth
(Annual percent change)



percent, while prices remained broadly stable; as in Brazil, financial market pressures emerged in October, with a significant stock market correction and widening spreads on sovereign debt. In Mexico, the Asian crisis led to a marked increase in exchange market and interest rate volatility. A substantial temporary increase in interest rates helped stabilize the exchange rate, but the peso fell against the dollar in February 1998. In Chile, the peso came under pressure in December but stabilized by late January after moderate foreign exchange market intervention and a sizable increase in interest rates.

For the Middle East and Europe region, the direct spillovers from the Asian crisis were limited, with temporary declines in equity prices in some countries and a widening of interest spreads on internationally traded debt. In the Islamic Republic of Iran, real GDP growth slowed to 3¼ percent in 1997 from 4¾ percent in 1996, reflecting stagnant non-oil exports, cutbacks in government capital expenditure associated with a decline in oil revenue, and delays in structural reforms. In Turkey, growth continued close to 7 percent in 1997, while in Egypt successful efforts at macroeconomic stabilization and structural reform in recent years helped growth pick up to 5 percent. Jordan continued to reap the benefits of successful implementation of stabilization and reform policies, with continued robust growth in output, further declines in inflation, and a narrowing current account deficit.

Economic growth in Africa in 1997 was just 3¼ percent. The disappointing outcome mainly reflected the impact on a number of countries of poor weather, declines in commodity prices, and, in a few cases,

armed conflicts. Among the largest countries in the region, growth in South Africa slowed to 1¾ percent in 1997, owing to weaknesses in domestic and external demand. Nigeria was also affected by weak domestic demand, worsened by a lack of foreign investor confidence. In Algeria, growth slowed significantly, owing mainly to the impact of drought on agriculture and further delays in the recovery of industrial activity. In Kenya, growth weakened partly as a result of financial market pressures related to political uncertainties. Inflation remained under control in most of the region.

Transition Economies

In 1997, both Russia and the transition countries recorded positive growth for the first time in eight years. For the countries as a group, output grew by 1¾ percent and inflation was reduced to about 27 percent—testimony to the progress since early in the decade with stabilization and reform policies in most countries.

Spillovers from the Asian crisis were most apparent in Russia, Ukraine, and, among the Baltic countries, in Estonia. In Russia, where the ruble came under attack in late October and November, and again in late January 1998, the authorities defended the exchange rate by raising interest rates sharply. There were associated steep declines in the stock market. The pressures arose despite an external current account close to balance; they reflected a persistently weak fiscal position characterized by poor revenue collection, concerns about how the external position might evolve if the fiscal imbalance were not dealt with, and the decline in oil prices. In Ukraine, although 1997 appeared to have brought single-digit inflation and positive growth within reach, inadequate fiscal adjustment led to increased reliance on official short-term foreign borrowing. Coupled with slow progress on structural reforms, this heightened Ukraine's vulnerability to adverse developments; thus, when the Asian crisis intensified in late 1997, exchange market pressures forced the authorities to tighten monetary conditions sharply. In Estonia, domestic pressures on financial markets, associated with a burgeoning current account deficit, were aggravated by contagion from the Asian crisis. Interest rates rose substantially in October and November 1997, and equity prices, which had earlier risen steeply, dropped sharply.

A number of other transition countries experienced little impact from the Asian crisis in their financial markets or in their access to external finance, despite their openness to international capital markets. While the Czech Republic suffered a currency crisis in May 1997, in part triggered by the events in Thailand, it responded by tightening fiscal and monetary policies. The result was a significant narrowing of the Czech current account deficit, albeit at the expense of slower growth, and the subsequent deepening of the Asian crisis brought only limited further turbulence. Hungary also experienced little exchange market pressure from the Asian crisis, owing in no small measure to the country's markedly improved fiscal, growth, and trade performance following the implementation of strong adjustment measures since 1995. In Poland, output grew by about 7 percent in 1997, maintaining the solid expansion of almost six years.

The critical importance of adjustment and reform was highlighted particularly sharply in Albania and Bulgaria. The financial crisis in Bulgaria that had begun in 1996 extended into 1997, and output declined for a second consecutive year. In Albania, the crisis that flared up in March 1997 with the collapse of financial pyramid schemes also led to a drop in output during the year. But in both cases, following significant policy improvements, macroeconomic imbalances narrowed and growth resumed toward the end of 1997 and in early 1998. Bulgaria also recorded a dramatic decline in inflation in 1997, with the currency board arrangement introduced as part of the IMF-supported program playing a central role.

