# III. Recovery from the crisis in the emerging markets

## Highlights

Macroeconomic performance in the emerging markets in 1999 proved much better than had been feared at the beginning of the year, with growth strong and inflation remaining under control in most countries. Both Brazil and Russia managed to contain inflation in the wake of sizeable devaluations. The recovery in Asia strengthened and widened to encompass most countries in the region, while the spectre of deflation in both China and Hong Kong faded. Better performance went hand in hand with returning confidence in financial markets, with credit spreads narrowing appreciably and international funds flowing into both equity and bond markets. While strong equity markets made it easier for governments to dispose of assets acquired from banks during the crisis, their vulnerability to possible capital outflows also raised concerns in some Asian countries.

Most Latin American countries gradually recovered from recession in the course of last year, as the improving external environment made it possible to ease monetary conditions, while measures to limit fiscal deficits contributed to greater stability. A wave of foreign direct investment and freer international trade further increased Latin America's integration with the world economy. The progressive rise in oil prices helped the oil-producing countries in the region as well as Russia and the Middle East. Yet high external deficits in a period of weak domestic demand and favourable global demand conditions remained a source of vulnerability, especially given the high external debts of several countries. This was also true for many countries in Africa. For that region as a whole, the current account deficit stayed high last year even though average growth declined.

While microeconomic reforms have made several economies more competitive, there are concerns that their resistance to future financial or economic crises is still quite low. Progress has been made in strengthening banks' balance sheets in several Asian countries. However, corporate restructuring appears to be taking more time even if, in Korea, manufacturing has been invigorated somewhat by more open markets and foreign direct investment. China and India are also reforming their financial and economic systems. However, progress has been slow and much depends on the ability of the authorities to carry forward their agendas.

As emerging market countries have moved towards more flexible exchange rate regimes, policymakers have searched for or adopted alternative ways to anchor expectations of inflation. A number of economies have already introduced inflation targeting frameworks for conducting monetary policy, and several Asian countries are contemplating a similar move.

## Principal economic and financial trends

*Improvement in economic and financial conditions*

As 1999 progressed and growth in the industrial countries picked up, the real and financial conditions of the emerging market economies gradually improved. Equity prices for the countries shown in Graph III.1 increased by about 60% during 1999, far more than in most industrial countries. Even though both short- and long-term interest rates rose in the industrial countries, the impact on emerging markets was muted and spreads on international borrowings continued to narrow. Another sign of increased confidence was that the currencies of countries which had adopted a managed float tended to stabilise or, in some cases, even appreciate against the US dollar.

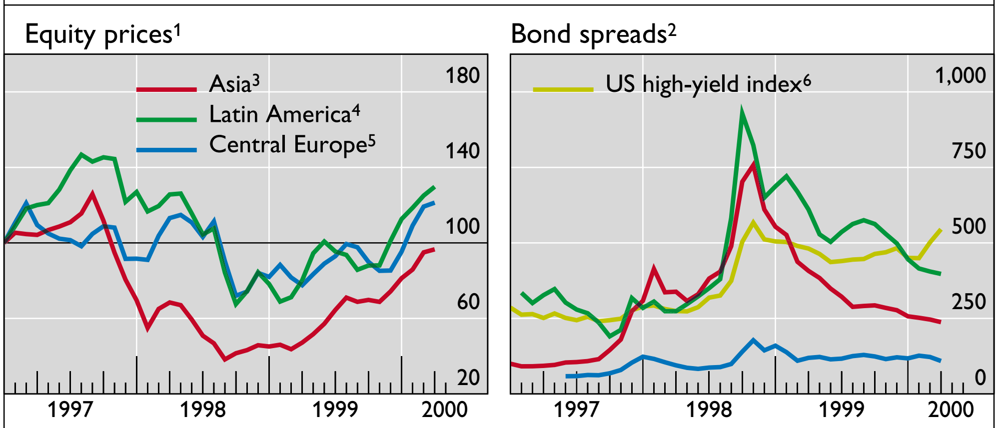
*Unexpectedly strong recovery in Asia*

While the strengthening of global demand was a crucial factor in the recovery of economic activity last year, policies and other domestic factors were also important, not only in bolstering the recovery, but also in keeping inflation low. This was particularly evident in Asia, where accommodating or expansionary policies supported a rebound that displayed the typical features of a "V-shaped" recovery, the strength of which was significantly underestimated by most forecasters. There was a positive swing of the inventory cycle, a large contribution to growth from net exports, initially mainly in the form of falling imports but progressively shifting towards a larger role for expanding exports, and finally a rebound of consumption. Asian exchange rates also strengthened as confidence and real growth improved. These changes tended to ease upward pressure on domestic prices without endangering competitive positions.

*Surprising strength in Latin America …*

Output growth in Latin America and the transition economies also turned out stronger than forecast. Following the depreciation of the Brazilian real early last year, output was generally expected to decline, not only in Brazil but also in a number of other countries in which recessionary tendencies had already been observed in late 1998. Partly because timely policy changes helped

**Equity prices and bond spreads in emerging markets**




[1] In US dollar terms, end-1996 = 100; weighted average of the countries shown, based on 1995 GDP and PPP exchange rates. [2] Over benchmark US Treasury bonds, in basis points; unweighted average of the countries shown. [3] China, India, Indonesia, Korea, Malaysia, the Philippines and Thailand. [4] Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela. [5] The Czech Republic, Hungary and Poland. [6] Sub-investment grade corporate bond yield.

Sources: Datastream; International Finance Corporation (IFC).

Graph III.1

to keep inflation subdued, Brazil recovered surprisingly quickly and overall output for the region was largely unchanged compared with 1998 (Table III.1). However, countries with a large export share of commodities with falling prices and/or that maintained a fixed exchange rate tended to suffer declines in output.

… and in the transition economies

Among the transition economies, the principal surprise last year was Russia's quick recovery from the financial crisis of autumn 1998. As in Brazil, this favourable outcome seems partly attributable to policies which prevented a full pass-through of currency depreciation into domestic inflation. In spite of

## Growth, inflation and current account balances

| | Real GDP | | | Consumer prices | | | Current account balance | | |
|---|---|---|---|---|---|---|---|---|---|
| | 1992–97 | 1998 | 1999 pe | 1992–97 | 1998 | 1999 pe | Average 1992–97 | 1998 | 1999 pe |
| | annual percentage changes | | | | | | as a percentage of GDP | | |
| Asia[1] | 8.8 | 2.0 | 6.0 | 9.7 | 7.4 | 2.2 | –0.3 | 4.5 | 3.0 |
| China | 11.5 | 7.8 | 7.1 | 13.3 | –0.9 | –1.4 | 1.0 | 3.0 | 1.5 |
| Hong Kong | 5.2 | – 5.1 | 2.9 | 7.8 | 2.8 | –4.0 | 0.1[2] | 0.5[2] | 4.4[2] |
| India | 6.3 | 6.0 | 6.3 | 8.4[3] | 6.9[3] | 3.5[3] | –1.2 | – 0.9 | – 0.8 |
| Korea | 6.8 | – 6.7 | 10.7 | 5.2 | 7.5 | 0.8 | –1.8 | 12.6 | 6.0 |
| Singapore | 9.1 | 0.4 | 5.4 | 2.1 | –0.3 | 0.5 | 14.7 | 25.4 | 25.3 |
| Taiwan | 6.6 | 4.6 | 5.7 | 3.2 | 1.7 | 0.2 | 3.1 | 1.3 | 2.0 |
| Indonesia | 6.9 | –13.7 | 0.2 | 8.2 | 58.4 | 20.5 | –2.4 | 4.4 | 3.8 |
| Malaysia | 9.2 | – 7.5 | 5.4 | 3.6 | 5.3 | 2.7 | –5.7 | 13.7 | 16.9 |
| Philippines | 3.8 | – 0.5 | 3.2 | 7.8 | 9.7 | 6.7 | –4.2 | 2.0 | 9.2 |
| Thailand | 6.5 | –10.2 | 4.1 | 5.0 | 8.1 | 0.3 | –5.9 | 12.5 | 8.9 |
| Latin America[1] | 4.1 | 1.9 | 0.1 | 102.9 | 10.5 | 9.1 | –2.7 | – 4.4 | – 2.6 |
| Argentina | 5.3 | 3.9 | –3.0 | 7.0 | 0.9 | –1.2 | –3.1 | – 4.9 | – 4.2 |
| Brazil | 4.4 | 0.1 | 0.8 | 363.3 | 3.8 | 4.9 | –1.8 | – 4.4 | – 4.0 |
| Chile | 8.4 | 3.4 | –1.1 | 10.2 | 5.1 | 3.4 | –3.9 | – 5.7 | – 0.1 |
| Colombia | 4.3 | 0.6 | –4.5 | 22.2 | 20.4 | 11.2 | –4.3 | – 5.3 | – 1.3 |
| Mexico | 2.5 | 4.8 | 3.4 | 19.9 | 15.9 | 16.6 | –4.0 | – 3.8 | – 2.9 |
| Peru | 5.6 | 0.3 | 3.8 | 27.5 | 7.2 | 3.5 | –5.6 | – 6.0 | – 3.6 |
| Venezuela | 2.2 | – 0.7 | –7.2 | 55.2 | 35.8 | 23.6 | 2.7 | – 2.7 | 5.4 |
| Central Europe[1] | 3.9 | 3.3 | 3.2 | 24.0 | 11.9 | 6.5 | –1.5 | – 4.1 | – 5.8 |
| Czech Republic | 1.9 | – 2.2 | –0.2 | 11.3 | 10.7 | 2.1 | –3.5 | – 2.5 | – 2.0 |
| Hungary | 1.1 | 4.9 | 4.5 | 22.4 | 14.3 | 10.0 | –4.8 | – 4.9 | – 4.3 |
| Poland | 5.2 | 4.8 | 4.1 | 29.3 | 11.8 | 7.3 | 0.5 | – 4.4 | – 7.5 |
| Russia | –7.2 | – 4.9 | 3.2 | 285.3 | 27.7 | 85.7 | 2.3 | 0.4 | 13.9 |
| Israel | 5.2 | 1.9 | 2.2 | 10.9 | 5.4 | 5.2 | –4.3 | – 0.9 | – 2.6 |
| Turkey | 4.9 | 2.8 | –5.0 | 82.3 | 84.6 | 64.9 | –1.2 | 0.9 | – 0.5 |
| Saudi Arabia | 1.1 | 1.6 | 1.0 | 1.3 | –0.4 | –1.6 | –6.4 | –10.2 | – 2.8 |
| Africa | 2.3 | 3.4 | 2.8 | 24.0 | 6.7 | 5.8 | –9.5[4] | –16.5[4] | –13.2[4] |
| South Africa | 1.7 | 0.1 | 1.2 | 9.5 | 6.9 | 5.2 | –0.4 | – 1.7 | – 0.4 |
| *Memorandum:* | | | | | | | | | |
| *Industrial countries* | *2.5* | *2.7* | *2.9* | *2.5* | *1.3* | *1.5* | – | *– 0.1* | *– 0.8* |

