The Asian Crisis

As the formative event of the financial year, the Asian financial crisis absorbed a large proportion of the Executive Board's time. Directors met frequently—at times, daily—to be briefed on and discuss developments in the countries at the center of the crisis and to guide the work of staff and management with those countries' authorities. IMF-supported adjustment programs, involving very large financial support, for Indonesia, Korea, and Thailand were approved by the Board. The Board also conducted several in-depth reviews—particularly during its World Economic Outlook and International Capital Markets discussions, and in the context of examining the record of IMF surveillance in the region (see Chapter VI)—of the broader questions prompted by the crisis: its origin, the appropriate response of policy, the appropriate role of the international community, and the lessons to be drawn from the experience. This chapter focuses primarily on the Board discussions on these broader issues through the end of the financial year (end-April 1998). Highlights of the IMF's response to the crisis are detailed in Box 1, and summaries of the evolution of IMF-supported adjustment programs for Thailand, Indonesia, and Korea (updated through mid-July 1998) are at the end of the chapter.

Origin and Evolution

The Asian financial crisis took place against the backdrop of severe financial market pressures in several Asian economies, linked in part to concerns about their weak financial systems, large external deficits, inflated property and stock market values, maintenance of relatively fixed exchange rates, and overdependence on short-term capital flows—which tended to be allocated to less-productive investment. In addition, shifts in competitiveness associated with wide swings in the yen/dollar exchange rate were also a contributing factor. The pressures were most acute in Thailand, where fragilities in the financial sector heightened concerns about the sustainability of the pegged exchange rate arrangement. Spillover effects from the crisis were felt by other countries in the region, notably Indonesia, Malaysia, and the Philippines. In all of these countries, acute exchange market pressures eventually led to the adoption of more flexible exchange rate arrangements and sizable depreciations of their currencies, as well as sharp declines in asset values.

In August 1997, several Directors during the Board discussion stressed the importance of containing external current account deficits and reducing the reliance on foreign borrowing—especially short-term borrowing denominated in foreign currency—to diminish the risk of disruptive changes in market sentiment. In this regard, Directors noted that the adoption of a strong adjustment program by the Thai authorities and the solid demonstration of regional and international cooperation would pave the way for a restoration of confidence and a gradual return to Thailand's characteristically strong economic performance. Several Directors observed that to restore economic and financial market stability, it was crucial for all countries in the region to pursue sound macroeconomic and structural policies, strengthen financial supervision, and enhance transparency through timely disclosure of economic and financial data.

By the time of subsequent World Economic Outlook discussions, the crisis had deepened and spread to Korea. In reviewing the reasons for the eruption of turbulence and its unexpectedly strong spillover to other countries, Directors noted that a number of elements had played a role. These included, somewhat ironically, the strong economic performance of the affected countries in recent decades, which had helped attract large capital inflows during the 1990s. The inflows had ultimately put heavy demands on economic policies and institutions, including those intended to promote monetary stability and financial sector soundness. The strength of past performance, moreover, was felt by many Directors to have contributed to initial delays in the implementation of remedial action. External influences had also played an important role. The appreciation of the U.S. dollar—to which the currencies of most of these countries were pegged—and slower export market growth had contributed in 1996–97 to

Box 1

The IMF's Response to the Asian Crisis

In seeking to restore confidence in the region in the wake of the Asian crisis, the IMF responded quickly by:

- helping the three countries most affected by the crisis—Indonesia, Korea, and Thailand—arrange programs of economic reform that could restore confidence and be supported by the IMF. The Philippines' existing IMF-supported program was extended and augmented in 1997, and a Stand-By Arrangement was approved in 1998;
- approving some SDR 26 billion of IMF financial support for reform programs in Indonesia, Korea, and Thailand and spearheading the mobilization of some $77 billion of additional financing commitments from multilateral and bilateral sources in support of these reform programs in 1997. In mid-1998, the IMF's committed assistance for Indonesia was augmented by SDR 1 billion, with an estimated $5 billion from multilateral and bilateral sources. Of the commitments to all three countries, some SDR 18 billion had been disbursed by the IMF by July 23, 1998. (See table.); and
- intensifying its consultations with other members both within and outside the region that, although not necessarily requiring IMF support, were affected by the crisis and needed to take policy steps to ward off contagion.

To implement its response to the crisis, the IMF:

- used the accelerated procedures established under the Emergency Financing Mechanism and the exceptional circumstances clause to meet the exceptional needs of the member countries in terms of approval time and access. This was followed by close monitoring of performance under the programs on a continuing basis and the approval of a number of adaptations to the original programs in light of developing circumstances;
- created the Supplemental Reserve Facility to help members experiencing exceptional balance of payments difficulties owing to a large short-term financing need resulting from a sudden loss of market confidence;
- stepped up coordination with other international financial institutions, notably the World Bank and the Asian Development Bank, and with bilateral donors, to augment international support for the affected countries' economic reform programs;
- strengthened its dialogue with a variety of constituencies in the program countries, including consultations with opposition and labor groups and extensive contacts with the press and the public;
- provided staff support to coordinate efforts by international creditor banks and debtors in the affected countries to resolve the severe private sector financing problems at the heart of the crisis;
- posted on the IMF website—with the consent of the governments of Indonesia, Korea, and Thailand—their Letters of Intent, describing in detail their IMF-supported programs, so that details of the programs would be readily available to all interested parties; and
- reinforced means of communication with officials and support for their efforts at consensus building through the appointment of former IMF Deputy Managing Director Prabhakar Narvekar as Special Advisor to the President of Indonesia; the establishment of resident representative posts in Korea and Thailand (in addition to the existing post in Indonesia); and the work of the IMF's new Asia and Pacific Regional Office (see Chapter VI).

Commitments of the International Community and Disbursements of the IMF in Response to the Asian Crisis, as of July 23, 1998[1]

(Billions of U.S. dollars)

	Commitments				IMF
Country	**IMF**	**Multilateral[2]**	**Bilateral[3]**	**Total**	**Disbursements**
Indonesia	11.2	10.0	21.1[4]	42.3	5.0
Korea	20.9	14.0	23.3	58.2	17.0
Thailand	4.0	2.7	10.5	17.2	2.8
Total	**36.1**	**26.7**	**54.9[4]**	**117.7**	**24.8**

[1]IMF commitments to the Philippines are not included.
[2]World Bank and Asian Development Bank.
[3]Bilateral contributions to Indonesia and Korea were a contingent second line of defense.
[4]Estimate; amount of new commitments not finalized as of July 23, 1998.

worsening the external positions and growth performance of the countries in deepest crisis. Also, international investors, in their drive for higher rates of return, had underestimated the risks in some emerging market economies.

Directors agreed, however, that policy weaknesses in the affected countries had been the most important contributor to the sudden shifts in market sentiment. In particular, inflexible exchange rate arrangements had been maintained for too long—even when fundamentals no longer supported them—constraining the response of monetary policy to overheating pressures. Investors had also viewed pegged exchange rates as implicit guarantees of exchange value, which, together with implicit guarantees of support to the banking sector, had encouraged external borrowing and excessive foreign exchange exposure, often at short maturities. Inadequate banking regulation, supervision, and prudential rules had contributed to the inefficient intermediation of these funds, resulting in fragile balance sheets of many banks and nonfinancial corporations. Excessive government intervention and problems with data availability had also—to varying degrees—impeded market discipline on resource allocation and on the volume of capital investment, further distorting the deployment of capital inflows from abroad as well as domestic financial resource intermediation. Significant delays in confronting the problems and adopting the requisite monetary policy and structural reform measures had compounded the affected countries' economic difficulties and the associated contagion effects.

Appropriate Policy Response

At their December 1997 discussion, Directors emphasized that the main responsibility for resolving the turmoil in Asia rested with the affected countries. Hesitation in implementing the needed adjustment and reform measures would only worsen the crisis and exacerbate overshooting in financial markets and contagion to other countries. In this context, a number of Directors questioned the adequacy of the commitments of the authorities in some of the affected countries, arguing that this had added to market turbulence. All Directors agreed that bold actions to address key policy weaknesses were indispensable for restoring confidence and preparing the ground for a solid rebound from the current difficulties. They stressed four areas for action:

- Domestic and foreign investors needed to be reassured that macroeconomic stability would be restored. Directors agreed that the required degree and composition of fiscal adjustment had to strike a balance between several objectives, including the need to contribute sufficiently to current account adjustment and to meet the costs of financial system restructuring, while avoiding excessive compression of domestic demand. Some Directors questioned the need for significant tightening of fiscal policy since the Asian economies in crisis generally did not suffer from fiscal imbalances.
- Monetary policies had to be kept sufficiently firm to resist excessive depreciation of the exchange rate and its inflationary consequences, while ensuring that domestic demand was not unduly squeezed and the banking sector not overly strained. Some Directors stressed the need for a strong, early monetary tightening to restore market confidence quickly, while the requisite banking and other structural reform measures were getting under way. Directors agreed that as confidence was restored, monetary conditions should be allowed to ease—with a gradual lowering of interest rates—to help support activity, but they emphasized the danger of premature easing. It was important to encourage financial institutions and corporations to roll over external short-term loans in cases where the repayment of such loans risked worsening downward pressures on the exchange rate.
- Weaknesses in the financial sector needed to be addressed through bold and comprehensive measures to dispel uncertainties. Although it was necessary to ensure adequate protection for small deposit holders, insolvent institutions had to be closed to facilitate an early restoration of confidence. Weak but viable institutions had to be restructured and recapitalized in ways that were fully transparent and did not inappropriately shield creditors and equity holders from losses or exacerbate problems of moral hazard.
- Public and corporate governance had to be strengthened to enhance transparency and accountability, and data—especially financial and banking sector indicators—had to be provided on an accurate and timely basis.

Directors noted in December 1997 that the prolonged crisis in Southeast Asia and East Asia had raised the prospect that other emerging market countries, which had already experienced some spillovers, could experience an intensification of financial market pressures. While reform efforts had been strengthened considerably among developing countries in recent years, a number of countries remained vulnerable to reversals of market sentiment. The policy requirements in these countries were similar to those in the countries that had already been affected. In addition, several Directors thought that some other emerging market countries should consider whether greater exchange rate flexibility might help to reduce the risk and cost of possible speculative attacks on their currencies. Directors agreed that, whichever exchange arrangement countries chose to follow, protection against currency market turmoil was likely only if it were fully supported by strong macroeconomic policies and robust financial systems.

During their March 1998 discussion, Directors affirmed their support for the programs put in place to restore confidence in the affected countries, including measures to strengthen financial sectors, correct macroeconomic imbalances, and improve data availability, transparency, and governance. Such measures were seen as the most effective means of addressing the causes of the crisis, limiting and reversing currency and stock market overshooting, and restoring sustainable growth.

Directors observed that delays in adopting and implementing reform packages had, in some countries, heightened the panic, deepened the crisis, and delayed its resolution. Delays in implementing critical reforms in Indonesia, in particular, had put stabilization and recovery in doubt. Korea and Thailand, in contrast, had made good progress in stabilizing financial markets and in beginning to rebuild confidence through concrete, timely measures backed by the strong resolve and the consistent message conveyed by the authorities. Directors broadly agreed that the Asian crisis countries would record substantial turnarounds in their current account balances in 1998, from deficit to surplus, as domestic demand declined and improved international competitiveness boosted net exports. Nevertheless, many Directors emphasized that the affected countries had to continue to undertake the necessary adjustment, especially in restructuring financial systems.

Role of the International Community

While financial market conditions remained unsettled, a number of Directors emphasized during their December 1997 discussion that the authorities in the major industrial countries should be cautious in considering any further tightening of monetary policy. Most Directors felt that further tightening should be put on hold, particularly given the prospect in most cases of continuing subdued inflation. Some Directors felt, however, that domestic monetary policy should aim solely at dealing with the condition of the domestic economy.