World Economic Outlook

The Executive Board regularly reviews global economic developments and policies, based on World Economic Outlook reports prepared by the staff. The reports, which are usually published twice a year, contain comprehensive analyses both of prospects for the world economy and for individual countries and regions, and of topical issues.

In 1997/98, the Board held three discussions on the World Economic Outlook: in August 1997, December 1997 (on the basis of an "Interim Assessment" by the staff), and March 1998.[4] The central focus was the Asian financial crisis.[5] In August 1997, a number of Directors had already cautioned that, while there were many reasons to believe the world expansion could be sustained, there was no room for complacency about the risks and fragilities confronting individual countries that could affect regional and global economic and financial conditions. Especially in the developing world, large external imbalances and fragile banking systems, several Directors noted, had adversely affected investor confidence and heightened the risks associated with volatile capital movements. These difficulties were not expected to affect the generally positive long-term prospects of those countries, provided that disciplined macroeconomic policies and the necessary structural reforms were implemented on a timely basis to ensure the elimination of unsustainable economic imbalances. Directors stressed, however, that those policy efforts would have to be supported by a broader range of institutional reforms aimed at increasing the efficiency of public administration, developing human capital, strengthening financial sector management, setting up transparent regulatory and legal systems, and improving governance. Such reforms would help establish and maintain private sector and investor confidence, which are critical for sustained, high-quality growth.

[4]The three reports were published as IMF, *World Economic Outlook,* issues dated October and December 1997 (the latter subtitled *Interim Assessment*) and May 1998.

[5]Chapter V reviews the Board's discussion of the causes and appropriate policy responses to the crisis.

In their March 1998 discussion, Executive Directors agreed that, while the financial market turmoil in Asia would have a significant negative impact on short-term growth prospects for the world economy, the slowdown was likely to be less pronounced than in earlier episodes of global economic weakness (in 1974–75, 1980–83, and 1990–91). Corrective actions by most countries at or near the center of the turmoil, the robust economic performance of most industrial countries, and policy reforms in many developing and transition economies over the past decade were seen as critical in containing the crisis and its global repercussions. Although growth projections for countries at the center of the crisis had been lowered considerably since the August 1997 discussion of the World Economic Outlook, Directors in March 1998 felt that prospects for other developing and transition economies remained generally encouraging.

This said, Directors noted that uncertainty still remained regarding the resolution of the crisis; resolute implementation of reforms by the crisis countries was therefore essential. Recent declines in oil and other commodity prices, moreover, could lengthen the adjustment process in some crisis countries and pose considerable challenges for commodity and oil-exporting countries in all regions. Also, a reevaluation of risks by international lenders as a result of the crisis, while welcomed, could limit financial flows to developing and transition economies to levels below those justified by the fundamentals. More generally, Directors were concerned that some emerging market economies had relied too heavily on foreign borrowing and short-term instruments to finance public deficits, thus increasing their risk of future financing difficulties.

Advanced Economies

In their March 1998 review of the outlook for the advanced economies, Directors observed that the spillovers from the Asian crisis for Japan were particularly unwelcome, given that its nascent recovery had already stalled in the first half of 1997; this stalling was due both to a fiscal policy that, in hindsight, was overly

tight and to continuing fragilities in the financial system. Directors stressed that boosting confidence and fostering stronger sustainable growth in Japan—through a combination of macroeconomic, financial sector, and structural policies—was critical, given the economy's importance for the region and for the world. Economic recovery should be supported by a more expansionary fiscal stance in the near term, while maintaining the objective of medium-term consolidation. Some Directors noted that a permanent tax cut would boost the prospects for an increase in private consumption but cautioned against overreliance on increased public works spending since it would have only a temporary impact and had not proven very effective in the past. In contrast, some other Directors expressed reservations about the effectiveness of tax cuts, fearing that the increase in disposable income might be added to household savings with little or no effect on consumption and growth. Pointing to the government debt accumulated in recent years and the prospective fiscal pressures associated with an aging population, some Directors argued that any backsliding with fiscal consolidation would pose risks while having little positive effect on activity.