[1] Weighted average of the countries shown, based on 1995 GDP and PPP exchange rates. [2] Balance of goods and non-factor services. [3] Wholesale prices. [4] As a percentage of exports of goods and services.

Sources: IMF; national data; BIS estimates. Table III.1

| Developments in world terms of trade | 1997 | 1998 | 1999 pe |
|---|---|---|---|
| | annual percentage changes | | |
| Emerging market economies | –0.4 | – 6.2 | 3.6 |
| Asia | –0.9 | – 0.8 | –1.3 |
| Latin America | –1.3 | – 7.2 | 5.2 |
| Africa | 0.9 | – 9.9 | 3.6 |
| Middle East | 1.0 | –14.4 | 12.3 |
| Industrial countries | –0.4 | 1.5 | 0.2 |

Source: IMF, *World Economic Outlook.* Table III.2

the slowdown in Latin America, Africa and the Middle East, average growth for the emerging market countries last year is estimated at 4%. Though significantly higher than in 1998, it remained well below the average for the early 1990s and only partly restored the historical growth differential vis-à-vis the industrial countries.

Adverse impact of low commodity prices

Movements in commodity prices, exchange rates and associated terms-of-trade changes had a significant influence on growth performances last year, notably as regards the relatively slow growth of regions and countries with less diversified exports (Table III.2). In Africa, the Middle East and most of Latin America, developments last year seemed to reflect the lagged effects of large terms-of-trade deteriorations in 1998, while the subsequent improvement in relative trade prices affected developments only from late 1999. The contractionary effects of lower terms of trade were most evident in countries with fixed exchange rate regimes and steep declines in the volume of their key exports. Other countries allowed a weakening of their currency against the US dollar to cushion the effect on real incomes of the fall in commodity prices. However, in most cases, such effects were partly offset by the adoption of tighter policies to prevent currency devaluations from pushing up domestic inflation.

Slow recovery of capital flows reflecting …

Although of a more indirect nature, both the size and the composition of net capital flows may also explain some of the growth divergences among the emerging market economies (Table III.3). Overall, net private inflows remained more or less constant compared with 1998 but significantly below the level seen prior to the Asian crisis. The sizeable current account surpluses in Asia permitted repayment of banking debt without hurting the recovery. The build-up of foreign exchange reserves was almost as large as in 1998. Conversely, the decline in net inflows to Latin America, combined with continued high current account deficits, led (or forced) several countries to tighten monetary and fiscal policies in early 1999 when the Brazilian crisis raised risk premia for the whole region. Net capital flows to Africa have been rather impervious to changes in international capital market conditions and, unfortunately, also to Africa’s external borrowing needs. Largely reflecting the weakness of agricultural commodity prices, the aggregate current account deficit for the region rose sharply in 1998 and stayed high last year, whereas net inflows remained at their previously low level. Given low domestic saving, the lack of external financing might, in some cases, have exacerbated the slowdown in output by constraining investment spending.

The composition of capital inflows probably also influenced growth patterns last year. Over the last 10 years, foreign direct investment (FDI) in the emerging market economies has increased significantly, both in absolute terms and as a share of total private inflows. Moreover, despite the crisis in Asia and the turbulence in 1998, FDI inflows have remained remarkably stable at a high level. This development has in part been the result of a general trend towards more global production structures. However, it also reflected more specific

… larger FDI inflows …

**Net private capital flows to emerging market countries**

| | 1996 | 1997 | 1998 | 1999 |
|---|---|---|---|---|
| | in billions of US dollars | | | |
| Emerging market economies | | | | |
| Total flows | 216 | 148 | 75 | 81 |
| Direct investment | 113 | 139 | 143 | 150 |
| Portfolio investment | 78 | 53 | 9 | 23 |
| Other inflows | 25 | –44 | –77 | –93 |
| *Memo: Current account* | *– 94* | *–72* | *–51* | *14* |
| *Change in reserves*[1] | *–114* | *–73* | *–38* | *–79* |
| Asia | | | | |
| Total flows | 104 | – 1 | –43 | –27 |
| Direct investment | 53 | 55 | 58 | 50 |
| Portfolio investment | 13 | 4 | –18 | – 6 |
| Other inflows | 38 | –60 | –83 | –71 |
| *Memo: Current account* | *– 37* | *23* | *114* | *96* |
| *Change in reserves*[1] | *– 50* | *–16* | *–70* | *–60* |
| Latin America | | | | |
| Total flows | 72 | 86 | 70 | 54 |
| Direct investment | 40 | 53 | 56 | 64 |
| Portfolio investment | 41 | 19 | 15 | 11 |
| Other inflows | – 8 | 13 | – 1 | –20 |
| *Memo: Current account* | *– 38* | *–64* | *–89* | *–54* |
| *Change in reserves*[1] | *– 31* | *–15* | *17* | *5* |
| Africa | | | | |
| Total flows | 8 | 17 | 12 | 15 |
| Direct investment | 5 | 7 | 5 | 10 |
| Portfolio investment | 1 | 4 | 4 | 4 |
| Other inflows | 1 | 6 | 2 | 1 |
| *Memo: Current account* | *– 7* | *– 7* | *–20* | *–17* |
| *Change in reserves*[1] | *– 9* | *–11* | *1* | *– 3* |
| Countries in transition | | | | |
| Total flows | 17 | 23 | 14 | 12 |
| Direct investment | 14 | 20 | 21 | 24 |
| Portfolio investment | 19 | 22 | 7 | 4 |
| Other inflows | – 16 | –18 | –14 | –16 |
| *Memo: Current account* | *– 17* | *–26* | *–25* | *– 5* |
| *Change in reserves*[1] | *– 2* | *–10* | *– 1* | *– 8* |

[1] A minus sign indicates an increase.
Source: IMF, *World Economic Outlook*.

Table III.3

features, such as the removal of restrictions on FDI inflows in some Asian countries, the attraction of low production costs following large depreciations and/or lower equity prices, and the privatisation of large public companies. In Latin America, such inflows last year financed almost the entire current account imbalance. Similarly, in transition economies such as Poland and Hungary, relatively stable FDI inflows eased the need for restrictive policies to prevent a further widening of current account imbalances. In contrast, receiving only a fraction of the FDI flows to the emerging markets, African countries have had to adjust monetary and fiscal policies to keep the current imbalances within narrow bounds.