Directors called for resolute action by the Japanese authorities to address the strains in Japan's financial sector, including through the closure of insolvent institutions, and the well-targeted use of public funds to assist in urgently needed restructuring. Most Directors also called for modest expansionary fiscal measures in Japan to help avoid any further withdrawal of fiscal stimulus until recovery was reestablished. Directors also emphasized the need to speed up deregulation to enhance domestic investment opportunities, thereby reducing Japan's persistently large external surplus.

Directors welcomed the fact that, despite the seriousness of the issues confronting many of the Asian economies, growth in North America and Europe had been sustained and was likely to provide support for the global economy in the period ahead. This meant that the economies in difficulty would benefit from a relatively favorable external environment. Directors stressed that, given the medium-term growth potential of the countries at the center of the crisis, they could reasonably expect to regain market confidence once their authorities had addressed structural weaknesses—especially in the financial sector.

In discussing the role of the international organizations in helping contain the crisis, several Directors were concerned about the possible moral hazard implications of the current crisis resolution mechanisms. They stressed the importance of ensuring to the maximum extent that IMF financing did not serve to bail out private creditors. The IMF, other international financial institutions, and the official sector should not assume the burden of financial support alone; private sector creditors should play a part as well.

Concerns about the IMF's ability to contain financial crises and about moral hazard were reflected in the Executive Board's decision, in December 1997, to adopt the Supplemental Reserve Facility (SRF) (see Chapter VIII). SRF financing carries higher interest rates than are charged on other IMF financing to encourage early repayment, to minimize the risk of moral hazard, and to ensure that only those countries with a compelling need will seek recourse to the facility. In addition, the decision establishing the new facility states that a member using IMF resources under the decision is encouraged to seek to maintain participation of creditors, both official and private, until the pressure on the balance of payments ceases. It also states that all options should be considered to ensure appropriate burden sharing. Similarly, in their February 1998 discussion of IMF policy on sovereign arrears to private creditors (see Chapter VIII), Directors emphasized the need to involve private creditors at an early stage of the crisis to ensure adequate burden sharing and limit moral hazard.

At its April 1998 meeting, the Interim Committee, while noting the difficult issues involved, requested the Board to intensify its consideration of possible steps to strengthen private sector involvement, suggested different mechanisms for meeting this objective, and asked the Board to report on all aspects of its work in these areas at the fall meeting of the Committee.

Early Lessons from Experience

In their regular review of members' policies in the context of IMF surveillance, Executive Directors drew several major lessons from the Asian financial crisis (see Chapter VI). In addition, during their March 1998 World Economic Outlook discussion, Directors pointed to the need for the international community to make greater efforts to identify emerging vulnerabilities for preemptive action; at the same time, they recognized that it was impossible to detect all incipient banking and exchange market crises. They thought that study of the Asian financial crisis could provide useful inputs for developing "vulnerability indicators" and early warning signals of imminent crises. Some Directors, however, were concerned about the reliability of such indicators in view of the complexity of the elements contributing to crises. They stressed that the recent experience amply demonstrated the importance of accurate and timely provision of information and, therefore, underscored the need for continued improvements in the coverage, timeliness, and quality of financial statistics, including indicators of bank profitability, interest rate spreads, levels of nonperforming loans, and indicators of competitiveness. They also called for further study of the contagion process.

One lesson that Directors drew from the crisis was that countries had to prepare carefully for the liberalization of capital account transactions to enjoy the benefits of access to global markets while reducing the risk of disruption. Important preconditions for successful liberalization were consistent domestic policies, a sound financial system, and the removal of economic distortions, as well as progress in transparency and disclosure on the part of governments and financial institutions. Some Directors suggested that emerging market countries—at least during a period of transition that might have to be relatively long—should adopt market-based safeguards aimed at limiting the exposure of financial and corporate sectors to reversals of short-term capital movements. This would reduce the risk that capital inflows could become a source of difficulty, rather than a benefit.

Some Directors also remarked that, while currency pegs had served many countries well, it was important to weigh the costs and benefits of these arrangements in the future, and in some cases design exit strategies. Some other Directors, however, cautioned, that a move toward greater exchange rate flexibility should not be regarded as a prescription for averting a financial crisis. Attention had to be paid to ensuring the consistency of the overall policy framework in order to maintain confidence and avoid excessive currency depreciation; this included the establishment of an alternative monetary anchor or inflation target and a preemptive strengthening of the banking system.

Thailand, Indonesia, and Korea: Evolution of IMF-Supported Adjustment Programs

Thailand

The Asian financial crisis started in Thailand with the baht coming under a series of increasingly serious attacks in May 1997, and the markets losing confidence in the economy. In the face of these pressures, the authorities ceased on July 2 to maintain the exchange rate peg. And on August 20, 1997, the Executive Board approved financial support for Thailand of up to SDR 2.9 billion, equivalent to 505 percent of Thailand's quota, over a 34-month period.

The initial program of economic reform featured:

- financial sector restructuring, focusing first on the identification and closure of unviable financial institutions (including 56 finance companies), intervention in the weakest banks, and the recapitalization of the banking system;
- fiscal measures equivalent to about 3 percent of GDP, to shift the consolidated public sector deficit into a surplus of 1 percent of GDP in 1997/98, to support the necessary improvement in the large current account deficit, and cover the interest costs of financial restructuring;
- a new framework for monetary policy in line with the new managed float regime; and
- structural initiatives to increase efficiency, deepen the role of the private sector in the Thai economy, and reinforce its outward orientation, including civil service reform, privatization, and initiatives to attract foreign capital.

The program was modified in a Letter of Intent on November 25, 1997, in light of the baht's subsequent larger-than-expected depreciation, a sharper slowdown than anticipated in the economy, and severe adverse regional economic developments. The modifications included:

- additional measures to maintain the public sector surplus at 1 percent of GDP;
- establishment of a specific timetable for implementing financial sector restructuring, including strategies for the preemptive recapitalization and strengthening of the financial system; and
- acceleration of plans to protect the weaker sectors of society.

The program was further modified in a Letter of Intent on February 24, 1998, and again on May 26, 1998, to give clear priority to stabilizing the exchange rate while limiting the magnitude and the negative social impact of the larger-than-expected economic downturn and to set the stage for Thailand's return to the international financial markets. The modifications provided, among other things, for:

- accelerating financial system restructuring, including the privatization of the four banks in which the authorities had intervened;
- adjusting fiscal policy targets from a targeted public sector surplus of about 1 percent of GDP to a deficit of 3 percent of GDP, allowing automatic stabilizers to work, and in part to finance higher social spending;
- ensuring an adequate availability of credit to help foster an economic recovery, while maintaining a tight monetary stance to support exchange rate stability;
- improving governance in both the corporate and government sectors;
- strengthening the social safety net;
- bringing the legal and regulatory framework, including the bankruptcy law, in line with international standards and consistent with the smooth implementation of corporate debt restructuring and the overall economic program; and
- further deepening the role of the private sector, including through initiatives to attract foreign capital.

Table 4 shows selected economic indicators for Thailand.

Table 4
Thailand: Selected Economic Indicators, as of July 23, 1998

	1995	1996	1997[1]	1998[2]
			Percent change	
Real GDP growth	8.8	5.5	–0.4	–4.0 to –5.5
Consumer prices (end of period)	7.4	4.8	7.7	10.0
			Percent of GDP; a minus sign signifies a deficit	
Central government balance	3.0	2.4	–0.9	–2.4
Current account balance	–7.8	–7.9	–2.0	6.9
			Billions of U.S. dollars	
External debt	82.6	90.5	91.8	89.7
Of which: short-term debt	41.1	37.6	29.9	22.8
			Percent of GDP	
External debt	49.1	49.9	59.6	72.5

Data: Thai authorities; and IMF staff estimates. Central government balance data are for financial years (October 1 to September 30).
[1]Estimate.
[2]May 1998 program.

* * *

Chronological Highlights

1997

August 11 — With negotiations on an adjustment program well advanced, the IMF convenes a meeting of interested countries in Tokyo; total support pledged for Thailand eventually reaches about $17.2 billion.

August 20 — The Board approves an SDR 2.9 billion Stand-By Arrangement for Thailand and releases a disbursement of SDR 1.2 billion.

October 17 — The Board reviews the Stand-By Arrangement under the Emergency Financing Mechanism procedures.

November 25 — Thailand issues a Letter of Intent detailing additional measures.

December 8 — The Board completes the first review under the Stand-By Arrangement and disburses SDR 600 million.

1998

February 24 — Thailand issues a Letter of Intent describing further measures.

March 4 — The Board completes the second review under the Stand-By Arrangement and disburses SDR 200 million.

May 26 — Thailand issues new Letter of Intent.

June 10 — The Board completes the third review under the Stand-By Arrangement, approving a disbursement of SDR 100 million and concluding the 1998/99 Article IV consultation.

Indonesia

The shift in financial market sentiment that originated in Thailand exposed structural weaknesses in Indonesia's economy, notably the weakness of the banking system and the large amount of unhedged short-term foreign debt owed by the corporate sector. On November 5, 1997, the Executive Board approved financial support of up to SDR 7.3 billion, equivalent to 490 percent of Indonesia's quota, over the next three years.

The initial program of economic reform envisaged:

- stabilizing the rupiah by retaining a tight monetary policy;
- financial sector restructuring, including closing unviable institutions, merging state banks, and establishing a timetable for dealing with remaining weak institutions and improving the institutional, legal, and regulatory framework for the financial system;
- structural reforms to enhance economic efficiency and transparency, including liberalization of foreign trade and investment, dismantling of domestic monopolies, and expanding the privatization program; and
- fiscal measures equivalent to about 1 percent of GDP in 1997/98 and 2 percent in 1998/99, to yield a public sector surplus of 1 percent of GDP in both years, to facilitate external adjustment and provide resources to pay for financial restructuring. The fiscal measures included cutting low-priority expenditures, including postponing or rescheduling major state enterprise infrastructure projects; reducing government subsidies; eliminating value-added tax (VAT) exemptions; and adjusting administered prices, including the prices of electricity and petroleum products.

Against the background of a continuing loss of confidence in the Indonesian economy and further sharp declines in the value of the rupiah, owing in part to a lack of progress in implementing the program and to uncertainty with respect to the government's commitment to the program, the Indonesian authorities announced a reinforcement and acceleration of the program in a new Memorandum of Economic and Financial Policies on January 15, 1998. Key reinforcing measures included:

- canceling 12 infrastructure projects and revoking or discontinuing financial privileges for the IPTN's (Nusantara Aircraft Industry's) airplane projects and the National Car project;
- strengthening the bank and corporate sector restructuring effort, including the subsequent announcement of a process to put in place a framework for

creditors and debtors to deal on a voluntary, case-by-case basis with the external debt problems of Indonesian corporations, the establishment of the Indonesian Bank Restructuring Agency (IBRA), and a government guarantee on bank deposits and credits;
- limiting the monopoly of the national marketing board (BULOG) to rice, deregulating domestic trade in agricultural produce, and eliminating restrictive market arrangements;
- adjusting the 1998/99 budget—to provide for a public sector deficit of about 1 percent of GDP—in order to accommodate part of the impact on the budget of the economic slowdown; and
- taking steps to alleviate the suffering caused by the drought, including ensuring that adequate food supplies were available at reasonable prices.