Directors noted indications from the Japanese authorities that a substantial fiscal stimulus package would soon be announced. They emphasized that, to have significant and durable effects, the measures needed to be accompanied by serious regulatory and financial sector reforms. Most Directors welcomed recently announced measures committing public funds to protect depositors of failed institutions and to recapitalize viable ones. These measures promised to restore public confidence and strengthen banks' willingness to lend. Directors cautioned, however, against indiscriminate support to banks where closures or consolidation were more appropriate. They suggested that any further allocation of public funds be accompanied by clear measures to facilitate the write-off of bad bank loans to ensure a fair sharing of the burden of restructuring costs and to limit moral hazard. At its April 1998 meeting, the Interim Committee welcomed the Japanese economic policy package, as well as Japan's steps to strengthen its financial system.

Directors agreed that the U.S. economy, in contrast to the Japanese economy, was likely to suffer relatively little from adverse developments in Asia, owing largely to the strength of its cyclical position prior to the crisis and to the positive developments in bond markets, which, in the view of many Directors, reflected a "flight to quality" of international investment flows. They judged the current stance of monetary policy as appropriate, noting that the moderating effects of the Asian crisis—together with the appreciation of the U.S. dollar and the decline in world commodity prices—had alleviated the need for an increase in official interest rates. In view of the tightening labor market conditions, however, the authorities would need to monitor the situation closely, looking for signs that would tip the balance of monetary policy assessment in either direction.

The risks posed by the Asian crisis for the advanced economies in Europe were also likely to be relatively small, Directors agreed. Among the economies operating near full capacity, Directors believed that the previous year's monetary tightening and continued fiscal consolidation in the United Kingdom were likely to keep demand close to productive capacity limits and hold inflation near to target. But further action would be warranted if inflation prospects worsened. In the same vein, the Interim Committee in its April 1998 meeting emphasized the need for the U.K. authorities to remain vigilant as always to inflation risks. In Germany, France, and Italy, where output—while remaining below potential—had recovered quite well since the beginning of 1997, Directors expected the overall impact of the Asian crisis also to be small. Some Directors, however, cautioned against overoptimism, noting that exports had been the main source of demand growth in some of these countries. A weakening of export markets could slow, and possibly stall, the recovery if domestic demand did not pick up. In continental Europe generally, with monetary union among a large number of countries scheduled to begin in nine months, attention had to be given to labor and product market reforms, to continuing fiscal consolidation, and to monetary policy in the transition period.

Developing and Transition Countries

Directors noted that the Asian crisis was affecting most developing and transition economies, albeit to varying degrees. The effects were being felt through, for example, increases in risk premiums in borrowing costs, lower commodity prices, losses in competitiveness to countries at or near the center of the turmoil, or the slowdown in demand in those countries. Several countries—including Brazil, Chile, the Czech Republic, and Mexico—that had suffered exchange market pressures in connection with the Asian crisis had been able to avoid full contagion through appropriate policy adjustments. Although these countries had generally weathered the crisis well, Directors felt it prudent for them to continue strengthening policies to avoid further challenges down the road. In this connection, it was particularly important to contain external imbalances, avoid overheating, and enhance the quality and timeliness of economic and financial information generally. Also critical was a strong financial sector infrastructure, including prudential regulation, internationally accepted accounting standards, and, for some, preestablished exit rules regarding shifting from a fixed exchange regime to a flexible one (see Chapter VI). Several

Directors welcomed China's commitment not to devalue its currency and its efforts to strengthen its banking system.

Many Directors expressed concern about recent trends in commodity prices and the potentially adverse implications for commodity-exporting developing countries of both a deterioration in the terms of trade and increased price volatility. For Africa, the impact of these forces, combined with poor weather and the continuing heavy debt burden, was of particular concern. Nevertheless, Directors remained cautiously optimistic about Africa's growth prospects, based on the expectation of continued implementation of macroeconomic adjustment and structural reforms and of an appropriate flow of foreign assistance. Directors underscored the need to create a favorable environment for foreign direct investment, including through a further opening up of their economies.