… but a further decline in banking flows

Aggregate cross-border bank lending to the emerging markets continued to decline in 1999 but less sharply than in 1998. Asian countries have reduced outstanding debt to international banks by some $160 billion since the onset of the crisis (Table III.4), as investment fell and banks and corporations restructured their balance sheets. International bank lending to Latin America and Russia also contracted. Net issuance of international debt securities, by contrast, has proved to be a more stable source of finance. In fact, Latin American countries have significantly increased bond issuance since mid-1997 despite wide fluctuations in bond spreads. Argentina and Mexico were

**International bank and securities financing of emerging market economies**

| | Average 1990–95[1] | 1996 | 1997 | 1998 | 1999 | June 1997 | December 1999 |
|---|---|---|---|---|---|---|---|
| | in billions of US dollars | | | | | | |
| | International bank lending[2] | | | | | Outstanding liabilities | |
| Asia[3] | 37 | 80 | 5 | –96 | –53 | 480 | 315 |
| *of which:* China | 7 | 13 | 10 | –11 | –15 | 85 | 68 |
| Crisis countries[4] | 28 | 58 | –10 | –83 | –31 | 329 | 190 |
| Latin America | 1 | 28 | 31 | – 8 | –16 | 284 | 280 |
| *of which:* Argentina | – | 5 | 8 | 1 | – | 42 | 48 |
| Brazil | – | 17 | 14 | –11 | – 9 | 98 | 85 |
| Mexico | – | – | – 7 | – | – 4 | 69 | 61 |
| Central Europe[5] | – | 2 | 6 | 6 | 5 | 26 | 39 |
| Russia | 1 | 6 | 10 | – 6 | – 8 | 54 | 44 |
| Africa | –2 | – | 3 | – 2 | 1 | 51 | 56 |
| | Net issuance of international debt securities | | | | | Outstanding amount | |
| Asia[3] | 15 | 42 | 34 | – | – 3 | 127 | 139 |
| *of which:* China | 2 | 2 | 4 | – | – | 17 | 18 |
| Crisis countries[4] | 11 | 38 | 25 | – | – 2 | 98 | 107 |
| Latin America | 13 | 41 | 42 | 22 | 32 | 136 | 205 |
| *of which:* Argentina | 6 | 11 | 14 | 11 | 11 | 35 | 63 |
| Brazil | 4 | 12 | 10 | 3 | 6 | 35 | 46 |
| Mexico | 2 | 13 | 8 | 2 | 10 | 50 | 63 |
| Central Europe[5] | 3 | – | 2 | 2 | 2 | 15 | 20 |
| Russia | – | – | 7 | 12 | – 1 | 6 | 19 |

[1] 1993 Q4–1995 for net securities issuance. [2] Exchange rate adjusted change in claims of BIS reporting banks. [3] Excluding Hong Kong and Singapore. [4] Indonesia, Korea, Malaysia, the Philippines and Thailand. [5] The Czech Republic, Hungary and Poland.

Source: BIS. Table III.4

particularly active in 1999 and bond issuance strengthened further early this year as more Latin American countries took advantage of the narrowing bond spreads.

## Recovering from the crisis in Asia

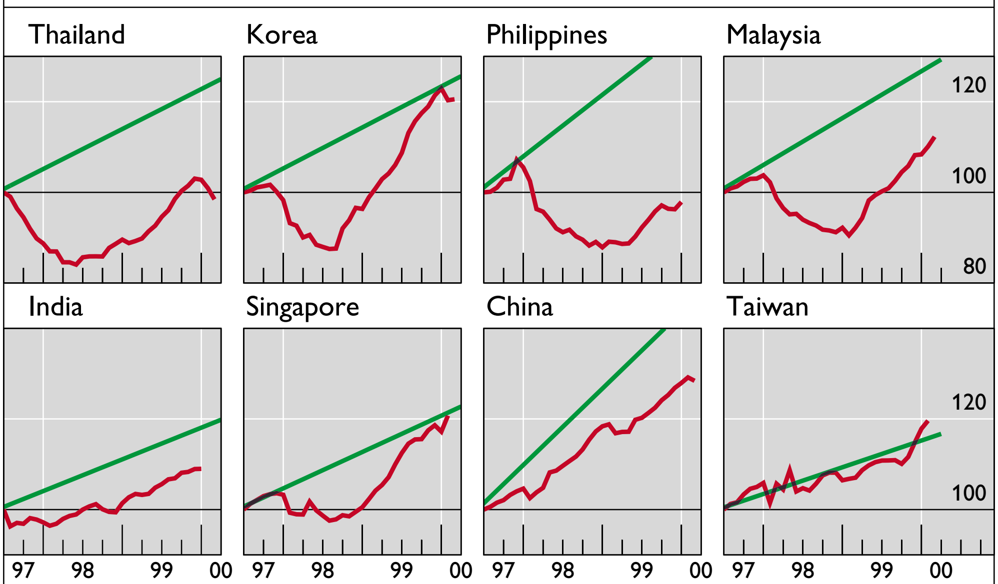
Strong but divergent recovery in Asia

The deep contraction of output in much of East Asia bottomed out in the second half of 1998. While the subsequent rebound was much stronger than generally expected, there were marked divergences between economies in its pace and in the extent to which earlier output losses were recovered (Table III.1). In *Korea*, *Singapore* and *Taiwan*, production was back around its pre-crisis trend by end-1999 while output in *Malaysia* and *Thailand* surpassed its pre-crisis levels (Graph III.2). Although the recovery came later in *Hong Kong*, activity turned up in the first half of 1999 and then progressively strengthened in the course of the year. The *Philippines* suffered a recession in 1998 induced by poor harvests as well as by the recession in neighbouring countries. However, the economy recovered in 1999, partly helped by the fact that it did not have as serious a problem with foreign debt and overstretched banks as other countries. The *Indonesian* economy, which had suffered the deepest and longest contraction, turned around in late 1999, though a firm recovery has yet to be established. Until late in the year, political uncertainty undermined household and business confidence and the fragility of the financial sector was a further impediment to recovery.

High but slowing growth in China …

*China* has grown faster than other Asian countries, although output growth has been on a slowing trend for several years. To compensate for the short-term contractionary effects of economic reform and the weakness of exports, public spending has been expanded. Confronted with falling prices

Industrial production in Asia[1]




[1] June 1997 = 100; three-month moving averages of seasonally adjusted data. The green lines are calculated by extrapolating 1990–mid-1997 trends.

Sources: IMF; national data. Graph III.2

and rising unemployment, as well as a weak banking sector, the authorities sought to ease monetary conditions by lowering nominal interest rates and cutting reserve requirements. They also directed banks to increase credit for infrastructure, housing and exports, provide more working capital to state-owned enterprises and grant more consumer credit.

*India* benefited from a pickup in industrial output and a fast growing information technology sector. Rising rural production and incomes also contributed to growth, while higher oil prices worsened the trade balance.

… and unexpectedly low inflation in India

Notwithstanding a high fiscal deficit (see below) and rapid monetary growth, underlying inflation fell to an unusually low rate, mainly reflecting good harvests and the impact of global disinflation. Even though microeconomic reform may also have lowered inflationary pressures, the importance of food prices implies that the exposure to supply shocks and sudden rises in inflation has not gone away. In the medium term, privatisation of major sectors is planned, which should ease the public sector debt burden and might also attract further foreign direct investment.

Large growth contribution from exports …

Exports were the driving force behind the recovery in East Asia during the first half of 1999. The extent of the export expansion differed markedly between countries, in part reflecting differences in the composition and direction of exports. For some economies the recovery in demand for electronic components, particularly in Japan, gave an important boost while those with a large share of industries suffering from global oversupply, such as motor vehicles, received less help from external factors. Those economies whose exports were more directed to US markets benefited from the strong demand there, but a significant recovery in intra-Asian trade also helped. In China, exports were stimulated in the latter half of 1999 by an increase in tax rebates. The initial depreciation of many emerging Asian currencies was followed by a strong appreciation of the yen, giving a further advantage over an important competitor. However, given Japan's importance as an export market and as a source of both finance and direct investment, its continued structural and cyclical weakness has, on balance, detracted from growth in the region.