Subsequently, owing to policy slippages, continuing uncertainty about the government's commitment to elements of the program, and other developments, the rupiah failed to stabilize, inflation picked up sharply, and economic conditions deteriorated. The government issued a Supplementary Memorandum of Economic and Financial Policies on April 10, 1998, adapting the macroeconomic policies to the deteriorated economic situation and further expanding the structural and banking reforms agreed in January. The envisaged measures included:
- a substantial strengthening of monetary policy aimed at stabilizing the rupiah;
- accelerated bank restructuring, with IBRA to continue its takeover or closure of weak or unviable institutions and be empowered to issue bonds to finance the restoration of financial viability for qualified institutions; the elimination of existing restrictions on foreign ownership of banks; and the issuance of a new bankruptcy law;
- an extensive agenda of structural reforms to increase competition and efficiency in the economy, reinforcing the commitments made in January and including the further privatization of six major state enterprises already listed and the identification of seven new enterprises for privatization in 1998/99;
- accelerated arrangements to develop a framework with foreign creditors to restore trade financing and resolve the issues of corporate debt and interbank credit;
- strengthening the social safety net through the temporary maintenance of subsidies on food and other essentials, through support for small and medium-sized enterprises, and through public works programs; and
- enhancing the implementation and credibility of the program through daily monitoring of the reform program by the Indonesian Executive Committee of the Resilience Council, in close cooperation with the IMF, the World Bank, and the Asian Development Bank; substantive actions prior to approval of the program by the Executive Board; and provision for frequent reviews of the program by the Board.

The government issued a Second Supplementary Memorandum of Economic and Financial Policies on June 24, 1998, after the economic situation was made worse and the economic program driven off track by social disturbances and political change in May. The envisaged measures gave high priority to strengthening the social safety net, comprehensively restructuring the banking system, and repairing the weakened distribution system. They included:
- increasing social expenditure to 7.5 percent of GDP, with provision for, among other things, food, fuel, medical, and other subsidies (to be phased out after the economy had begun to improve); the expansion of employment-generating programs, supported by the World Bank, Asian Development Bank, and bilateral donors; and aid to students;
- measures to limit the budget deficit to 8.5 percent of GDP, a level that could be financed with foreign funds, including cuts in infrastructure projects and improvements in the efficiency of state-run operations;
- rehabilitating and strengthening the distribution system, following the disruption caused by social disturbances, to ensure adequate supplies of essential commodities—including the establishment of a special monitoring unit to identify potential shortages of foodstuffs or distribution bottlenecks;
- restructuring the banking system by strengthening relatively sound banks—partly through the infusion of new capital—while moving swiftly to recapitalize, merge, or effectively close weak banks, and maintaining the commitment to guarantee all depositors and creditors. The authorities would also establish a high-level Financial Sector Advisory Committee to advise on the coordination of actions for bank restructuring;
- establishing an effective bankruptcy system, as an essential part of the corporate debt-restructuring strategy envisaged by the June 4 agreement between the government and creditor banks on debt restructuring; and
- strengthening the monitoring of the economic program.

Table 5 shows selected economic indicators for Indonesia.

* * *

Chronological Highlights

1997

November 5 The Executive Board approves a Stand-By Arrangement for Indonesia authorizing drawings of up to SDR 7.3 billion, and disburses SDR 2.2 billion.

Table 5
Indonesia: Selected Economic Indicators, as of July 23, 1998

	1995	1996	1997[1]	1998[2]
		Percent change		
Real GDP growth	8.2	8.0	4.6	–13 to –14
Consumer prices (end of period)	9.0	6.6	11.6	80.6
		Percent of GDP; a minus sign signifies a deficit		
Central government balance	0.9	1.2	–0.9	–8.5
Current account balance	–3.2	–3.3	–1.8	1.6
		Billions of U.S. dollars		
External debt	107.8	110.2	136.1	135.0
Of which: short-term debt	9.5	13.4	18.8	. . .
		Percent of GDP		
External debt	53.3	48.5	64.5	162.7

Data: Indonesian authorities; and IMF staff estimates. Fiscal and external sector data are for Indonesian fiscal years (April 1 to March 31).
[1]Estimate.
[2]June 1998 program.

1998

Mid-January IMF management visits Jakarta to consult with President Suharto on an acceleration of reforms already agreed under the program, after further depreciation of the rupiah.

January 15 Indonesia issues Memorandum of Economic and Financial Policies on additional measures.

January 26 The IMF welcomes Indonesia's plans for a comprehensive program to rehabilitate the banking sector and put into place a framework for creditors and debtors to deal, on a voluntary and case-by-case basis, with the external debt problems of corporations.

April 10 Indonesia issues a Supplementary Memorandum of Economic and Financial Policies on additional measures.

May 4 The Board completes the first review under the Stand-By Arrangement and disburses SDR 734 million.

June 24 Indonesia issues a Second Supplementary Memorandum of Economic and Financial Policies on additional measures.

July 15 The Board completes the second review of the Stand-By Arrangement, disbursing SDR 734 million, and approves an increase in IMF financing under the Stand-By Arrangement by SDR 1 billion. The IMF also announces that additional multilateral and bilateral financing for the program will be made available, in part through an informal arrangement among bilateral creditors that involves debt rescheduling or the provision of new money—for total additional financing of more than $6 billion, including the increase in IMF financing.

Korea

Over a number of decades, Korea transformed itself into an advanced industrial economy. Economic overheating, however, led to an increase in structural problems; in particular, the financial system was undermined by excessive government interference in the economy, close linkages between banks and conglomerates, an inadequate sequencing of capital account liberalization, and the lack of prudential regulation that should accompany liberalization. As the Asian financial crisis spread in the latter part of 1997, a loss of market confidence brought the country close to depleting its foreign exchange reserves. On December 4, 1997, the Executive Board approved financing of up to SDR 15.5 billion, equivalent to 1,939 percent of Korea's quota in the IMF, over the next three years.

The initial program of economic reform featured:

- comprehensive financial sector restructuring that introduced a clear and firm exit policy for weak financial institutions, strong market and supervisory discipline, and more independence for the central bank. The operations of nine insolvent merchant banks were suspended, two large distressed commercial banks received capital injections from the government, and all commercial banks with inadequate capital were required to submit plans for recapitalization;
- fiscal measures expected to yield savings equivalent to about 2 percent of GDP to make room for the costs of financial sector restructuring in the budget, while maintaining a prudent fiscal stance. Fiscal measures included widening the bases for corporate, income, and value-added taxes;
- efforts to dismantle the nontransparent and inefficient ties among the government, banks, and businesses, including measures to upgrade accounting, auditing, and disclosure standards, to require that corporate financial statements be prepared on a consolidated basis and certified by external auditors, and to phase out the system of cross guarantees within conglomerates;
- trade liberalization measures, including setting a timetable to eliminate trade-related subsidies and an import diversification program, as well as streamlin-

ing and improving the transparency of import certification procedures;
- capital account liberalization measures to open up the Korean money, bond, and equity markets to capital inflows, and to liberalize foreign direct investment;
- labor market reform to facilitate the redeployment of labor; and
- the publication and dissemination of key economic and financial data.

Table 6
Korea: Selected Economic Indicators, as of July 23, 1998

	1995	1996	1997	1998[1]
		Percent change		
Real GDP growth	8.9	7.1	5.5	–1 to –2
Consumer prices (end of period)	4.7	4.9	6.6	8.2
		Percent of GDP; a minus sign signifies a deficit		
Central government balance	0.3	0.3	0.0	–1.7
Current account balance	–1.9	–4.7	–1.9	7.3
		Billions of U.S. dollars		
External debt	119.7	157.5	154.4	163.3
Of which: short-term debt	78.7	100.0	68.4	39.6
		Percent of GDP		
External debt	26.4	32.5	34.9	51.5

Data: Korean authorities; and IMF staff estimates. Data are for financial years (January 1 to December 31).
[1]May 1998 program.

As described in a Letter of Intent of December 24, 1997, the program was intensified and accelerated as the financial crisis in Korea worsened and concerns about whether international banks would roll over Korean short-term external debt placed additional pressures on international reserves and the won. Announcement of the strengthened program was accompanied by the start of negotiations between the Korean government and creditor banks to extend the maturities of short-term interbank debts. The measures included:
- further monetary tightening and the abolition of the daily exchange rate band;
- speeding up the liberalization of capital and money markets, including the lifting of all capital account restrictions on foreign investors' access to the Korean bond market by December 31, 1997; and
- accelerating the implementation of the comprehensive restructuring plan for the financial sector, including establishing a high-level team to negotiate with foreign creditors and reducing the recourse of Korean banks to the foreign exchange window of the central bank.

A Letter of Intent dated January 7, 1998, provided additional details of the Korean government's external and reserve management strategies and further articulated the financial sector reform program.

In a subsequent Letter of Intent of February 7, 1998, the macroeconomic framework was further revised and the policies that the government intended to pursue for 1998 were set out. These policies, formulated against the background of the January 29 agreement between the Korean authorities and a group of creditor banks on a voluntary debt exchange, included:
- targeting a fiscal deficit of about 1 percent of GDP for 1998 to accommodate the impact of weaker economic activity on the budget and to allow for higher expenditure on the social safety net;
- moving forward to implement a broader strategy of financial sector restructuring, having contained the immediate dangers of disruptions to the financial system;
- increasing the range and amounts of financial instruments available to foreign investors, increasing the access of Korean companies to foreign capital markets, and liberalizing the scope for mergers and acquisitions in the corporate sector; and
- introducing a number of measures to improve corporate transparency, including strengthening the oversight functions of corporate boards of directors, increasing accountability to shareholders, and introducing outside directors and external audit committees.

In a Letter of Intent of May 2, 1998, the Korean authorities updated the program of economic reform in view of the progress made in resolving the external financing crisis, on the one hand, and the even weaker outlook for economic activity, on the other. Positive developments included the conclusion of the restructuring of $22 billion of Korean banks' short-term foreign debt, a successful return to international capital markets through a sovereign global bond issue of $4 billion, the shifting of the current account into substantial surplus, and an increase in usable reserves to more than $30 billion. The measures cited in the Letter of Intent included:
- accommodation of a larger fiscal deficit of about 2 percent of GDP in 1998, in light of weaker growth and through the operation of automatic stabilizers;
- measures to strengthen and expand the social safety net, including through a widening of the coverage of unemployment insurance and increases in minimum benefit duration and levels, as well as a temporary lowering of minimum contribution periods;

- formation of an appraisal committee, including international experts, to evaluate the recapitalization plans of undercapitalized commercial banks;
- publication by August 15, 1998, of regulations to bring Korea's prudential regulations closer to international best practices, including by strengthening compliance with existing guidelines concerning foreign exchange maturity mismatches; and
- further phased liberalization of the capital account, including loosening restrictions on foreign exchange transactions, foreign ownership of certain assets, and ceilings on foreign equity investment in nonlisted companies.

Table 6 (previous page) shows selected economic indicators for Korea.

* * *

Chronological Highlights

1997

December 3 The IMF notes the successful conclusion of staff discussions with the Korean authorities and the pledges of support coming from the World Bank, ADB, and countries in the group of potential participants in the supplemental financing support package for Korea.

December 4 The Board approves an SDR 15.5 billion Stand-By Arrangement for Korea and releases a disbursement of SDR 4.1 billion.

December 18 The Board concludes the first biweekly review of the Stand-By Arrangement and releases a further SDR 2.6 billion, activating the IMF's new Supplemental Reserve Facility.

December 24 Korea issues a Letter of Intent, providing for an intensification and acceleration of its program. The Managing Director announces his intention to recommend to the Board a significant acceleration of the resources available to Korea—in light of Korea's Letter of Intent and in the context of the progress between Korean and international banks in dealing with Korea's external debt—and notes that the World Bank and ADB will disburse $5 billion before the year's end.

December 30 The Board approves a request by Korea for a modification of the schedule of drawings, bringing forward part of the amounts originally scheduled for February and May 1998, but without changing overall access to IMF resources, and disburses SDR 1.5 billion.

1998

January 7 Korea issues a Letter of Intent describing additional measures.

January 8 The Board concludes the second biweekly review of the Stand-By Arrangement and disburses SDR 1.5 billion.

January 29 The government, Korean domestic financial institutions, and international banks announce a debt-rescheduling agreement.

February 7 Korea issues a Letter of Intent on additional measures.

February 17 The Board completes the first quarterly review of the Stand-By Arrangement and disburses a further SDR 1.5 billion.

May 2 Korea issues a Letter of Intent describing additional measures.