Regarding the economies in transition, Directors expressed satisfaction that both Russia and the transition countries as a group had recorded positive growth in 1997 for the first time since the transition began. They noted, however, that although considerable progress was being made in macroeconomic stabilization in virtually all countries, differences in the pace of reform and progress in transformation appeared to have grown larger. Most countries had made substantial progress toward reasonable fiscal balance, but sizable deficits continued to be registered in a number of countries, including Russia and Ukraine. Financing these deficits through foreign currency and short-term borrowing, Directors observed, put the sustainability of fiscal policies in question, indirectly threatened to undermine the soundness of banking sectors, and endangered hard-earned economic stabilization achievements. Severe revenue collection problems in a number of transition countries, moreover, were preventing governments from carrying out their proper functions. Further tax policy reform and improvements in tax administration were unlikely to show their full effect, Directors recognized, unless the political will to collect taxes was also strengthened. Directors also advised central and eastern European transition countries to improve the cost-effectiveness of their social security and welfare systems, and thereby reduce the overall level of government spending.

International Capital Markets

In their annual review of developments in international capital markets, conducted in July 1997 shortly after the eruption of the financial crisis in Thailand, Executive Directors engaged in a wide-ranging discussion of mature and emerging capital markets and banking systems. They also assessed the implications of European Economic and Monetary Union for international capital markets. Directors discussed at length developments in emerging markets, strategies for dealing with speculative attacks, and approaches to more effective management of sovereign external liabilities. Later in the fiscal year, in March 1998, the Board examined the role of hedge funds and institutional investors both in connection with the Asian crisis and, more generally, in a world of increasingly integrated capital markets.[6]

Mature Capital Markets

Directors noted the narrowing of interest rate differentials among the mature economies and attributed this to several causes, including fiscal consolidation, reductions in inflation rates, and increased competition in international banking markets. Directors also saw the continued convergence of interest rates as a sign that markets expected a broad EMU to begin on January 1, 1999. As to a second major trend in the mature markets—the continued sharp advances in equity prices, particularly in the United States—many Directors felt that the relatively high valuations of stocks rested on investor expectations of continued strong growth in corporate earnings and relatively low inflation rates. Although diverse views were expressed about the implications of conventional market indicators, many Directors were concerned about the potential for corrections in some equity markets and the possible negative impact of such corrections, especially in emerging equity markets. Directors urged careful monitoring of stock markets in the United States and other economies.

Banking in Mature Markets

Directors noted that the banking systems in some mature markets had been highly profitable during the preceding 12 months, while others continued to be affected by high levels of nonperforming loans. They discussed the difficulties in ensuring effective financial supervision created by financial deregulation and globalization and noted that, as distinctions between banks and other financial institutions had blurred, a growing number of countries had moved toward consolidating supervision over a broad range of financial institutions into one agency.

Structural Aspects of EMU

Directors viewed the creation of EMU as an important international financial event that was likely to foster the creation of EMU-wide financial markets, benefit European banking systems, and lead to a more efficient European payments system. Although some consolidation and restructuring of banking systems was generally seen as inevitable, several Directors cited the diverse situations of banking systems among European countries. Some stressed the importance of taking into account the performance of all types of financial institutions, such as savings, post office, and cooperative banks, in assessing the efficiency of the European banking system. Market-based solutions were seen as desirable for addressing banking sector problems. Some Directors cautioned that regulatory practices, local market power, rigid labor practices, and public ownership structures could delay the required adjustments. A number of Directors cautioned against both the fiscal costs and the moral hazard that might be associated with public interventions for addressing the problems of the more seriously troubled financial institutions.

Emerging Markets

Directors noted the growing integration of many emerging markets into the global financial system, as

[6]The background papers were published as IMF, *International Capital Markets: Developments, Prospects, and Key Policy Issues* (1997), and IMF, *Hedge Funds and Financial Market Dynamics,* IMF Occasional Paper 166 (1998).

evidenced by the record level of private capital flows to these countries in 1996. The scale of such flows reflected improvements in the economic fundamentals in many recipients, the growing international diversification of institutional investor portfolios, and the increased ability of investors to search for higher yields. Directors expressed concern, however, that interest rate spreads on emerging market bonds and syndicated loans might have been bid too low and that many of these investors might not be fully cognizant of the credit risks they faced. Some Directors also thought that the low level of emerging market spreads might reflect investor expectations that systemically important emerging markets would receive official assistance that would allow them to avoid debt-service interruptions. To avoid moral hazard, several Directors cited the need to dispel the notion that the IMF would step in to bail out creditors.