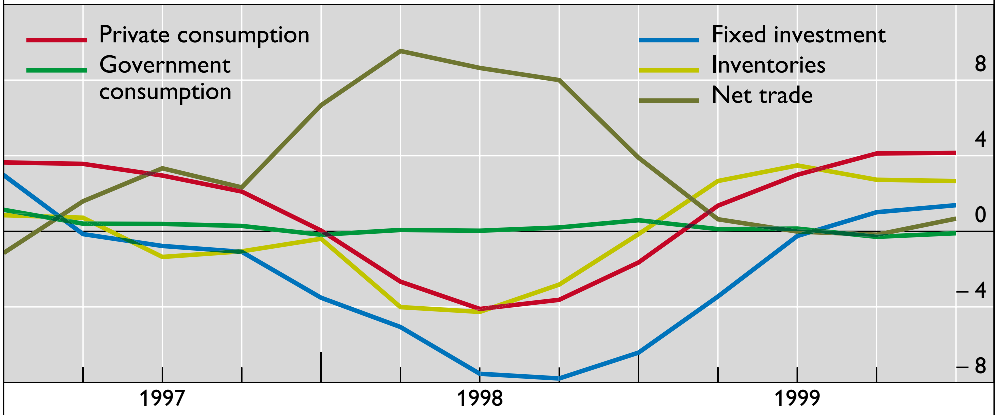
… and a progressive pickup of domestic demand

As 1999 progressed, stronger domestic demand, including a turn in the inventory cycle, replaced the reliance on export-led growth (Graph III.3). As consumers regained confidence about employment prospects and asset prices recovered, deferred expenditure on durables began to be undertaken. There was a modest recovery in business investment during 1999 in Korea and Malaysia. However, because of excess capacity in several sectors and the focus by many companies on restructuring and debt reduction, investment generally remained weak. The problems in the banking sector made it particularly hard for small enterprises to fund new investment whereas large companies relied more on equity or bond issuance to finance investment or to repay banks.

Large current account surpluses …

The region continued to post a large current account surplus. The recession had led to a marked contraction in imports and, as exports strengthened, the aggregate current account position had moved from a deficit of \$37 billion in 1996 to a surplus of \$114 billion in 1998. In 1999 domestic demand revived somewhat and imports increased accordingly as firms moved to rebuild inventories, cutting the surplus to \$96 billion. In China there was

**Emerging Asia: contribution to real GDP growth[1]**




[1] In percentage points. Weighted average of Hong Kong, Korea, the Philippines, Singapore, Taiwan and Thailand, based on 1995 GDP and PPP exchange rates.
Source: National data. Graph III.3

a particularly large rise in reported imports, although this was at least partly a result of a crackdown on smuggling. FDI flows to emerging Asia were relatively stable, although more went to Korea and Taiwan and less to China and Malaysia. Portfolio investment remained modest while international bank lending continued to contract in 1999, reflecting both the demand influences discussed above and the measures taken by Japanese banks to pare down their international balance sheets.

… and stable FDI flows

*Capacity constraints and inflationary pressures*

Continued low inflation

Inflation remained low in most of Asia (Table III.1) and forecasts were revised downwards in the course of 1999 even as forecasts of real growth were upgraded. The pass-through of the large exchange rate depreciations was very modest. This partly reflected unusually weak domestic demand in 1998, but also the fact that the more extreme exchange rate movements were correctly viewed as only transitory. Prices in China and Hong Kong were falling for most of 1999. This can be attributed to an appreciation of their effective exchange rates as well as the impact on food prices of a bumper harvest and, in the case of China, the effects of restructuring the economy. Even in Indonesia, where the depreciation was much larger and there were the additional influences of poor harvests and civil disturbances, inflation came down quickly after a sharp increase in 1998.

The rise in oil prices starting in early 1999 boosted headline CPIs in most countries but does not yet seem to have sparked second-round effects and inflation forecasts have remained low. A possible exception is Korea, where output may be approaching capacity limits. However, the early move by the Korean authorities to raise interest rates might have moderated inflation concerns.

*Fiscal imbalances and government debt*

The 1997–98 crisis left a marked impact on fiscal balances and government debt (see Table III.7 on page 53). Revenue declines, combined with discretionary

Widening deficits and growing public debt ratios

measures to stimulate the economies and rising interest expenses on government debt, meant that most Asian countries were running budget deficits by end-1998. Thanks to the unexpected strength of the recovery and consequent revenue gains, Hong Kong and Korea managed to reduce their deficits in 1999, while a combination of poor revenue collection, lack of expenditure control and, in the case of Taiwan, the effects of a major earthquake led to higher deficits (or smaller surpluses) in other countries. Reflecting measures taken to restructure and recapitalise the banking system, the effect of the crisis was even more pronounced with respect to government debt, with several countries recording debt/GDP ratios of 40–60% last year.

In India, concerns about the fiscal situation progressively increased during the 1990s. Last year the deficit of the central government increased to about 6% of GDP and that of the public sector as a whole was around 10%. The resultant rise in public sector debt to almost 60% of GDP, combined with the large contingent liabilities arising from guarantees provided by various levels of government and only modest proposals for reform in the last budget, have exacerbated concerns about sustainability.

### *Financial markets and monetary policy regimes*

Stable exchange rates allow lower interest rates …

Most of the Asian currencies that had sharply depreciated in 1997–98 had partly recovered their losses by early 1999 and were either fairly steady against the dollar or appreciated gradually during the year (Graph III.4). This allowed the authorities to reduce nominal interest rates, in most cases to below pre-crisis levels. However, in some countries declining inflation meant that real interest rates changed only little. Some central banks intervened to buy foreign currency, partly to build up foreign exchange reserves further, but partly also to preserve competitiveness gains.

… but future responses depend on the exchange rate regime

While interest rates were generally quite steady by the end of 1999, the actual and expected increases in US and European interest rates also threatened an adjustment of monetary conditions in Asia. With its currency board, Hong Kong was forced to follow movements in US rates, whereas for the economies that had abandoned their pegs to the dollar this was no longer necessary. For instance, in those economies experiencing upward pressure on their exchange rates due to a combination of large current account surpluses and FDI inflows, the authorities could tighten monetary conditions by keeping interest rates constant and letting the exchange rate appreciate.

Strong rise in equity prices

Equity prices in the region rose strongly in 1999, in many cases almost doubling, and thus regained some of the ground lost during the crisis. With corporate earnings still low in most economies, price/earnings ratios tended to be higher than before the crisis, although in most cases still below those in the United States (Graph III.5). While high P/E ratios are common in early stages of recoveries, concerns about overvaluation could re-emerge if prices are not soon underpinned by improved profits. Equity prices are also vulnerable to higher interest rates in Europe and the United States and, generally, to lower equity prices in the industrial countries (see Chapter V). However, it is hard to gauge the extent to which lower equity prices in Asia would affect the real economy.

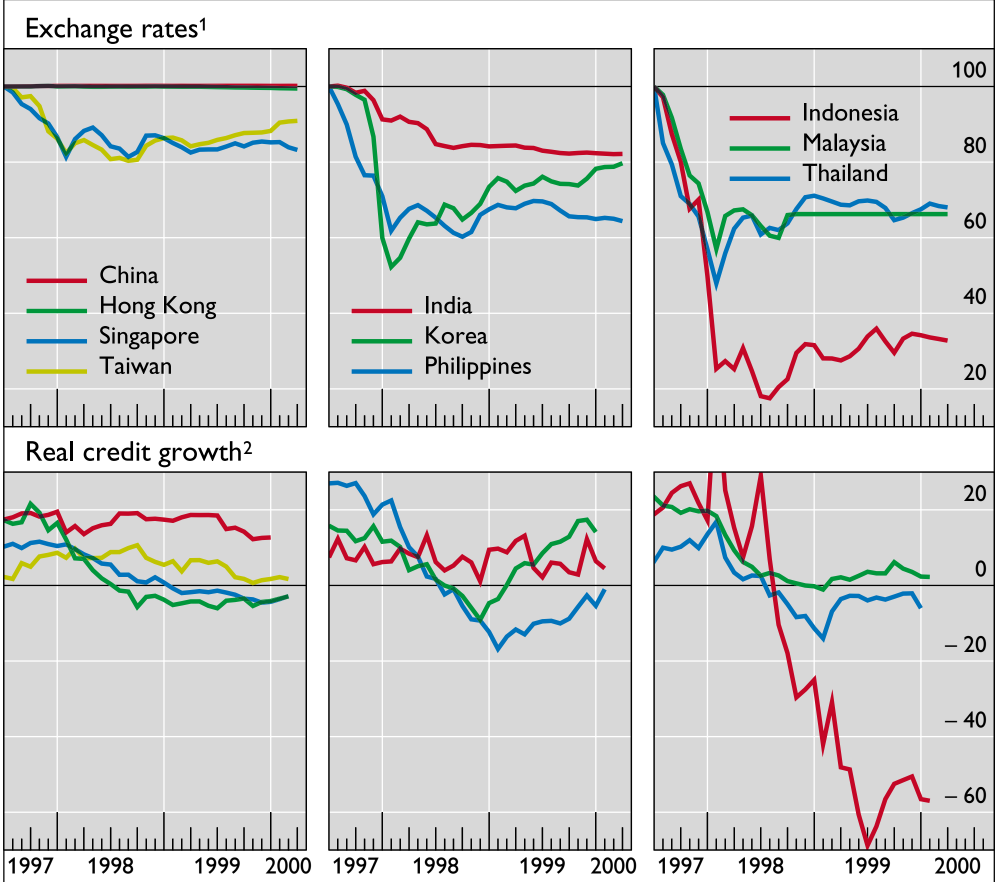
Following the crisis, a majority of central banks in the region adopted floating exchange rate regimes. Three important exceptions were Malaysia, China and Hong Kong. Malaysia maintained the fixed exchange rate it adopted in the midst of the crisis, though it eased some exchange controls and allowed others to expire. China was able to retain its de facto peg to the US dollar because of its exchange controls, while the currency board arrangements were maintained in Hong Kong, at the expense of temporarily higher interest rates. In both China and Hong Kong, the appreciation of many neighbouring currencies against the dollar combined with domestic deflation to lower their real effective exchange rate back to around pre-crisis levels in 1999. In contrast, the real effective exchange rate of Malaysia ended 1999 about 25% below its mid-1997 level, as did those of Thailand and the Philippines despite different exchange rate regimes.