May 29 The Board completes the second quarterly review of the Stand-By Arrangement, disbursing an additional SDR 1.4 billion and concluding the 1998 Article IV consultation.

Surveillance

Central to the IMF's purposes and operations is the mandate, under its Articles of Agreement, to "exercise firm surveillance over the exchange rate policies of members." To carry out this mandate, the IMF exercises surveillance through both multilateral and bilateral means. Multilateral surveillance consists of Executive Board reviews of developments in the international monetary system based principally on the staff's World Economic Outlook reports and through periodic discussions of developments, prospects, and key policy issues in international capital markets. Bilateral surveillance takes the form of consultations with individual member countries, conducted annually for most members, under Article IV of the IMF's Articles of Agreement. The Board supplements this systematic monitoring of individual country and global developments with informal related discussions.

Traditionally, the IMF's main focus in surveillance has been to encourage countries to correct macroeconomic imbalances, reduce inflation, and undertake key trade, exchange, and other market reforms. But increasingly, and depending on the situation in each country, a much broader range of institutional measures has been seen as necessary for countries to establish and maintain private sector confidence and lay the groundwork for sustained growth (see Box 2). In 1997/98, in addition to its discussions of regular Article IV consultations, the Board met a number of times to develop guidance in each of these areas.

Article IV Consultations in 1997/98

Consultations under Article IV of the IMF's Articles of Agreement are held with each member country, for the most part, every year. An IMF staff team visits the country, collects economic and financial information, and discusses with the authorities the economic developments and the monetary, fiscal, and structural policies they are following. The staff generally prepares a concluding statement for discussion with the authorities at the end of the visit; in some instances, the concluding statement is released to the public. On its return to headquarters, the staff team prepares a report analyzing the economic situation and evaluating the stance of policies. This report is then discussed by the Executive Board. At the end of the discussion, the Chairman of the Board summarizes the views expressed by Directors during the meeting. This "summing up" is transmitted to the country's authorities. It is then released to the public—at the option of the country—in the form of a Press (now "Public") Information Notice (see Box 3). During 1997/98, the IMF concluded 136 Article IV consultations (Table 7).

To ensure more continuous and effective surveillance, the Board supplements this systematic monitoring of individual country developments with regular informal sessions—sometimes monthly, or even more frequently—on significant developments in selected countries and regions. It also meets regularly to discuss world economic and financial market developments. These continuing assessments by the Board inform and guide the work of IMF staff on member countries and are communicated to national authorities by Executive Directors.

Other Means of Surveillance

Surveillance through Article IV consultations is the main channel for collaboration between the IMF and its members. In addition, for members facing balance of payments difficulties, formal financial arrangements for the immediate use of IMF resources provide a framework for more intensive collaboration (see Chapter VIII). In some cases, members collaborate with the IMF in other ways, such as precautionary financial arrangements, informal staff-monitored programs, and enhanced surveillance.

- *Precautionary Arrangements.* Members agree with the IMF on a Stand-By or Extended Arrangement but do not intend to use resources committed under these arrangements unless circumstances warrant. The country has the right, however, to draw on the resources provided it has met the conditions agreed in the arrangement. Such arrangements help members by providing a framework for economic policy and highlighting the IMF's endorsement of its poli-

Box 2
Second-Generation Reforms

Although macroeconomic stability, liberalization, and the basic institutional framework of a market economy are essential for strong growth, the IMF's experience with its member countries has shown that deeper and broader-based reforms are necessary to achieve high-quality growth that is sustainable and more equitably shared. Such reforms—so-called second-generation reforms—cover a number of areas highlighted most recently by the Asian financial crisis.

The IMF, in collaboration with the World Bank, has been contributing to second-generation reforms in member countries through its surveillance (along with other international organizations as appropriate), technical assistance, and financing, on several fronts:

- helping members strengthen the efficiency and robustness of their financial sectors, including through appropriate prudential oversight;
- helping members enhance the transparency of fiscal policy and practices and the quality, timeliness, and dissemination of economic and financial data to reduce the risk of disruptive changes in investor confidence when economic or financial problems appear;
- helping members improve governance by establishing a simple and transparent regulatory environment and a professional and independent judicial system that will uphold the rule of law, including property rights;
- assisting members in redefining the role of the state in the economy as a positive force for private sector activity, including through the restructuring and privatization of state-owned enterprises and by generally reducing government intervention in areas where market forces provide greater efficiency;
- helping improve the quality of public expenditure in member countries, for example, through greater attention to education and health spending; and
- helping members promote greater flexibility of labor markets.

cies, thereby boosting confidence in them. They also assure the country that IMF resources will be available if needed and provided the agreed conditions are met.

- *Informal Staff-Monitored Programs.* IMF staff monitor the country's economic program and regularly discuss progress under that program with the authorities; however, there is no formal IMF endorsement of the member's policies.
- *Enhanced Surveillance.* This also does not constitute formal IMF endorsement of a member's economic policies. Rather, the emphasis is on close and formal monitoring by the IMF. The procedure was initially established to facilitate debt-rescheduling arrangements with commercial banks but has been used occasionally in other situations.

In a few cases, the intensified monitoring described above has been a prelude to an IMF-supported adjustment program. More often, monitoring provides the authorities with a framework to reassure interested third parties, such as donors, creditors, or financial markets.

Lessons for Surveillance from the Asian Crisis

In March 1998, the Executive Board undertook its regular review of members' policies in the context of surveillance, this time focusing on the lessons for surveillance from the Asian crisis. In their review, Directors noted that the IMF's performance in identifying emerging tensions in crisis-affected countries at an early stage had been mixed. In the case of Thailand, the IMF had expressed serious concerns about economic developments beginning in 1996—concerns conveyed to the authorities in several ways, including through confidential contacts at the highest level. Indeed, the IMF appeared to have been more aware of the risks in Thailand's economic policy course than had most market observers. In other cases in Asia, however, the IMF—while having identified critical weaknesses, particularly in the financial sector—had been taken by surprise, owing in part to the lack of access to requisite information and also to an inability to see the full consequences of the combination of structural weaknesses in the economy and contagion effects. In particular, in the case of Korea, the IMF had not attached sufficient urgency to the financial tensions that had begun developing in early 1997.

With hindsight it was clear that the affected countries' vulnerabilities had been underestimated, including by the markets. Directors also remarked that some other emerging market economies had taken timely and sustained policy measures in the face of market pressures and had been able to fend off spreading turmoil successfully. In those cases, close IMF surveillance had been helpful. Some Directors stressed that it was unrealistic to expect IMF surveillance to detect all problems early and prevent all crises, and that the contagion effects of the crisis in Thailand were, to a large extent, unpredictable. Nevertheless, they encouraged the staff, in exercising surveillance, to place increased emphasis on the risks of contagion effects.

Directors agreed that the experience of the past nine months had provided valuable lessons for the IMF and for the international financial community. Events were still unfolding, and many issues would need revisiting, including the design and implementation of IMF-supported programs; the role of the IMF and other official financing for these programs; collaboration between the IMF and other international institutions, especially the World Bank; the role of the private sector in crisis situations; and the IMF's policy on public information. To this end, it was agreed early in the new financial year 1998/99 that a review of the experience with IMF programs in the Asian crisis countries should be undertaken before the October 1998 Annual Meetings to address questions of program orientation and design, implementation, and, to the extent possible, early program results. The experience with the Asian crisis countries would also be examined in 1998/99 as part of the world economic outlook exercise and in the context of the annual report on international capital markets. The lessons from the Asian experience would be reflected in several papers addressing various aspects of strengthening the architecture of the international monetary system, focusing on the availability and the dissemination of economic data, transparency in members' policies and in IMF surveillance, and the role of international standards in assessing countries' policies and practices. There would also be further Board discussion on establishing appropriate incentives for international financial flows by involving the private sector in forestalling or resolving financial crises. The IMF would be incorporating lessons from the Asian crisis in its continuing work on orderly and appropriately sequenced capital account liberalization. In addition, the experience with World Bank–IMF collaboration, notably in the area of financial sector reform, would be reviewed with the aim of identifying areas with scope for improvement.

In March 1998, looking at IMF surveillance, Directors identified five main lessons.

Box 3

Enhancing Information on Article IV Consultations

Since May 1997, the Executive Board has been issuing Press (now "Public") Information Notices (PINs) following the conclusion of Article IV consultations with members. PINs set out:

- a background description of the country's economic situation at the time of the consultation;
- the Board's assessment of that situation and the country's policies as detailed in the Chairman's summing up of the Board's discussion; and
- a table of selected economic indicators.

PINs are issued on a voluntary basis, at the request of countries seeking to make public the views of the IMF on their policies and prospects. Of the 136 consultations completed during 1997/98, 77 resulted in the issuance of PINs (see Table 7). The full text of PINs is available on the IMF's website (http://www.imf.org). Collections of PINs are also being published three times a year in a new IMF publication, *IMF Economic Reviews;* the first issue was released in May 1998.

Lesson One

The effectiveness of surveillance depended critically on the timely availability of accurate information. Directors saw some improvement since 1995 in members' provision of data, both to the IMF and to the markets, but felt that further progress was essential. The Asian crisis had revealed the critical importance of certain data that had not been available, either because the authorities had been reluctant to provide them, such as reserve-related liabilities of the central bank, or because systems did not exist to produce timely data, such as that on private short-term debt. The crisis had also demonstrated that adequate provision of data to the public was important for promoting transparency and strengthening market confidence. Directors emphasized that further efforts to strengthen members' provision of data to the IMF and to the public could be realized through the Special Data Dissemination Standard; in both domains, the monitoring of compliance had to be strengthened. Several Directors cautioned that access to highly sensitive data or data for which appropriate standards were not yet universally adopted, such as prudential indicators, had to be handled carefully. Directors particularly stressed the importance of compiling timely and accurate data on short-term external debt, while recognizing that this would require substantial statistical efforts on the part of most countries concerned. It was agreed that, in cases where countries were unable to collect the required data, technical assistance—including from the IMF in its areas of competence—was important. In the meantime, more attention should be paid to using and improving existing data sources, including data from the Bank for International Settlements.

More generally, considering the changing architecture of the international financial system and the variety of data sources, some Directors felt that the IMF needed to begin work with other international organizations, including national regulatory authorities and market participants, toward developing a conceptual framework for data compilation and dissemination. Directors strongly urged the staff to bring to the Board's attention cases where its inability to obtain the necessary data had hampered effective surveillance, and they suggested that ways to strengthen the IMF's reaction to such cases be explored. Some Directors suggested that consideration be given to not concluding Article IV consultations where members' willingness to provide the IMF with the data required for surveillance was in question. This view was endorsed by the Interim Committee, which in its April 1998 meeting recommended that if persistent deficiencies in disclosing relevant data to the IMF seriously impede surveillance, conclusion of Article IV consultations should be delayed.