Speculative Attacks and Exchange Rate Regimes

Executive Directors noted that the events in Thailand and neighboring foreign exchange markets had—as during the Mexican and European exchange rate mechanism crises—again demonstrated that the growing integration of financial markets meant that perceived macroeconomic uncertainties and structural weaknesses were more likely to generate large-scale speculative pressures on rigidly managed exchange rate arrangements than on flexible regimes. Many Directors argued that an inflexible exchange rate system could be sustained only if actively supported by strong macroeconomic policies and a sound financial system able to withstand sharp and sometimes sustained increases in interest rates to defend against speculative pressures.

The first line of defense against speculative attack must be sound macroeconomic policies, Directors stressed. When economic fundamentals were broadly correct, the authorities could mount a graduated defense based, first, on sterilized foreign exchange intervention and then, if necessary, unsterilized intervention, allowing short-term domestic interest rates to rise. Even in situations where the cost of maintaining high interest rates was considered excessive, Directors saw only a limited, short-term role for capital controls designed to limit the access of speculators to domestic credit. Such measures, they felt, should be used only in crisis situations to buy time to undertake corrective policies and should not be seen as a substitute for necessary reforms. Some Directors also emphasized that exchange restrictions that discriminated between domestic and foreign residents were inappropriate.

In discussing the appropriateness of fixed exchange rates, a few Directors drew attention to the choice of the peg currency and whether this should be based on the currency composition of trade flows or of external borrowing. Many Directors underscored the importance of moving to more flexible exchange rate systems in the face of sustained market pressures. Some also felt that allowing for more exchange rate flexibility would reduce the need to build up foreign exchange reserves and mitigate the problems in sterilizing sizable capital inflows and the associated cost (see also Chapter VI).

Banking in Emerging Markets

Directors commended the progress made in improving the health of banking systems in several countries but observed that significant problems remained in some others. Several Directors noted that investor concerns about potential vulnerabilities in the banking systems of some Asian emerging markets had contributed to instability in foreign exchange markets. Concerns about the impact of the Thai devaluation echoed similar concerns raised in 1995 in the context of the Mexican financial crisis. Both episodes had underscored the importance of sound risk management and prudential regulation in emerging market banking systems.

Managing Sovereign External Liabilities

Directors stressed the importance of improving the emerging market countries' management of sovereign external liabilities (both gross and net). They generally viewed foreign currency borrowing as necessary for complementing domestic debt instruments, broadening the investor base, and establishing international benchmarks. But they cautioned that such borrowing should be guided by strategic debt-management considerations—namely, the ability to generate corresponding foreign currency revenues—and not be driven by short-term fiscal savings. Cost considerations should be based on the hedged (risk-adjusted) cost for a country. The debt-management strategy should incorporate clear guidelines on currency composition and maturity structure and should take into account foreign borrowing by the private sector, especially by commercial banks. Directors noted the risks and constraints that a large stock of short-term foreign currency debt could impose on macroeconomic policies; they referred to the unfolding Asian turmoil as a clear example of what could occur.

Greater policy transparency and accountability of debt managers in managing foreign assets and liabilities were generally viewed as enhancing the ability to manage exposures to external shocks. In this regard, many Directors highlighted the potential merits of a separate debt-management agency with expertise and experience in risk-management techniques. They also underscored the need for coordination and consistency between such an agency and the monetary and fiscal authorities.

Hedge Funds and Financial Market Dynamics

As a point of departure for their March 1998 discussion on hedge funds, Directors noted that detailed information on these funds was limited. As private investment pools, hedge funds were not subject to most of the reporting and disclosure requirements applicable to banks and mutual funds. More fundamentally, it was difficult to demarcate clearly the boundaries of the hedge fund industry from other institutional investors, or to generalize about its activities given the great diversity of investment strategies pursued by fund managers. Still, several commercial services gathered information on the industry. Excluding "funds of funds" (funds made up of smaller funds), such estimates suggested that hedge fund capital was in the neighborhood of $100 billion as of the third quarter of 1997. Of that, some $25 billion was in the hands of so-called macro funds, that is, funds that take large unhedged positions on changes in global economic conditions and typically leverage their capital through borrowing by a factor of 4 to 7. The remainder was managed by so-called relative value funds that take bets on the relative prices of closely related securities and are less exposed to economic fluctuations; they tend to be more highly leveraged than macro funds. By contrast, the capital of such other institutional investors as investment and commercial banks exceeded $20 trillion in the mature markets alone.