The experience of countries with fixed exchange rate regimes

Views differ about whether the current floating exchange rate regimes in the region are only interim arrangements. Adjustable exchange rate pegs may impede structural change and are often subject to speculative attacks. One particular weakness of the earlier pegs to the dollar was that they left the Asian currencies vulnerable to large swings in the yen/dollar rate, possibly suggesting that a peg to a basket of currencies (including, for example, the

The shortcomings of adjustable pegs

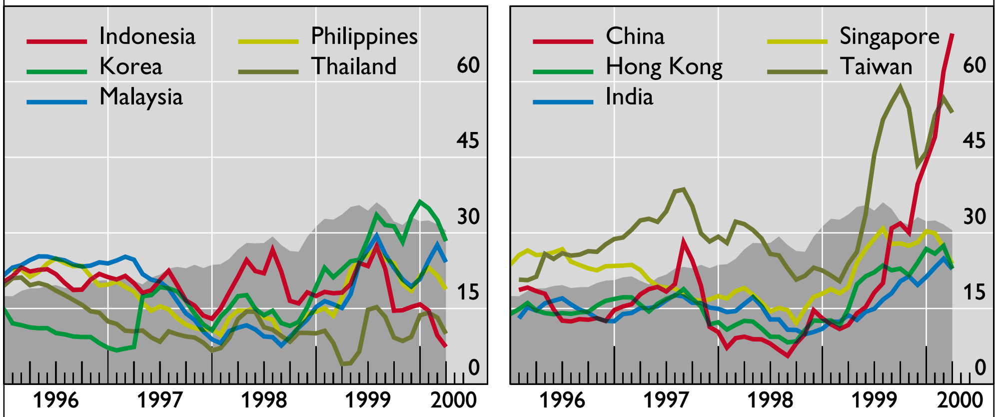
## Exchange rates and real credit growth in Asia




[1] US dollars per unit of domestic currency, June 1997 = 100. [2] Annual percentage changes in domestic credit to the private sector deflated by the annual rate of inflation.

Sources: IMF; national data. Graph III.4

Price/earnings ratios in Asia




Note: The shaded area indicates the price/earnings ratio for the United States.
Sources: Datastream; IFC. Graph III.5

dollar, the yen, the euro and perhaps the renminbi) would be preferable. However, with media and public attention focused on the bilateral rate against the dollar, public confidence as well as transparency could be weakened by an exchange rate that appears to be continually fluctuating.

Currency board arrangements

Probably influenced by the fact that three of the economies that were able to maintain their exchange rate parities during the crisis (Brunei, Macau and, above all, Hong Kong) were operating various types of *currency boards*, some countries are considering such arrangements as an alternative. Four factors have been key to Hong Kong's success in maintaining its link to the US dollar in recent years. The first is widespread political and public support and acceptance of any short-term pain. The second is a well respected monetary authority that enjoys the operational independence needed to support its fixed exchange rate and has been seen to have achieved it for a long period in the face of large shocks. The third is a strong and well capitalised banking system able to withstand sizeable financial and monetary disturbances. The fourth is a sufficient degree of flexibility of domestic prices and wages.

Inflation targets

In searching for a new nominal anchor, several Asian economies with floating exchange rates have implemented or are considering some form of *inflation targeting*. However, the optimal configuration of such a target may well differ from those in the advanced economies. In particular, the higher share of imports in consumption could make it difficult to meet a narrow inflation target given volatile exchange rates or commodity prices.

*Longer-term growth prospects*

Lower forecasts ...

Most forecasts made in late 1999 envisaged longer-term growth rates 1–2 percentage points below pre-crisis rates. This may have reflected concerns about "headwinds" following the collapse of asset price bubbles, shortages of skilled workers or hysteresis effects, such as the contraction of investment leading to a smaller capital stock and unemployed workers losing their skills. However, these forecasts still anticipated rapid growth by global standards, owing to the strong fundamentals in the region.

Most Asian economies still have substantial scope to increase their capital/labour ratios and, unlike many other countries, a sufficiently well educated labour force to use more capital. In addition, they have high savings rates with which to fund such investment. Fiscal and monetary policies have remained sound despite increases in government debt/GDP ratios, and the currency depreciations have not led to a marked rise in inflation. The economies have also resisted the temptation to introduce protectionist measures. In addition, many Asian economies are well placed to benefit more than other regions from the productivity improvements evident in advanced economies and attributed to information technology. Finally, even if sustainable long-term rates of growth are expected to be lower than in the past, the large excess capacity remaining in most East Asian economies implies some room for rather fast growth in the early years of the recovery, as has been seen in Korea recently.

… but still scope for high medium-term growth

## Some aspects of corporate and financial restructuring in Asia

Corporate and financial restructuring have been particularly closely linked in the Asian crisis economies because of the heavy reliance of most corporations on bank debt. As a result of the high gearing of corporations and the low interest cover of banks, much of the risk that in other countries would have been taken on by shareholders was carried by financial institutions. As the banks entered the crisis with weak balance sheets and substantial off-balance sheet exposures, the debt servicing problems experienced by many large corporations and smaller companies in 1997 were bound to spread quickly to the financial sector.

### *Corporate restructuring*

Causes of corporate distress in Korea …

The *Korean* experience illustrates the major causes of corporate distress in Asia, as well as the main approaches to corporate reform. Following a series of diversification drives and ambitious investment projects undertaken by the large conglomerates during the mid-1990s, the debt/equity ratio in Korean manufacturing had increased to 400% at end-1996 from under 300% in the early 1990s. When these investments failed to deliver adequate returns, further borrowing, mostly short-term, became necessary. Problems were allowed to accumulate because there was no effective monitoring and reporting of company operations and balance sheets. Against this background, the main objective of corporate restructuring was to overhaul the corporate governance system by enhancing transparency and strengthening the bankruptcy system. As a complement, broad financial sector reforms were undertaken with a view to improving the pricing of credit and market risk by liberalising capital markets. Finally, an attempt was made to improve competitiveness through deregulation and liberalisation of foreign investment.

… and the progress made

Two years into the programme, there is evidence that Korean corporations are meeting their restructuring objectives, even if the enthusiasm for reform is ebbing. Faced with a collapse in demand in the wake of the crisis, firms cut employment by more than 5% (over 1 million workers) and real wages fell by 9% in 1998. Lower labour costs and the recovery of external demand, benefiting from a competitive exchange rate and rising semiconductor prices, improved profitability and enabled companies to reduce debt in 1999. Corporations also contained their capital expenditure and the institutional framework was strengthened. Thus, markets became somewhat more open, corporate governance and financial disclosure improved, prudential regulations forced banks to tighten their lending practices and risk assessment, and a specialised bankruptcy court was established. Including equity issues and asset sales, debt/equity ratios for the top five chaebol fell by 30–40%, though they remained high by international standards, and many of the top 30 chaebol downsized and improved their production structure by focusing on their core strengths.