Lesson Two

The focus of surveillance had to extend beyond short-term macroeconomic issues, while remaining appropri-

Table 7
Article IV Consultations Concluded in 1997/98

Country	Board Date	PIN Issued
Algeria	June 27, 1997	July 23, 1997
Angola	October 8, 1997	—
Antigua and Barbuda	December 3, 1997	December 17, 1997
Argentina	February 4, 1998	February 23, 1998
Armenia	February 6, 1998	March 12, 1998
Aruba	May 19, 1997	May 27, 1997
Austria	June 13, 1997	June 20, 1997
Bahamas, the	March 13, 1998	March 31, 1998
Bahrain	March 4, 1998	—
Bangladesh	August 18, 1997	—
Barbados	January 30, 1998	February 25, 1998
Belarus	August 21, 1997	—
Belgium	February 23, 1998	March 3, 1998
Belize	May 12, 1997	June 5, 1997`
Bolivia	September 10, 1997	September 19, 1997
Botswana	March 13, 1998	April 10, 1998
Brazil	February 11, 1998	March 13, 1998
Brunei Darussalam	October 6, 1997	—
Bulgaria	July 23, 1997	July 29, 1997
Burundi	October 8, 1997	—
Cambodia	April 27, 1998	—
Cameroon	January 7, 1998	January 21, 1998
Canada	January 30, 1998	February 19, 1998
Cape Verde	February 20, 1998	March 10, 1998
Chad	June 13, 1997	July 15, 1997
Chile	February 11, 1998	February 20, 1998
China, People's Republic of	June 30, 1997	—
Colombia	June 6, 1997	—
Comoros	October 8, 1997	—
Costa Rica	March 18, 1998	May 14, 1998
Côte D' Ivoire	March 17, 1998	—
Czech Republic	February 13, 1998	March 6, 1998
Djibouti	May 21, 1997	—
Dominica	May 23, 1997	June 27, 1997
Dominican Republic	August 21, 1997	September 17, 1997
Ecuador	September 3, 1997	—
Egypt	January 7, 1998	—
El Salvador	February 20, 1998	April 6, 1998
Equatorial Guinea	February 2, 1998	—
Eritrea	July 28, 1997	—
Estonia	December 17, 1997	December 24, 1997
Ethiopia	November 21, 1997	—
Finland	July 14, 1997	July 23, 1997
France	October 22, 1997	November 4, 1997
Gabon	May 21, 1997	—
Gambia, the	October 6, 1997	—
Germany	August 25, 1997	August 29, 1997
Ghana	October 31, 1997	December 1, 1997
Greece	August 1, 1997	—
Grenada	October 6, 1997	October 22, 1997
Guinea	April 3, 1998	April 29, 1998
Guinea-Bissau	March 6, 1998	March 26, 1998
Guyana	December 22, 1997	—
Hong Kong SAR	January 26, 1998	February 16, 1998
Hungary	September 8, 1997	—
India	July 2, 1997	July 16, 1997
Indonesia	July 9, 1997	—
Iran, Islamic Republic of	January 30, 1998	—
Ireland	July 2, 1997	July 25, 1997
Israel	February 11, 1998	March 10, 1998
Italy	March 13, 1998	—
Jamaica	September 8, 1997	October 2, 1997
Japan	July 25, 1997	August 13, 1997
Jordan	April 23, 1998	—
Kazakhstan	June 20, 1997	—
Kiribati	June 2, 1997	—
Kuwait	October 15, 1997	February 3, 1998
Kyrgyz Republic	December 12, 1997	—
Laos	June 16, 1997	—
Latvia	March 23, 1998	April 14, 1998
Lebanon	December 12, 1997	—
Lesotho	February 4, 1998	—
Lithuania	June 25, 1997	July 14, 1997
Madagascar	September 10, 1997	October 28, 1997
Malawi	September 12, 1997	—
Malaysia	September 5, 1997	—
Malaysia[1]	April 20, 1998	April 27, 1998
Maldives	January 26, 1998	—
Mali	December 22, 1997	April 1, 1998
Malta	May 23, 1997	—
Mauritania	July 14, 1997	August 27, 1997
Mexico	September 2, 1997	—
Moldova	April 20, 1998	May 27, 1998
Mongolia	July 30, 1997	September 3, 1997
Morocco	March 6, 1998	March 31, 1998
Mozambique	April 7, 1998	April 30, 1998
Namibia	October 22, 1997	—
Nepal	May 28, 1997	June 13, 1997
Netherlands	June 12, 1997	July 1, 1997
New Zealand	November 7, 1997	January 12, 1998
Nicaragua	March 18, 1998	April 9, 1998
Niger	July 28, 1997	—
Norway	February 23, 1998	March 9, 1998
Pakistan	October 20, 1997	November 4, 1997
Panama	December 10, 1997	December 22, 1997
Papua New Guinea	January 23, 1998	—
Paraguay	October 10, 1997	October 22, 1997
Peru	June 25, 1997	—
Philippines	March 27, 1998	—
Poland	March 16, 1998	March 30, 1998
Portugal	October 17, 1997	November 7, 1997
Qatar	June 23, 1997	—
Russian Federation	May 16, 1997	—
São Tomé and Príncipe	July 16, 1997	—
Senegal	July 28, 1997	August 26, 1997
Sierra Leone	May 5, 1997	—
Singapore	February 20, 1998	March 16, 1998
Slovak Republic	February 13, 1998	—
Slovenia	January 9, 1998	January 26, 1998
South Africa	July 11, 1997	August 25, 1997

Table 7 *(concluded)*

Country	Board Date	PIN Issued	Country	Board Date	PIN Issued
Spain	March 16, 1998	April 6, 1998	Turkey	July 9, 1997	August 5, 1997
Sri Lanka	July 23, 1997	August 5, 1997	Turkmenistan	May 21, 1997	—
St. Kitts and Nevis	June 18, 1997	June 26, 1997	United Arab Emirates	October 8, 1997	—
St. Vincent	December 3, 1997	December 17, 1997	Uganda	April 8, 1998	June 11, 1998
Sudan	February 27, 1998	April 13, 1998	Ukraine	August 25, 1997	—
Suriname	June 4, 1997	—	United Kingdom	October 27, 1997	November 6, 1997
Sweden	August 22, 1997	September 2, 1997	United States	July 28, 1997	August 4, 1997
Switzerland	February 20, 1998	March 6, 1998	Uruguay	June 20, 1997	—
Tajikistan	December 19, 1997	—	Uzbekistan	July 30, 1997	—
Tanzania	December 3, 1997	December 23, 1997	Vietnam	February 2, 1998	—
Thailand	June 13, 1997	—	Yemen	October 29, 1997	—
Togo	January 21, 1998	February 19, 1998	Zambia	October 8, 1997	—
Tunisia	May 23, 1997	June 5, 1997	Zimbabwe	May 21, 1997	—

[1]Malaysia's 1998/99 Article IV consultation was advanced to April 20, 1998.

ately selective. There had been increased coverage and analysis of key structural policies, especially financial sector policies, in emerging market economies since 1995. Problems in the financial sector were often complex and long in gestation, however, and many Directors felt that the IMF needed to develop more expertise in their analysis, including by expanding staff resources with the relevant experience. Noting that the IMF's comparative advantage was in analyzing macroeconomic developments, some Directors felt that financial sector restructuring should be left to other institutions, especially the World Bank. Others considered that, in the context of the Asian crisis, such a distinction had not always been easy to draw, and that the initial intensive role of the IMF in all aspects of the financial sector reforms had been essential. Collaboration with other institutions, it was agreed, had to be close and aimed at avoiding duplication of efforts, especially those of the World Bank, as well as national supervisory authorities and the BIS. Several Directors emphasized the usefulness of developing standards in a variety of areas that could help in the conduct of surveillance and provide information to markets; they suggested that IMF surveillance could usefully encourage members to adapt their practices in line with international standards, such as those laid out in the Basle Committee on Banking Supervision's *Core Principles on Banking Supervision.*

The vulnerability of many emerging market economies to large capital flows was seen as underlining the importance, also, of close IMF surveillance over capital account issues. Some Directors stressed the need to monitor carefully the sequencing and the pace of moves toward capital account liberalization. In particular, IMF surveillance should focus on the risks posed by the potential reversal of large capital flows, the rapid accumulation of short-term external debt, and the impact of selective capital account liberalization. In this area, too, Directors stressed the critical importance of accurate and timely data. A few speakers proposed that consultation reports systematically address progress toward capital account liberalization. Some other Directors thought that the experience of the previous nine months suggested that selective, well-targeted capital controls could play a useful role in reducing a country's vulnerability. Most Directors, however, were skeptical that introducing controls in economies with already relatively open capital accounts could be helpful, beyond perhaps providing temporary breathing space to put in place more fundamental adjustment policies.

Lesson Three

In an environment of increased financial and trade flows between countries, IMF surveillance at the country level should pay greater attention to policy interdependence and to the risks of contagion. How policies in systemically or regionally important countries affect other countries should receive closer attention, Directors remarked. At the same time, the vulnerability of domestic conditions to external developments should be examined in bilateral consultations, with the objective of urging early, forceful action to mitigate the risks of contagion. Directors noted that multilateral surveillance could help in identifying potential spillover effects; they underlined the importance of more fully integrating the IMF's multilateral surveillance exercises with its bilateral dialogue with members and ensuring that the available staff expertise in capital market and financial sector issues was fully used in bilateral surveillance. Many Directors also supported a more frequent and systematic exchange of views between staff and market participants as part of surveillance; they considered that, in relevant cases, staff reports should include a summary assessment

Box 4
IMF Regional Office for Asia and the Pacific

The establishment of a new Regional Office for Asia and the Pacific in Tokyo reflects the importance of the Asia-Pacific region in the global economy and for the work of the IMF. The Director of the Office, Kunio Saito, administers a staff of 10. The main functions of the Office include the following:

- *Regional Policy Forums.* The Office is responsible for the IMF's dialogue with Asian policymakers that is conducted through various regional policy forums, including the Manila Framework Group, Asia-Pacific Economic Cooperation (APEC), Association of South East Asian Nations (ASEAN), and the Executives' Meeting of East Asian and Pacific Central Banks and Monetary Authorities (EMEAP), and for facilitating regional and mutual surveillance activities. The Manila Framework Group brings together deputies from ministries of finance and central banks of 14 economies across the region. It is the principal new grouping aimed at strengthening surveillance, enhancing cooperation, and promoting financial stability in the region. The Regional Office provides the Secretariat for this Group.
- *Financial Market Surveillance.* The Office monitors and analyzes financial markets in the region with a view to ensuring that the IMF has timely and comprehensive knowledge of market developments and trends. This analysis deepens the IMF's understanding of economic developments in the region and is an important element in strengthening surveillance.

The Office also undertakes a wide range of external relations activities, and facilitates the delivery of technical assistance and training in the region.

of market sentiment. A few Directors cautioned that such contacts should take into account the confidentiality of the IMF's dialogue with members.

Lesson Four

The crucial role of credibility in restoring market confidence underscored the importance of transparency. In this regard, Directors welcomed the decision by the authorities in Indonesia, Korea, and Thailand to release the Letters of Intent to the IMF detailing their adjustment programs. Several Directors also welcomed the fact that an increasing number of countries were agreeing to the release of Press (now "Public") Information Notices, summarizing the content of Article IV consultations in the Board, and felt that it would be desirable if as many countries as possible could agree to do so. Some Directors felt that the IMF could go further in disseminating its views on the economic policies of its members; they suggested revisiting the issue of publication of staff reports for Article IV consultations. Some other Directors, however, advocated a more cautious approach, noting that maintaining confidentiality was key to effective surveillance. A few Directors also supported the suggestion that if, after a period of time, a member continued to ignore IMF warnings expressed confidentially, the IMF should, as a last resort, make use of the provision of Article XII, Section 8, of its Articles of Agreement, to make its concerns known to the public. But most Directors doubted that more public warnings would increase the effectiveness of surveillance. They were particularly concerned that the threat of publicity would jeopardize the frank dialogue between the IMF and member countries and that public warnings could accelerate crises rather than prevent them.

Lesson Five

The effectiveness of IMF surveillance depended crucially on the willingness of members to take its advice. A candid dialogue and the ability of the IMF to focus on the issues of importance to individual members were vital for effective surveillance. In addition, Directors emphasized the opportunity for IMF staff to harness the opinions of the international community by engaging in regional forums more actively; they believed the IMF should work closely with such forums in Asia and elsewhere (Box 4). Some Directors noted the importance of peer pressure both in regional forums and through the Board. Directors welcomed the IMF's involvement in the discussions of the Asia-Pacific Economic Cooperation Council and the Second Manila Framework Meeting in Tokyo.