Against this background, Directors differed on the impact of hedge funds on market dynamics. While agreeing that hedge fund capital represented only a fraction of liquidity in global financial markets, several Directors emphasized that highly leveraged hedge funds could take large positions in the smaller emerging markets. They also noted the relative freedom and flexibility of hedge fund activities. Some Directors argued that hedge funds encouraged herding behavior among investors. Others saw only limited evidence that hedge funds contributed significantly to herding and noted their potential role as contrarians or stabilizing speculators.

Hedge Funds and the Asian Crisis

Directors differed on the extent of the involvement of hedge funds in the Asian crisis. Several saw no clear evidence that hedge funds took short positions against Asian currencies any earlier than other investors, or that their trades were necessarily a signal for other investors. Directors noted that while hedge funds had large short positions on the Thai baht, the same did not appear to have been true for Asian currencies in general. Because some governments and central banks limited the ability of offshore counterparties to borrow domestic currency from onshore banks, other investors with better access to the domestic broker market might have acted as market leaders. The entire constellation of institutional investors, and not merely hedge funds, in the Board's view, had played a role in the market fluctuations of 1997.

A few Directors felt that hedge funds had played a more important role in the crisis than indicated by the staff paper on hedge funds.[7] They argued that hedge funds at times had a strong effect on asset prices, particularly in light of the relative size of their positions in specific markets. Directors generally agreed, however, that the events in Asia highlighted the need for policymakers to pursue sound and prudent macroeconomic policies that were transparent to markets in order to protect their economies against sharp market volatility and speculation. In particular, they recommended avoiding offering one-way bets in the form of inconsistent policies and indefensible currency pegs; maintaining strong, well-regulated, and competitive financial systems; and providing timely and comprehensive information to the public about government policy and private sector financial conditions. While recognizing the role of better information in curbing herd behavior, several Directors cautioned that disclosing market-sensitive information could on occasion trigger or worsen market volatility.

More Regulation?

Board members expressed diverse views on whether hedge funds should be subject to additional regulatory and disclosure requirements. Some argued that, given the scant evidence of market failure associated specifically with hedge funds, the case for new regulations was slim. Some other Directors, however, indicated that further options needed to be explored to render hedge fund operations more transparent and assure officials and market participants that hedge funds were not dominating or manipulating markets.

A number of Directors warned that hedge funds were only one part of the larger constellation of institutional investors, so that, to convey useful information, any system of detailed portfolio and position reporting would also have to encompass, among others, commercial banks, investment banks, insurance companies, and pension funds. It was also noted that reporting systems were more difficult to implement in an over-the-counter environment, such as the foreign exchange market, than on organized exchanges. Moreover, to be totally effective, reporting requirements would have to be applied by all countries. Otherwise, market participants who regarded reporting as onerous would simply book their transactions offshore.

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[7] Ibid.

European Economic and Monetary Union

During 1997/98, the Executive Board held a series of discussions on issues related to EMU. Early in the year, Directors assessed the implications of EMU for financial markets (see Chapter III); preparations for EMU and EMU in the context of the World Economic Outlook were taken up in May and August 1997 and in March 1998.

At their meeting in May 1997, Directors noted that completion of EMU would represent a milestone in the economic integration of Europe and was of major importance for the international monetary system. They underlined the desirability of completing the project in a timely way, noting that a great deal had been accomplished already in preparing EU economies for EMU and in establishing the policy framework within which economic policies would be conducted once monetary union commenced. The EU authorities needed to follow through on their policy commitments and work closely together to secure the foundations for monetary union to ensure a smooth transition to EMU, Directors noted.

While noting that most EU countries had already achieved a high degree of convergence in the areas required by the Maastricht Treaty—most remarkably with regard to inflation—Directors observed that further progress was needed in the fiscal area in 1997. They underlined that, for most countries, additional fiscal measures would also be needed in 1998 to reduce deficits further in line with the medium-term requirements reflected in the Stability and Growth Pact.