Restructuring in Indonesia, Thailand …

Progress with corporate restructuring has been more limited in other economies, either because of the sheer scale of the problem (Indonesia and China), or due to a weak institutional framework (Indonesia and Thailand) or the perception that the debt overhang could only be resolved gradually (Malaysia). In *Indonesia*, most of the corporate sector was insolvent by early 1998, with foreign debt equivalent to around two thirds of GDP. The main vehicles for corporate restructuring have included a voluntary scheme for out-of-court agreements, an official restructuring agency and an amended bankruptcy law. By September 1999, around 170 companies had sought assistance to restructure about one third of their foreign debt. However, owing to inadequate fiscal and administrative support, so far fewer than 30 companies have reached agreement with their creditors. To facilitate corporate restructuring in *Thailand*, a new bankruptcy law was passed and new creditors' rights, as well as a framework for out-of-court debt restructuring, were established. Even though most foreign and local banks have signed debtor-creditor and inter-creditor agreements, only a quarter of reported non-performing loans had been restructured by August 1999. However, an important precedent was finally set in March 2000, when the country's largest corporate debtor was declared insolvent.

… Malaysia and China

Historically, *Malaysia* has had a relatively effective legal framework for corporate debt restructuring and only needed to create a framework for voluntary debt restructuring agreements. Yet progress to date has been slow, with only nine cases (about 7% of the total debt) having been dealt with and fewer than 50 others being processed. Various patterns of restructuring are also beginning to emerge in *China*, where the state-owned enterprise (SOE) reform agenda has focused on improving management and governance. Budget constraints for the SOEs are being progressively hardened, their social functions transferred to local governments and pension funds, redundant workers laid off, idled capacity closed, and funds for debt writedowns established. Large SOEs are being corporatised and many are forming joint ventures with foreign investors, while small SOEs are quickly moving out of the state sector.

### *Bank restructuring*

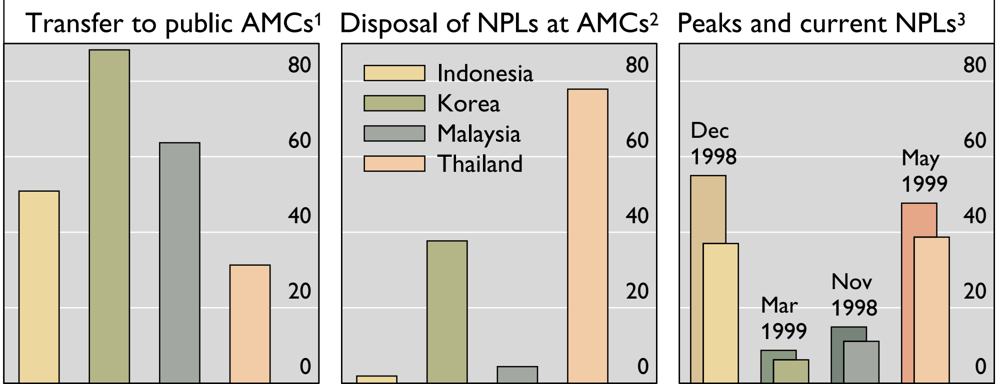
Two approaches to bank restructuring

Asian governments have followed two basic approaches in refinancing and restructuring their banking systems, depending on the seriousness of the problems, the fiscal capacity of the government and political constraints. Korea and Malaysia followed an interventionist course. They required banks to sell non-performing loans (NPLs) at large discounts to asset management companies (AMCs) owned and financed by the governments and injected government capital into weak but still viable banks. Thailand's approach (and initially also Indonesia's) was to leave resolution more to the banks themselves and to the market. Under both approaches, bank depositors were protected as banks were closed, merged or nationalised. In addition, supervisory oversight was significantly strengthened and prudential measures addressed a wide range of concerns, including loan classification and provisioning standards, connected lending and cross guarantees, capital adequacy and accounting and disclosure standards.

Use of AMCs to take over NPLs ...

As their basic strategy to resuscitate virtually paralysed financial systems, the Asian crisis economies established AMCs to buy NPLs from distressed banks or non-bank financial institutions (Graph III.6, left-hand panel). The sale of loans at their estimated market value had crystallised the loan losses for the selling institutions and once these losses had been dealt with (discussed below), banks were left with clean balance sheets and managements could focus on operational issues. Progress to date has been good. The AMCs in Korea and Malaysia have basically completed the purchase of NPLs from their banking systems, in both cases at an average discount slightly above 50%. The Indonesian agency had by May 1999 taken control of 48 failed banks and had stakes in about 200 companies. In Thailand, where the crisis first affected the non-bank financial sector, the government formed two agencies to buy and liquidate bad assets from closed finance companies. By early this year, both agencies had largely completed the sale of all core assets acquired. However, commercial banks were left to deal with their NPLs mainly on their own, resulting in relatively slow disposal and leading several banks to establish their own AMCs.

**Progress in financial restructuring in 1999**




AMC: Asset management company. NPL: Non-performing loan.

[1] As a percentage of peak NPLs. [2] As a percentage of acquired NPLs. [3] As a percentage of outstanding credit.

Sources: Fuji Research Institute; IMF; national data. Graph III.6

The AMC approach has not been trouble-free. The losses realised on the sale of loans to the AMCs led to widespread solvency problems, which forced shareholders to write down their equity and raise additional capital. When sufficient capital could not be raised, governments intervened through closures, forced mergers and, in some cases, nationalisations. Thus, the Thai government closed 53 finance companies and one bank by the end of 1999, the Indonesian government closed 67 banks, and the Korean government closed five commercial and 17 merchant banks. In all countries, a large number of mergers were consummated, including the creation of 10 "anchor" banking groups in Malaysia as part of a nationwide merger programme. Local banks were also required to raise external capital and Indonesia, Korea and Thailand now allow full foreign ownership of local banks. As a result, foreign financial institutions have acquired all or part of 18 East Asian banks since January 1998.

… did not prevent closures and mergers

Capital injections have been costly but necessary

Public capital injections to recapitalise banking systems complemented the activities of AMCs. The Korean Deposit Insurance Corporation issued government bonds worth $13 billion to recapitalise banking institutions while Malaysia injected fresh capital into 11 banks that account for about 20% of banking system assets. The Thai government offered to recapitalise banks which adopted new loan classification and provisioning rules, but only a few banks complied with the stringent conditions imposed. By contrast, the Indonesian government selected eight private banks for recapitalisation after due diligence audits. Owners who wanted to keep managing these banks had to inject about 20% of the new capital required after writing down their previous equity to zero, and were given the first right to buy back government shares within three years. Reflecting the scale of the banking crisis and the government's guarantee of deposits, the cost of recapitalising the Indonesian banking system is estimated at 50–60% of GDP, compared with about 40% in Thailand, 15% in Korea and 12% in Malaysia.

Strategies for NPL disposals involve trade-offs

The loan disposal strategies of the AMCs have varied. Korea's AMC started disposals quite quickly, while its Malaysian counterpart put more emphasis on managing and restructuring assets and only started disposals in the second half of 1999 (Graph III.6, middle panel). By allowing time to restructure the loans and the underlying assets, the latter approach can raise the prices obtained, especially if the economy recovers. However, holding NPLs involves considerable interest costs on bonds issued to the banks in return for NPLs. By contrast, the Thai AMCs disposed of assets acquired from failed finance companies in a "fire sale" at about 25% of face value.

Bank restructuring in China

Elsewhere, progress with bank reform has remained slow. *China* established four AMCs in 1999. These would use bonds to buy, at face value, the bulk of NPLs accumulated from pre-1997 loans thought to have any residual value, while assets with no value would be written off. Though funding arrangements for the AMCs and the debt write-offs are still to be finalised, the AMCs would be expected to maximise asset recovery by selling collateral backing the loans and securitising and auctioning NPLs, including to foreign investors. Debt/equity swaps, which can help enterprises with cash flow that only partly meets current interest charges but not firms unable to cover variable costs, would also be used, implying that bank restructuring will

## Indicators of bank performance in the Asian crisis countries

| | Korea | | Thailand | | Malaysia | | Indonesia | |
|---|---|---|---|---|---|---|---|---|
| | 1996 | 1999 | 1997 | 1999 | 1997 | 1999 | 1997 | 1999 |
| | at end-year, in percentages and percentage points | | | | | | | |
| Non-performing loans[1] | 4.1 | 6.2[2] | 22.5 | 38.6 | 3.2 | 9.0 | 7.1 | 37.0 |
| Return on assets | 0.3 | 3.3[2] | –0.1 | –2.5[3] | 0.6 | –0.2[3] | –0.1 | –17.4[3] |
| Intermediation spread[4] | 3.6 | 2.2 | 3.8 | 4.8 | 2.5 | 4.4 | 1.5 | 7.7 |
| Capital/asset ratio[5] | 9.1 | 9.8[6] | 9.3 | 12.4 | 10.3 | 12.5 | 4.6 | –18.2[2] |

[1] As a percentage of total loans of commercial banks; national definitions. NPLs do not include loans transferred to AMCs. [2] September. [3] December 1998. [4] Short-term lending rate minus short-term deposit rate. [5] Risk-weighted. [6] June.