Government Transparency and Accountability

The IMF has long provided advice and technical assistance to help foster good governance in member countries, including by promoting public sector transparency and accountability. In recent years, increased attention has been focused on issues associated with good governance. In particular, in its Declaration on Partnership for Sustainable Global Growth, adopted in September 1996, the IMF's Interim Committee identified "promoting good governance in all its aspects, including ensuring the rule of law, improving the efficiency and accountability of the public sector, and tackling corruption" as essential for helping economies prosper. Similarly, at its April 1998 meeting, the Interim Committee, in an effort to enhance the accountability and credibility of fiscal policy as a key feature of good governance, adopted a Code of Good Practices on Fiscal Transparency: Declaration on Principles.

In 1997/98, the IMF's Executive Board met a number of times to develop guidance for the institution regarding governance issues and a code of good practices for member countries in the area of fiscal transparency.

Good Governance

In a discussion of the IMF's role in governance issues in May 1997, Executive Directors strongly endorsed the importance of good governance for economic efficiency and growth. It was observed that the IMF's role in this area was evolving pragmatically as more was learned about the contribution that greater attention to governance issues could make to macroeconomic stability and sustainable growth in member countries. Directors strongly supported the role the IMF had been playing in this area in recent years through its policy advice and technical assistance and welcomed the aim of ensuring a more comprehensive treatment, in the context of both Article IV consultations and IMF-supported programs, of governance issues within the IMF's mandate and expertise. Directors stressed the need for evenhandedness in the treatment of governance issues in all member countries. Directors also felt the IMF's efforts to encourage good governance had to be supported by enhanced collaboration with other multilateral institutions—in particular, the World Bank—to make better use of complementary areas of expertise.

Governance issues were, first and foremost, the responsibility of national authorities, Directors stressed. Wherever possible, IMF staff should build on the willingness of those authorities to address such issues. The IMF's mandate did not allow the institution to assume the role of an investigative agency or guardian of financial integrity in member countries.

Directors emphasized that the IMF's involvement in governance should focus on its economic aspects. The IMF could contribute to good governance principally in two spheres: improving the management of public resources and supporting the development and maintenance of a transparent and stable regulatory environment conducive to efficient private sector activities. In this context, Directors emphasized the potential benefits of such reforms as enhancing the transparency and accountability of public sector activities and providing a level playing field for the private sector. In addressing governance issues, the IMF should be guided by an assessment of whether the issue in question would have significant current or potential impact on macroeconomic performance in the short and medium term. Directors cautioned that the IMF should remain apolitical in its dealings on issues relating to governance. At the same time, they acknowledged that a clear delineation between the economic and political dimensions of governance was often difficult in practice: what was important was that the IMF's advice be based on solid economic considerations within its mandate.

Directors emphasized that weak governance that threatened macroeconomic performance should be tackled early on in reform efforts. Although the requirement to safeguard IMF resources was primarily addressed through the implementation of appropriate macroeconomic adjustment policies, Directors recognized that governance issues could influence macroeconomic performance and the effectiveness of those policies. Thus, conditionality could be attached to policy measures relating to governance if those measures were necessary for the achievement of the program's objectives.

In the wake of the May discussion, on July 25, 1997, the Executive Board adopted guidelines addressing the IMF's role in governance issues.[8] The guidelines seek to promote greater attention by the IMF to governance issues, in particular through:

- a more comprehensive treatment in the context of both Article IV consultations and IMF-supported adjustment programs of those governance issues within the IMF's mandate and expertise;
- a more proactive approach in advocating policies and the development of institutions and administrative systems that eliminate the opportunity for bribery, corruption, and fraudulent activity in the management of public resources;
- an evenhanded treatment of governance issues in all member countries; and
- enhanced collaboration with other multilateral institutions, in particular the World Bank, to make better use of complementary areas of expertise.

Transparency in Budgetary Operations

Fiscal transparency can be defined as openness toward the public at large about government structure and functions, fiscal policy intentions, public sector accounts, and projections. It means ready access to reliable, comprehensive, timely, understandable, and internationally comparable information on government activities—including those activities undertaken outside the government sector—so that the electorate and financial markets can accurately assess the government's current and future financial position. Noting that fiscal policy is a key focus of IMF surveillance, and with the aim of strengthening the approach of governments to fiscal policy issues, the Executive Board took up the questions of transparency in government operations and fiscal policy rules in October 1997. And in April 1998, the Board agreed on a draft code of good practices in the area of fiscal transparency for submission to the Interim Committee.

In their October 1997 discussion, Directors agreed that transparency in government operations was conducive to fiscal discipline, sound public sector management, good governance, and improved macroeconomic performance. Moreover, in a globalized economy, where the costs of loss of market confidence had

[8]Published as IMF, *Good Governance: The IMF's Role* (1997); also available at http://www.imf.org.

become increasingly clear, fiscal transparency helped instill confidence in a government's economic policies. Fiscal transparency entailed setting out clear fiscal objectives, building clear institutional arrangements (including a proper budgetary process), using transparent and widely accepted accounting methods, and providing timely and reliable information.

The IMF should continue to help its members achieve greater fiscal transparency through surveillance, technical assistance, and program design, Directors agreed. Improving fiscal transparency was a multiyear endeavor, and the priorities for improving transparency could differ among countries. Therefore, the IMF should pay due regard to the specific circumstances of individual countries. Some Directors stressed that the IMF's involvement in fiscal transparency should focus on issues of macroeconomic significance, and they noted the need for an evenhanded approach.

Directors supported greater emphasis in the staff's surveillance work on promoting transparency in government operations. Many favored asking the staff to prepare a brief manual of good practices for fiscal transparency, while some Directors expressed reservations about establishing "best practices." Some others considered that the staff could gradually accumulate an inventory of transparent practices in the context of Article IV consultations. Many Directors cautioned about the resource implications of any such initiative.

Timely and comprehensive reporting of public sector accounts was also important. To this end, Directors urged that the coverage of fiscal accounts be extended to the general government level and include information on off-budget operations and the cost of quasi-fiscal activities. Also, cash-based recording should be supplemented with accrual-based recording of transactions. Where possible, the authorities should publish information on guarantees and unfunded public sector liabilities. Noting that discretionary tax relief, tax exemptions, and arbitrary tax administration were among the most important problems affecting fiscal performance in many countries, Directors also stressed the need for transparent and stable tax systems and for estimates of tax expenditures as part of the budget process.

Fiscal Policy Rules. In October 1997, the Executive Board also discussed the strengths and weaknesses of fiscal policy rules. These included such permanent restraints on fiscal policy as balanced budget or deficit rules, borrowing rules, and debt or reserve rules. Many Directors commented favorably on the potential usefulness of such rules in strengthening or restoring policy credibility in specific circumstances. Some also noted the usefulness of fiscal rules and limits in the context of common currency areas, citing the benefits for fiscal convergence in the European Union that had accrued from the fiscal reference values under the Maastricht Treaty.

At the same time, Directors cautioned that fiscal rules were not a panacea. Good economic performance depended on the political will to implement sound policies; simply promulgating rules without building the political consensus to put in place the implied sound policies was unlikely to yield the desired results. The view was also expressed that it might be difficult in practice for fiscal policy rules to embody all the properties of the model rule outlined by the staff (i.e., that it be well-defined, transparent, adequate, consistent, simple, flexible enough to accommodate exogenous shocks and cyclical fluctuations in activity, enforceable, and efficient).[9] Moreover, attempts at complying with a fiscal rule through excessive reliance on tax rate increases and unsustainable or cosmetic expenditure cuts, or one-off measures, might tend to be counterproductive. Directors indicated that there were circumstances in which fiscal rules could prove useful for countries to institutionalize better macroeconomic policies. Where members were interested in formulating fiscal rules, or incorporating them in the design of adjustment programs, Directors believed that the IMF should be prepared to provide policy advice and technical assistance.

Code of Good Practices on Fiscal Transparency. Following further work by the staff in light of the October 1997 discussion, a draft code of good practices on fiscal transparency was submitted for the Board's consideration in April 1998. The underlying rationale was that fiscal transparency could lead to better-informed public debate about the design and results of fiscal policy, make governments more accountable for the implementation of fiscal policy, and thereby promote good governance, strengthen credibility, and mobilize popular support for sound macroeconomic policies. Because of the IMF's fiscal management expertise, it was well placed to take the lead in promoting greater transparency in this area. The draft presented to the Board set out specific principles and practices that a government could implement to ensure that:

- roles and responsibilities in the government are clear;
- information on government activities is provided to the public;
- budget preparation, execution, and reporting are undertaken in an open manner; and
- fiscal information is subjected to independent assurances of integrity.

Directors generally welcomed the draft code. Most saw merit in reaching a consensus on the broad principles and essential elements of a transparent approach to fiscal management and stressed the importance of moving ahead with a proposed manual to address some of

[9]Published as IMF, *Fiscal Policy Rules,* IMF Occasional Paper 162 (1998).

the practical issues that could arise. They also suggested that the code be subject to periodic review and revision.

Directors pointed out that implementation of the code should be tailored to individual country circumstances, with recognition of the legitimate differences in approach that countries might take to improving fiscal transparency. For countries with weaker institutions or binding legal constraints, progress toward achieving fiscal transparency consistent with the code might take time. The IMF had to be prepared to provide technical assistance, in cooperation with other international organizations, to those countries that requested it.

At its April 1998 meeting, the Interim Committee adopted the Code of Good Practices on Fiscal Transparency—Declaration on Principles (Box 5; the full text is reproduced in Appendix VI), recognizing that implementation would be affected by diversity in fiscal institutions, legal systems, and implementation capacity.

Box 5

Code of Good Practices on Fiscal Transparency: Declaration on Principles

The Code's main provisions are as follows:

Clarity of Roles and Responsibilities

- The government sector should be clearly distinguished from the rest of the economy, and policy and management roles within government should be well defined.
- There should be a clear legal and administrative framework for fiscal management.

Public Availability of Information

- The public should be provided with full information on the past, current, and projected fiscal activity of government.
- A public commitment should be made to timely publication of fiscal information.

Open Budget Preparation, Execution, and Reporting

- Budget documentation should specify fiscal policy objectives, the macroeconomic framework, the policy basis for the budget, and identifiable major fiscal risks.
- Budget estimates should be classified and presented in a way that facilitates policy analysis and promotes accountability.
- Procedures for the execution and monitoring of approved expenditures should be clearly specified.
- Fiscal reporting should be timely, comprehensive, and reliable and identify deviations from the budget.

Independent Assurances of Integrity

- The integrity of fiscal information should be subject to public and independent scrutiny.

Data Issues

Economic policymakers and financial institutions and markets—public and private—rely on information. When underlying information about the true economic and financial situation of countries, banks, and enterprises is poor, when disclosure of available information is limited, and when potentially damaging information can be disguised or withheld, national and international financial systems work less efficiently. Thus, the international community encourages the development and promulgation of sound information practices, in accord with broadly accepted international norms.

For its part, the IMF has paid increasing attention in recent years to data issues—the comprehensiveness, quality, frequency, and timeliness of the data that members provide to it, and the data that members disseminate to the public. To guide members in the latter, the Board has endorsed a two-tiered approach: a Special Data Dissemination Standard (SDDS), established in March 1996, to guide member countries that have or might seek access to international financial markets, and a General Data Dissemination System (GDDS), approved by the Board in December 1997, to guide all member countries. In September 1996, the IMF opened an electronic bulletin board on the Internet that provides public access to information about the data dissemination practices of members that subscribe to the SDDS (Box 6).

Members' Provision of Information to the IMF

In December 1997, the Board conducted its third review of progress by members in providing data to the IMF for surveillance. Directors noted the provision of core indicators by member countries to the IMF had continued to improve modestly (this refers to data on exchange rates, international reserves, reserve or base money, broad money, interest rates, consumer prices, exports and imports, external current account balance, overall government balance, gross domestic product or gross national income, and external debt). But they expressed concern that some members did not provide these data regularly or in a timely way, and that, in a number of cases, lags in data provision had continued or even increased. Directors urged members to improve the timeliness and frequency of their data reporting.