The continuing high structural unemployment in Europe concerned Directors, and they emphasized that urgent action was needed to reduce labor market rigidities in most EU countries. In the context of a common monetary and exchange rate policy, inadequate flexibility in labor markets would impair the ability of individual countries to adjust to asymmetric shocks. Some Directors were concerned that failure to address labor market rigidities would result in persistently high unemployment that could erode public support over time for macroeconomic policies directed at low inflation. Directors also stressed the importance of factor and product market liberalization to ensure sustainable growth and job creation in the EU.

In establishing a macroeconomic policy framework for the monetary union, it was important to balance policymakers' need for flexibility with the desire to establish rules that would help underpin the credibility of policies in the new environment. Directors thought that the Stability and Growth Pact had struck a reasonable balance between those two considerations. They believed that surveillance by the EU's Council—oriented to giving an early warning of the emergence of excessive deficits—together with the threat of financial penalties, should provide a strong bulwark against fiscal indiscipline.

Directors generally agreed that the euro would, over time, constitute an attractive reserve currency that might rival the dollar. The roles of the euro and the dollar would depend importantly on developments in financial markets in Europe, including the regulatory environment and the variety of instruments available, as well as fundamental economic developments.

When the Executive Board discussed EMU in August 1997 at its review of the World Economic Outlook, Directors again remarked on the impressive degree of economic convergence achieved in Europe, including strengthened public finances, lower inflation and interest rates, and relatively stable exchange rates. Some Directors were of the view that the advances in economic convergence and the strong commitment to begin EMU as envisaged had served to lessen considerably the risks and uncertainties in the run-up to EMU.

A number of Directors stressed that the best way to minimize any remaining uncertainties about the start of EMU, and to ensure that a sustainable and strong EMU began on time, would be for countries to take fiscal action in the remainder of 1997 and in 1998 that continued to demonstrate their commitment to the requirements of the Maastricht Treaty and of the Stability and Growth Pact. Several Directors noted the risk that a number of candidates for membership might slightly exceed the fiscal deficit target. They agreed with the staff, however, that—particularly in view of

the reductions achieved in cyclically adjusted deficits and the longer-term framework established with the Stability and Growth Pact on fiscal discipline—small excesses of actual deficits over the reference value should not be viewed as an impediment to EMU proceeding on schedule. In contrast, a few other Directors noted that a strict application of the Maastricht fiscal deficit criterion would be important so as not to impair the credibility of EMU.

Directors noted other challenges to sustain a successful monetary union that still had to be faced during the transition to the single currency. They broadly agreed that, in addition to sound financial policies, improving Europe's labor market performance was critical for the success of EMU. Directors emphasized that comprehensive labor market reforms to reduce structural unemployment would not only help boost medium-term growth and improve fiscal performance, but would also help Europe adjust faster to adverse economic disturbances when monetary union was in place and increase public support for the project. Directors generally agreed that the independence of the European System of Central Banks, and its mandate and capacity to achieve price stability, should be well safeguarded by the provisions that had been put in place relating to its functioning. They generally felt that the exchange rate would not be a suitable nominal anchor for monetary policy in the euro area. Directors felt that the introduction of the euro would be accompanied by a significant restructuring of financial markets and possible instability in money demand relationships. Directors considered that the European Central Bank (ECB) would likely use a wide range of indicators in conducting monetary policy, especially in the early stages of EMU. It was noted that transparency of monetary policy would be important in securing and maintaining the credibility of the ECB.

A number of Directors observed that despite the considerable progress in fiscal consolidation, budgetary positions in many EU members might worsen in the medium to long term as a result of demographic developments; these problems would have to be addressed, irrespective of EMU.

At their March 1998 discussion of the World Economic Outlook, Directors considered that the objective of establishing a monetary union among a large number of EU member countries was within reach, in accordance with the agreed timetable. Progress in fiscal adjustment and the convergence of inflation and interest rates had been impressive. But further fiscal consolidation was desirable in the near term to strengthen medium-term growth potential and to provide for greater policy flexibility within the Stability and Growth Pact. Directors expressed particular concern, however, that structural reforms in labor and product markets were lagging.

In its April 1998 meeting, the Interim Committee requested the Executive Board to examine further the implications of EMU for IMF operations and for the conduct of IMF surveillance and to report its findings in time for the Committee's next meeting in October 1998.