Sources: Fitch-IBCA; IMF; national data. Table III.5

require restructuring of the state-owned enterprises as well. Once the transfer of NPLs to the AMCs is completed, banks are expected to focus on commercial lending, with management taking responsibility for future loan losses and agreeing to meet best performance targets.

Favourable impact of reforms in Korea, Malaysia and Thailand ...

It is still too early to assess the full impact of these reforms on banks' ongoing operations. The transfer of NPLs to AMCs led to a fairly rapid strengthening of the banks' balance sheets in Korea and Malaysia (Graph III.6, right-hand panel and Table III.5). In Thailand, where banks had to work out the loans on their own, NPLs declined from a peak of 48% of total loans in May 1999 to 38% in January this year, but progress slowed in recent months and there are concerns that the NPL ratio could start climbing again. There was also progress in cutting operating costs as a result of branch closures. Employment in Korean commercial banks declined by about 25% and remaining employees had to accept salary reductions. The profitability of Korean banks also improved in the first half of 1999 as a result of the resumption of economic growth and gains in the stock market. However, as several of the agreed debt workouts of the large chaebol are revisited, banks may have to accept additional losses.

... but much remains to be done elsewhere

In other countries, banks continued to operate with losses. Thus to sustain the balance sheet improvements, it will be imperative for banks to improve business practices such as risk analysis, loan approval and monitoring procedures, and to enhance profitability by cutting costs and concentrating on core business strengths. The authorities will need to continue to enforce the newly tightened prudential regulations through close supervision, and will also have to decide when and how banks which have been effectively nationalised are to be returned to private ownership. The greater presence of foreign financial institutions could be an important factor contributing to a more permanent change in the culture of Asian banking in the future.

## Diverging and unusual performance of countries in Latin America

Macroeconomic developments in Latin America displayed several unusual features last year, not only in relation to other emerging market economies but also compared with historical trends. First, with Mexico as a major exception, Latin America was in recession through most of 1999 and average growth declined quite sharply compared with 1998. Second, reflecting domestic as well as external factors, growth divergences across countries more than doubled. Third, contrary to historical patterns, depreciating exchange rates or even the abandonment of an earlier peg did not lead to higher inflation.

The influence of external factors

Although most Latin American countries are relatively closed economies, their low and diverging growth rates last year can, to a large extent, be attributed to differences in export performance and terms-of-trade changes (Table III.6). In particular, Argentina suffered a large terms-of-trade shock, mainly as a result of the weakness of food prices. Moreover, export volumes declined due to the depreciation of exchange rates in neighbouring countries, the general slowdown in the region and, above all, developments in Brazil, which takes the bulk of Argentina's exports. In contrast, the growth of export earnings in Mexico was helped by the booming US economy and the rise in oil prices. Other countries, such as Chile and Peru, benefited from the pickup in metals prices while the continued decline of food and beverage prices combined with weak demand in the region to constrain growth in Bolivia, Colombia, Paraguay and Uruguay.

The devaluation in Brazil …

Domestic factors and policies were also important in explaining the divergent growth performance. One key event was the devaluation of the *Brazilian* real in early 1999 (Graph III.7). It was immediately followed by a worsening of expectations with respect to output growth as well as inflation. However, the abandonment of the almost-fixed exchange rate regime did not trigger a crisis, primarily because demand was already rather depressed and the adoption of a tight monetary policy and new measures of fiscal restraint reassured investors and limited the inflationary response. Moreover, the devaluation did not cause an acute problem in the banking system, since most banks had a favourable balance of dollar-denominated assets and liabilities and well managed derivatives operations. In particular, by virtue of their large holdings of liquid, floating rate and dollar-indexed government securities, banks were able to meet deposit withdrawals and overcome the cutoff of credit lines by foreign banks without suffering severe liquidity problems.

… did not trigger a crisis …

Once the policy measures were in place, external financial pressure started to ease. The IMF announced a second tranche of financial support in March 1999 and an informal agreement was reached with some of the

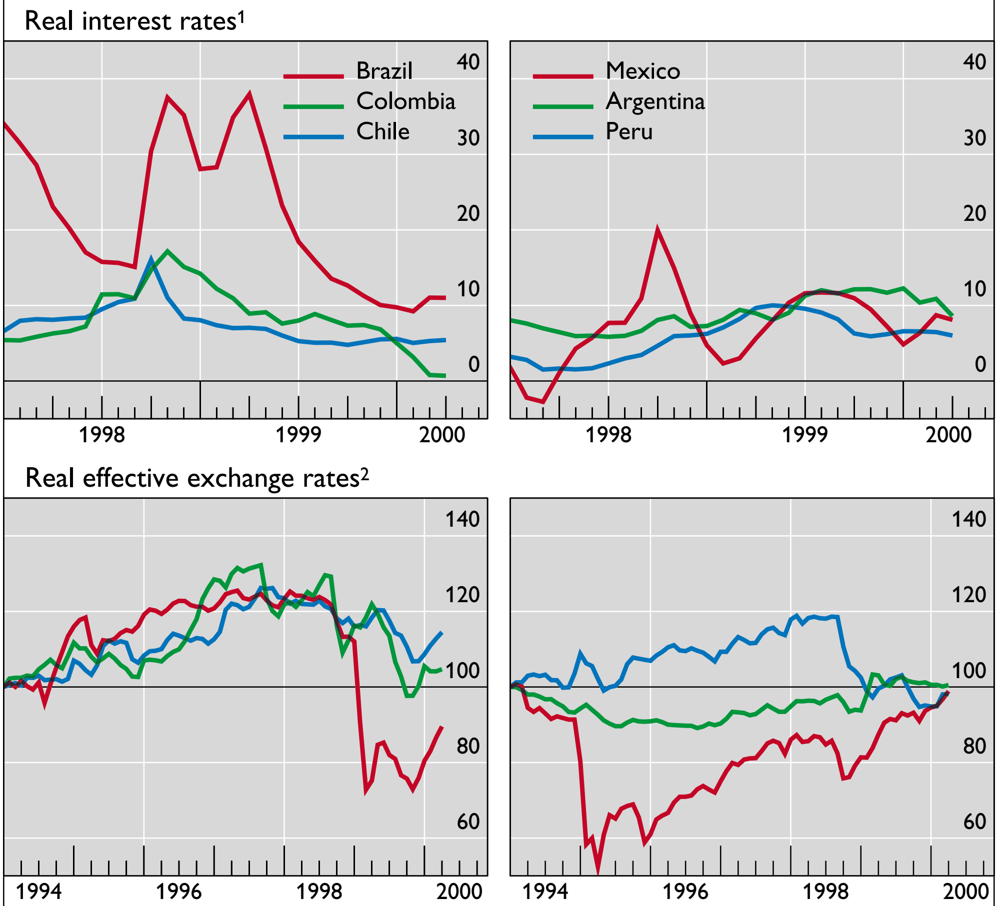
**Export performance of major Latin American countries in 1999**

| | Growth[1] | | | Destination[2] | | | |
|---|---|---|---|---|---|---|---|
| | Prices[3] | Volume | Value[3] | United States | European Union | Asia | Latin America |
| Argentina | −13.4[4] | 2.2 | −11.5 | 10.2 | 20.6 | 15.5 | 43.2 |
| Brazil | −11.3 | 6.4 | − 6.1 | 22.8 | 28.8 | 12.0 | 23.4 |
| Mexico | 3.7 | 12.2 | 16.4 | 83.0 | 3.5 | 2.2 | 5.1 |

[1] Percentage change over 1998. [2] As a percentage of total exports. [3] In US dollar terms. [4] Up to third quarter.

Sources: IMF; national data; BIS estimates. Table III.6

## Interest rates and real effective exchange rates in Latin America




¹ Short-term rates deflated by the annual rate of inflation, in percentages (for Mexico, by annualised inflation in subsequent months). ² In terms of relative consumer prices, December 1993 = 100; an increase indicates an appreciation.

Sources: IMF; national data; BIS calculations. Graph III.7

international banks to roll over existing credit lines, allowing the authorities to reduce interest rates from the peak of 45% in late March. Together with the shift in relative prices brought about by the currency depreciation, easier monetary conditions led to an expansion of output in the tradable goods sector even though the responsiveness of exports was limited by their concentration on commodities with falling prices and by the recession in neighbouring countries.