Recent experience had also suggested that the core indicators needed to be complemented by other data in light of the circumstances of individual countries, so as to increase the effectiveness of surveillance in the period between Article IV consultations and to identify emerging financial market tensions. Directors identified reserve-related liabilities, central bank derivative transactions, private sector external debt, and prudential-type bank indicators as desirable supplementary data. Within these broad categories, Directors identified a number of specific data items—including forward

Box 6

Dissemination Standards Bulletin Board

The DSBB is a tool for market analysts and others who track economic growth, inflation, and other economic and financial developments in countries around the world. It describes the statistical practices—such as methodologies and data release calendars—of countries subscribing to the Special Data Dissemination Standard (SDDS) in key areas: the real, fiscal, financial, and external sectors. It also describes steps subscribers have taken to improve practices to move toward full observance of the SDDS by the end of the transition period.

Beginning in April 1997, electronic links (hyperlinks) between the bulletin board and actual data on national data sites have been established, enabling users to move directly from the bulletin board to current economic and financial data on an Internet site maintained by the subscriber. (The links do not indicate IMF endorsement of the data.) The bulletin board can be accessed on the Internet at http://dsbb.imf.org, or through the IMF's website, http://www.imf.org.

Subscribers to the SDDS as of the end of April 1998 are listed below; those for which hyperlinks were in place are indicated by an asterisk:

Argentina*	France	Korea	Singapore*
Australia	Germany	Latvia	Slovak Republic
Austria	Hong Kong SAR*	Lithuania	Slovenia*
Belgium	Hungary	Malaysia	South Africa*
Canada*	Iceland	Mexico*	Spain
Chile	India	Netherlands	Sweden
Colombia*	Indonesia	Norway	Switzerland*
Croatia	Ireland	Peru*	Thailand
Czech Republic	Israel*	Philippines	Turkey*
Denmark	Italy	Poland	United Kingdom*
Ecuador	Japan*	Portugal	United States
Finland			

for the Special Standard and the General System. Some Directors suggested that staff papers indicate clearly data adjustments to help identify for the authorities the data deficiencies and required improvements.

Members' Dissemination of Data to the Public

Review of Special Data Dissemination Standard. In their first review of the Special Data Dissemination Standard, in December 1997, Directors noted that the number of subscribers (43) had been about as expected and hoped that, over time, more members would subscribe. They welcomed the growing external use of the Dissemination Standards Bulletin Board, especially since the introduction of hyperlinks from the bulletin board to national data sites (see Box 6). Directors believed the SDDS provided incentives and a structure for improvements in data dissemination practices; subscribers' views on their initial experience with the Special Standard had been generally positive.

Directors agreed that the proposals for updating the SDDS were timely, given the economic and financial developments in Southeast Asia and elsewhere. They endorsed the procedures for modifying the SDDS, which were in keeping with the consultative and transparent process underlying the Special Standard. These entailed the shifting of the data components for countries' reserve-related liabilities from an "encouraged" to a "prescribed" component and adding a prescribed component for net commitments under derivative positions. Some Directors expressed reservations in this regard, pointing to definitional problems and issues of confidentiality.

Directors agreed that the procedure for modifying the SDDS to include indicators of financial soundness should await the development of standards for the disclosure of macroprudential data and should draw on the work of other organizations, including the BIS. They also agreed to consider in the next review of the SDDS the possibility of establishing a more precise timetable for the dissemination by subscribing countries of data on international investment positions, which would include data on the short-term external indebtedness of the private nonbank sector.

Directors considered that in the period ahead, the credibility of the IMF and of the SDDS subscribers would depend on ensuring that subscribers had imple-

transactions (outright or arising from swaps), the maturity structure of external debt, the composition of short-term external debt, information on foreign exchange reserves, and information on the financial sector. Some Directors suggested that the definition of core data should be expanded to include these additional data, given their critical importance in identifying emerging tensions at an early stage. And some Directors suggested consideration of a common standard for timeliness and frequency of data provided to the IMF.

On the related issue of data quality, inadequate coverage and deficiencies in compilation methods had often compromised the usefulness of the reported data and posed problems for the design and monitoring of members' programs, particularly with regard to national accounts, government finance, and balance of payments statistics. Directors therefore urged the staff to continue its work on the assessment of data quality. Several Directors stressed the high cost of technical assistance and suggested monitoring recipient countries' implementation of recommendations. Directors agreed that efforts to improve data quality must be part of a broad effort to build solid statistical frameworks in member countries, consistent with efforts undertaken mented the necessary changes to their dissemination practices so that they would fully comply with the Special Standard by the end of 1998. Noting that a number of current subscribers had made limited progress in completing the outstanding actions, Directors urged members to implement rapidly their announced transition plans and asked staff to give priority to assisting subscribers in successfully concluding the transition period. Directors agreed it would be prudent for members intending to subscribe during 1998 to assess carefully the likelihood of fully observing the Special Standard by the end of the transition period. On the same point, in its April 1998 meeting, the Interim Committee emphasized the importance of subscribers being in full observance of the standards by the end of the transition period in December 1998.

In discussing how to deal with possible nonobservance by a subscriber after the end of the transition period, some Directors cited the need to differentiate between minor and serious breaches; Directors agreed to reconsider the issue of possible nonobservance during the next review of the SDDS. Although some Directors suggested exploring some form of cost recovery, the Board agreed that, for the present, the costs associated with the Special Standard and maintenance of the associated bulletin board should not be borne by users on the grounds that the wide reach of the bulletin board benefited the entire international community.

General Data Dissemination System. In contrast to the Special Data Dissemination Standard, whose focus is on dissemination in countries that generally already meet high standards of data quality, the General Data Dissemination System aims primarily to improve the quality of data for all members. It focuses on the development and dissemination of a full range of economic, financial, and sociodemographic data with objectives for comprehensive statistical frameworks—comprising national accounts for the real sector, central government accounts for the fiscal sector, a broad money survey for the financial sector, and balance of payments accounts for the external sector, as well as a set of sociodemographic indicators. In December 1997, in approving the proposal to establish the GDDS, Directors recognized that it was an important step for all IMF members—not only in guiding the provision of data to the public, but also in encouraging improvements in the quality and accessibility of data.

Directors recognized that for many countries improvements in data quality were a necessary precursor to enhanced dissemination of data to the public and that the GDDS was a useful framework for developing a broad range of statistics. Directors favored the General System's focus on a set of core frameworks and indicators, supplemented by improved data systems and categories; this made the General System relevant to a broad range of countries and provided a clear set of links between the General System and the Special Standard. These links were particularly helpful to countries that wished to use participation in the GDDS as a step toward subscription to the SDDS. Most Directors supported including in the General System a set of sociodemographic indicators because of the importance of these data in assessing economic developments in many countries. Some Directors reiterated that the responsibility for developing social indicators should be left mainly to other international organizations, and some expressed doubts about the appropriateness of including these data in the GDDS. Directors agreed that the IMF should cooperate closely with regional and other international organizations in developing social indicators.

The Board acknowledged that, as aspects of openness and transparency, the issues of access and integrity were important dimensions of the GDDS. The principles embodied in these dimensions were not yet standard practice in many countries, and it was therefore appropriate that the General System focus on developing these dimensions in the practices of data compiling and disseminating agencies.

Most Directors supported a phased approach in implementing the GDDS, focusing first on education and training through appropriate documentation, seminars, and workshops (Box 7). The Board recognized that the General System was an ambitious project, both for the IMF and for countries that might wish to participate, and many Directors agreed that a longer-term approach to implementing the General System was appropriate, taking into account the substantial resource costs to the IMF and to countries, as well as the absorptive capacity of participating countries.

Strengthening IMF-Bank Collaboration on Financial Sector Reform

The IMF and World Bank have long collaborated on financial sector issues (see also Appendix IV). In August 1997, the Board discussed this collaboration, stressing that it was crucial to maximizing the effectiveness of both institutions in helping countries strengthen their financial systems and saw improving this cooperation as an urgent priority.

Although the 1989 agreement between the IMF and the World Bank on Bank-IMF collaboration in assisting member countries in their respective areas of expertise continued to provide an appropriate overall framework, Directors felt that the roles of the two institutions on financial sector issues needed to be clarified and collaboration procedures improved. They stressed the role of collaboration in ensuring that emerging financial sector problems in all countries are promptly identified, that each institution would take the lead in its own areas of primary responsibility, that duplication of activity in areas of mutual interest be avoided, and that the IMF's macroeconomic analysis and the Bank's

Box 7
How the GDDS Will Work

Participation in the General Data Dissemination System (GDDS), which is voluntary, consists of three steps:

- commitment to using the GDDS as a framework for statistical development;
- designation of a country coordinator; and
- preparation of descriptions of current statistical production and dissemination practices, and plans for short- and long-term improvements in these practices that could be disseminated by the IMF on the Internet.

The GDDS will be implemented in two phases. The first will focus on education and training, and the second on direct country work. The training phase will include eight regional seminars and workshops, beginning in mid-1998 and ending in the fall of 1999, for up to 120 member countries. Following the training phase, IMF staff will work directly with member countries to assist them in assessing their practice against those of the GDDS and developing plans for improvement.

As of April 1998, some 25 countries had indicated preliminary interest in the GDDS by appointing a country coordinator. Formal invitations to participate have been sent to all member countries that have not subscribed to the Special Data Dissemination Standard (SDDS) following completion of guidance materials on the GDDS.

sectoral policy recommendations be fully coordinated. In this context, the two institutions would also have to pay due regard to the responsibility of the Basle Committee in the area of banking supervision.

Many Directors remarked that they would have liked a clearer delineation of the spheres of responsibility of the two institutions, while recognizing that overlap in some areas—especially banking supervision and regulation, and banking legislation—was probably unavoidable. Most Directors stressed that banking system restructuring was the primary responsibility of the World Bank. Nevertheless, many Directors felt that the IMF had to play a role in banking system restructuring in crisis situations, especially in countries where it had been more actively involved. They emphasized, however, that those instances were expected to be rare, that the IMF's involvement in such cases should be temporary, and that the implementation of restructuring programs should be handled by the Bank. In light of the IMF's mandate, some Directors expected the IMF to focus on the macroeconomic implications of such reforms. But Directors hoped that the Bank, by strengthening its financial sector activities—including the establishment of the Financial Sector Board—would be better able to respond quickly and flexibly to help design financial sector restructuring programs in crisis situations. Directors also emphasized the Bank's role—and early involvement—in helping to identify specific benchmarks for banking system restructuring to be incorporated in IMF financial programs.

Exchange Rate Issues

The Board considered two surveillance-related exchange rate issues in 1997/98: the methodology for assessing exchange rates and strategies for moving from a fixed to a flexible exchange rate regime ("exit strategies").

Exchange Rate Assessments and IMF Surveillance

In discussing the methodology of exchange rate assessments and its application in IMF surveillance over major industrial countries, the Board emphasized in October 1997 that the IMF, as the central institution of the international monetary system, must continuously seek to strengthen its analysis and surveillance over exchange rate policies. The IMF had the advantage of a global perspective and a blend of technical expertise and practical policy experience that enabled its staff to add value in advancing the analytical framework and making judgments on exchange rate issues. In this context, Directors also pointed to the need for cooperation with the academic community.

Directors concurred with the view that the macroeconomic balance methodology used by IMF staff (Box 8) complemented rather than substituted for the various measures of international competitiveness and financial market conditions that had traditionally played a major role in IMF surveillance over members' exchange rates and exchange rate policies. Directors generally agreed it was not possible to identify precisely "equilibrium" values for exchange rates and that point estimates of notional equilibrium rates should generally be avoided. Nevertheless, they agreed that a rigorous, systematic, and transparent methodology was important to underpin IMF surveillance. They considered the existing methodology to be a useful starting point.

Directors emphasized that it was essential to consider the appropriateness of exchange rates against the background of prevailing cyclical positions and the attainment of overall macroeconomic objectives. Deviations of exchange rates from their medium-term equilibrium levels might be warranted, and even helpful, in cases of divergence in the cyclical positions of the major industrial countries. For these reasons, Directors advocated a case-by-case approach in considering what actions, if any, should be taken when exchange rates appeared to deviate substantially from their medium-term equilibrium values.

Many Directors considered that the current methodology for assessing exchange rates could be applied more broadly, in particular to nonindustrial countries of regional importance with access to international capital markets. Some Directors recognized, however, that data deficiencies and the diversity of economic conditions might limit the applicability of the methodology in the case of emerging and developing economies.

Box 8
A Methodology for Exchange Rate Assessments

Oversight of members' exchange rate policies is at the core of the IMF's surveillance mandate. The methodology used for assessing the appropriateness of current account positions and exchange rates for major industrial countries embodies four steps:

- applying a trade-equation model to calculate the underlying current account positions that would emerge at prevailing market exchange rates if all countries were producing at their potential output levels;
- using a separate model to estimate a normal or equilibrium level of the saving-investment balance consistent with medium-run fundamentals, including the assumption that countries were operating at potential output;
- calculating the amount by which the exchange rate would have to change, other things being equal, to equilibrate the underlying current account position with the medium-term saving-investment norm; and
- assessing whether the estimates of exchange rates consistent with medium-term fundamentals suggest that any currencies are badly misaligned.

Exit Strategies: Policy Options for Countries Seeking Greater Flexibility

In January 1998, in their discussion of a staff paper[10] on strategies for exiting from relatively fixed exchange rate regimes to regimes of greater exchange rate flexibility, Directors acknowledged that the choice of exchange rate regime was a complex issue that depended on the specific circumstances of individual countries. Particularly relevant were the structural characteristics of the economy and its historical inflation performance, the degree of vulnerability to shocks and the nature of those shocks, the extent of export and import diversification, and the degree of capital account liberalization and exposure to global capital markets. More generally, whatever regime was chosen, macroeconomic and structural policies needed to be credibly consistent with the regime, and the authorities needed to be transparent about policy objectives and how they intended to achieve them.

Several Directors noted that currency pegs, currency unions, or currency boards have served countries well in a number of cases, including small, open economies and a number of developing and transition economies, at least at some stage of their development and stabilization efforts. In the case of transition economies, a few Directors noted that the balance of costs and benefits tended to shift in favor of greater exchange rate flexibility as inflation subsided and the transition proceeded.

Most Directors were of the view that the increasing globalization of financial markets had made pegged regimes more difficult to manage. Many Directors particularly cited the heightened risk posed by fixed rates in encouraging unhedged exposure by borrowers. While some countries, with the appropriate supportive policies, would continue to benefit from a fixed rate—it being emphasized that there was no presumption that all countries would be better off with flexible rates—Directors noted that some countries with fixed or relatively fixed exchange rate regimes might now wish to move to more flexible arrangements. It was therefore desirable to consider the best ways to engineer an exit.

Directors emphasized that careful attention needed to be given, when exiting a peg, to the design of the new macroeconomic policy framework. In light of the many, often complex, considerations in the decision to exit—even from a position of strength—Directors believed that the IMF could play an important role in providing timely and candid advice to member countries on the appropriate exit strategy and the timing of such action. Too rapid an abandonment of the peg could be as harmful to credibility as too protracted a defense of the peg was to the level of foreign exchange reserves. It was suggested that the IMF's regular Article IV consultations with its member countries should, when appropriate, give greater priority to discussing these issues.

Most Directors agreed that if a case for moving to a flexible regime existed, the best time to do so was during a period of relative calm in exchange markets or when there were pressures for appreciation of the currency, rather than when the exchange rate was under downward pressure. They noted, however, that much judgment was involved and it was often difficult to make such a decision when times were good and there seemed no reason to tinker with an apparently successful regime.

There was no question, Directors agreed, that it was much more difficult to exit a peg during a crisis, when some degree of exchange rate volatility was likely. To minimize depreciation and bolster policy credibility in such circumstances, it was essential that a country implement a strong and credible package of policy measures, including macroeconomic policies and accelerated structural reforms, and ensure the complementarity of those measures. Directors also

[10]Published as IMF, *Exit Strategies: Policy Options for Countries Seeking Greater Flexibility,* IMF Occasional Paper 168 (1998).

stressed the need for an alternative policy framework after the exit to provide an anchor for inflation expectations.

Directors differed on how much macroeconomic policy should be tightened in these circumstances. Some pointed to the recent situation in East Asia as one where early and concerted monetary policy actions had not been sufficiently strong to prevent a continuing slide in a number of currencies in the region. Some other Directors noted that very high interest rates could increase pressures on already fragile banking and corporate sectors in most of these countries and could risk accentuating the resulting economic contraction. For similar reasons, some Directors argued that a more flexible approach to fiscal policy might be desirable in some cases, especially in countries where fiscal policy had been on a sustainable footing before the crisis.

The difficulties posed by financial sector problems for the choice of exchange rate regime were discussed at some length. Directors noted that financial fragility made the defense of a pegged rate through higher interest rates more problematic, since higher rates would exacerbate debt-servicing problems and further weaken the financial sector. As East Asia illustrated, however, depreciation of the currency after a long period of exchange rate stability could also endanger the soundness of financial and nonfinancial institutions, to the extent that they had tended not to hedge foreign currency exposures. The ideal solution was clearly to strengthen prudential regulations and supervision, and limit unhedged exposure, before the exit. Directors were divided on whether the absence of such measures merited delaying a needed move to greater exchange rate flexibility. Some pointed mainly to the further weakening of the financial and corporate sectors associated with the defense of the peg, while others noted that in some cases it was essential to begin financial restructuring and reduce unhedged foreign currency exposure before any large exchange rate depreciation. Several Directors suggested that further analysis of second-best policies for countries with less than robust financial sectors would be helpful, including ways to strengthen banking and prudential standards and establish clear bankruptcy legislation as rapidly as possible.

A number of Directors saw merit in imposing selective capital controls to limit the severity of the currency depreciation in the aftermath of an exchange rate crisis, as well as to reduce the risks of crises in the first instance. Several other Directors, however, cautioned that such controls were likely to be ineffectual beyond the short run and could even prove counterproductive, by leading to a surge in capital outflows. A better approach, these speakers felt, was to strengthen prudential regulation and supervision of financial and nonfinancial institutions. Areas to be governed by such regulation could include short-term foreign currency borrowing by domestic corporations and reporting requirements for foreign financial institutions.

Monetary Policy in Dollarized Economies

"Dollarization," the holding by residents of a large share of their assets in instruments denominated in foreign currency, is common in developing and transition countries. Among countries that have undertaken IMF-supported adjustment programs over the past 10 years, almost half could be regarded as dollarized and a significant number of the others as largely dollarized.

In a review of the economic effects of dollarization in January 1998, the Board agreed that in a globalized economy with increasingly free capital movements and deregulated financial markets, most countries experienced some degree of dollarization—whether in the form of currency substitution, asset substitution as part of currency diversification of asset holdings, or a combination of the two. Several Directors saw this as a benign feature of the modern economic environment, to which all countries should adapt. Others were less sure, citing such issues as the policy adaptations required to cope with the challenges posed by currency substitution. Although Directors agreed that dollarization was an important feature in the advanced countries as well—and would become even more so with the introduction of the euro—their discussion centered on the effects of dollarization in developing and transition economies. In many of these countries, dollarization indicated a lack of confidence in the ability of the domestic currency to perform its functions effectively.

Benefits and Risks of Dollarization

Dollarization was seen as presenting both benefits and risks for developing countries. In some circumstances, foreign currency deposits could promote the growth of the domestic financial sector, for example, by allowing domestic banks to compete with cross-border accounts. Dollarization was sometimes the only effective way to remonetize an economy in cases of extreme price instability and capital flight. But, especially in weak and immature financial systems, dollarization could increase risks in the financial sector. Such risks could stem from a deterioration in the quality of the foreign currency loan portfolio in the case of a sharp devaluation of the domestic currency, as well as from the limited ability of the central bank to act as the lender of last resort. Countries with large cash holdings of foreign money would also lose seigniorage revenues.

With regard to the implications of dollarization for exchange rate and monetary policy, Directors noted that the likely higher volatility of money demand in economies with high currency substitution would tend to make the exchange rate more unstable and limit the effectiveness of monetary policy. Several Directors favored the adoption of a fixed rate or a currency board arrangement supported by appropriate macroeconomic policies to handle these types of monetary shocks. A number of Directors, however, stressed that the degree of currency substitution was only one of many elements to be taken into account in choosing an exchange rate regime; also significant were such considerations as the importance of real shocks, the degree of capital mobility, the scope for fiscal adjustment, and the overall macroeconomic situation.

What of the effects of dollarization for inflation? Although this was essentially an empirical question without a unique answer, Directors felt that the relevance of foreign currency aggregates should not be discounted and despite measurement difficulties, these aggregates should be included among the broader set of indicators monitored by the monetary authorities. Some Directors thought that certain dollarized economies could suitably adopt an inflation-targeting framework for monetary policy.

Directors generally preferred that monetary operations be conducted in domestic currency. They recognized, however, that monetary instruments denominated in foreign currency could be useful in highly dollarized economies where the bulk of credits and interbank operations were already denominated in that currency. Similar qualifications applied to the provision of foreign currency interbank settlement on the books of the central bank. In this regard, however, Directors advised that such operations be backed by ample international reserves, as well as effective measures to limit settlement risk.

Special vigilance was needed to limit prudential risk in highly dollarized economies, Directors stressed. Because of the impact of dollarization on credit risk, as well as risks to the banking system, dollarization argued for banks in developing countries to exceed Basle guidelines for capital adequacy. Directors noted that a central bank had limited ability to act as a lender of last resort in foreign currency and that sizable currency reserves and contingent credit lines could usefully contribute to limiting systemic liquidity risk in these circumstances. While recognizing the difficulties in monitoring limits on foreign exchange positions given the sophistication of financial markets, Directors stressed the importance of closely monitoring off-balance-sheet operations, as well as the maturity and composition of foreign exchange exposures.

Most Directors agreed that the focus of monetary policy should be on macroeconomic stabilization. In their view, measures to improve the attractiveness of the domestic currency were generally preferable to those for discouraging the use of foreign currency. Thus, Directors broadly agreed that dollarization should not be tackled by restricting residents' ability to maintain accounts in foreign currency or imposing punitive reserve requirements on foreign currency deposits. Such measures would be counterproductive, weakening financial intermediation or leading to capital outflows. Interest rate liberalization, measures to increase financial deepening, an effective domestic payments system, and an independent monetary authority were the best avenues for limiting dollarization over the medium term. Also important—particularly in countries with weak financial systems—was an appropriate sequence of financial liberalization measures, supported by strong macroeconomic policies. Although Directors recognized that indexed financial instruments could also limit dollarization, the risks of promoting inflationary inertia had to be carefully weighed when contemplating such instruments.

Dollarization and the Design of IMF-Supported Adjustment Programs

The Board stressed the need to consider the prevalence of dollarization in designing adjustment programs supported by the IMF. Although dollarization had not seriously hampered the attainment of growth and inflation objectives, Directors argued that velocity and the money multiplier appeared to be more variable in dollarized economies, pointing to potential problems in selecting intermediate monetary aggregates.

In the Board's view, programs should continue to apply conditionality in a way that would take into account the presence of dollarization, rather than attacking it directly, and to address the more fundamental policies needed to restore confidence and the long-term credibility of the domestic currency. Programs should continue to focus on the underlying causes of dollarization, the development of domestic financial systems, and, where necessary, the adoption of prudential measures. Noting that the costs of dollarization might outweigh the benefits, a few Directors saw greater merit in pursuing an active de-dollarization strategy. In view of the uncertain duration of foreign currency deposits in the banking system, the Board generally agreed that domestic banks' reserves with the central bank against foreign currency deposits be considered part of the central bank's liabilities for purposes of measuring net international reserves.