… though the fiscal deficit was a concern

The restoration of confidence in Brazil also hinged on reducing the fiscal deficit to a more sustainable level (Table III.7). While the government eventually achieved a primary surplus of just above 3% of GDP, some of the measures taken were temporary or one-off actions since a consensus for far-reaching structural measures could not be found. Moreover, with the nominal deficit still close to 10% of GDP, concerns about fiscal stability led to renewed uncertainty in the foreign exchange market. To limit the weakening of the exchange rate, the government again relied on issuing dollar-indexed bonds and agreed with the IMF on a reduction of the minimum level of net international reserves. These measures, even though they may have increased longer-term vulnerabilities, eventually allowed interest rates to be reduced further.

Strong growth performance in Mexico …

In contrast to most other countries, the contagion from Brazil to *Mexico* was rather limited. Strong export growth, facilitated by the continued buoyancy of the US economy, limited the downturn in early 1999, while domestic demand was the main source of growth during the second half. Boosted by high employment growth and the income effects of the higher oil price, private consumption grew strongly while investment was stimulated by a further easing of monetary policy. It is also worth noting that, over the last four years, domestic demand has expanded by a cumulative 25% without any increase in bank credit. In part, this reflects a lack of loan demand as business investment was largely financed through FDI inflows. However, it also resulted from banks' reluctance to lend to risky sectors and from the slow progress in restructuring banks' balance sheets and changing the legal system within which banks operate.

… but deep recession in Argentina

The recession in *Argentina* should not be attributed to external factors alone. Because of the convertibility law and Argentina's growing dependence on external financing, changes in external conditions had a direct impact on domestic policies. Thus interest rates were driven up following the Brazilian devaluation. Subsequently, as tax revenues declined in response to lower

## Fiscal balances and public debt

| | Nominal balance | | | Interest payments | | | Public debt | | |
|---|---|---|---|---|---|---|---|---|---|
| | 1996 | 1998 | 1999 pe | 1996 | 1998 | 1999 pe | 1996 | 1998 | 1999 pe |
| | as a percentage of GDP | | | | | | | | |
| Asia | | | | | | | | | |
| China | –0.8[1] | –1.2 | – 2.1 | 0.8[1] | 1.0 | … | 7.4[1] | 9.9 | … |
| Hong Kong | 2.2 | –1.8 | – 0.1 | – | – | – | – | – | – |
| India | –4.7 | –5.9 | – 5.7 | 4.2 | 4.4 | … | 47.9 | 49.8 | … |
| Korea | 0.3 | –4.2 | – 2.9 | 0.5 | 0.8 | … | 12.0 | 19.5 | 22.2 |
| Singapore | 14.7 | 16.7 | 10.1 | – | – | – | 73.7 | 83.1 | 87.4 |
| Taiwan | –3.3 | 0.7 | – 0.9 | 1.6 | 1.5 | 1.4 | 22.9 | 24.0 | 25.5 |
| Indonesia | 1.1 | –2.5 | – 2.7 | 2.0 | 2.4 | 3.8 | 27.3 | 73.9 | 60.0 |
| Malaysia | 0.7 | –1.9 | – 3.4 | 2.7 | 2.6 | 2.8 | 35.9 | 38.3 | 40.0 |
| Philippines | –0.3 | –1.8 | – 3.6 | 3.4 | 3.6 | 3.4 | … | … | … |
| Thailand | 3.0 | –2.9 | – 3.4 | 0.2 | 0.2 | 1.0 | 13.5 | 22.1 | 37.1 |
| Latin America | | | | | | | | | |
| Argentina | –2.2 | –1.4 | – 2.6 | 1.7 | 2.2 | 2.9 | 35.7 | 37.7 | 43.1 |
| Brazil | –5.9 | –8.1 | –10.0 | 5.8 | 8.1 | 13.1 | 33.3 | 42.4 | 47.0 |
| Chile | 2.3 | 0.4 | – 1.5 | 0.6 | 0.7 | 0.4 | 38.4 | 35.3 | 34.2 |
| Colombia | –1.7 | –3.4 | – 4.3 | 3.5 | 4.2 | 3.8 | 13.9 | 21.6 | 29.8 |
| Mexico | – | –1.3 | – 1.1 | 4.4 | 2.9 | 3.6 | 30.5 | 27.9 | 25.3 |
| Peru | –1.1 | –0.6 | – 2.5 | 2.2 | 1.7 | 1.9 | 25.4 | 20.4 | 20.6 |
| Venezuela | 0.7 | –4.2 | – 2.8 | 5.0 | 3.0 | 3.3 | 48.8 | 28.9 | 29.5 |

Note: Comparisons across countries should take account of the fact that different definitions of the public sector are used.
[1] 1997.
Source: National data.

Table III.7

nominal incomes and debt service increased, there was growing uncertainty as to whether the fiscal targets agreed with the IMF would be achieved. The uncertainty and the associated upward pressure on interest rates were compounded by fears that the government might encounter difficulties in financing even a moderate rise in the deficit (1.2% of GDP), since it was already issuing debt heavily in international capital markets to finance the current account deficit and amortisation payments (Table III.4). Although the announcement of more stringent fiscal measures by the end of the year provided some relief, the need to support the exchange rate meant that interest rates had to be kept high. Indeed, the absence of any domestic instrument to cushion the effects of adverse external developments was manifest in the 2% decline of consumer prices during 1999.

Unlike Argentina, *Chile* was able to ease monetary conditions in response to the externally induced recession early in the year and its solid fiscal position made it possible to use fiscal policy countercyclically. By contrast, in *Ecuador* and *Venezuela*, which both benefited from the rise in oil prices, uncertainty about policies and other domestic events led to a steep decline in output.

*Inflation developments*

Containment of inflation …

A notable development in Latin America last year was the containment of inflation at low levels in most countries. The average inflation rate in the region declined to 9% and the median rate to just 4%. Moreover, some traditional high-inflation countries (Colombia, Uruguay and Venezuela) recorded their lowest inflation rates in decades. This achievement was all the more remarkable, given the background of lower nominal exchange rates in many countries and an earlier history of depreciations inducing sharply higher rates of inflation.

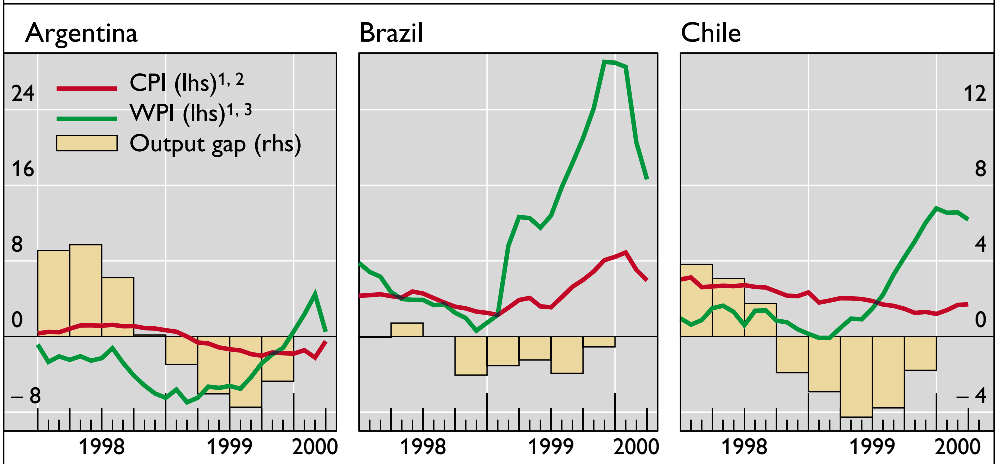
… could be only transitory …

Some of the disinflationary influences in 1999 might prove only transitory. First, disinflation was imported from the rest of the world through lower import prices in US dollars and, in the case of Mexico, an appreciation of the peso against the dollar. Second, most economies were operating at low levels of capacity utilisation and in a recessionary environment such that firms tended to reduce margins and workers restrained wage demands. In Brazil, for instance, profit margins in most manufacturing industries had already contracted before the devaluation and real wages had fallen by 8% by end-1999. Moreover, weak demand contributed to a relatively low pass-through of changes in import and wholesale prices into consumer prices. In other countries, a similar compression of profit margins and a low pass-through of exchange rate and import price movements also seem to have taken place (Graph III.8).

… but might become permanent

However, there are several reasons to believe that the current low inflation prevailing in Latin America could become a permanent feature. Deregulation has led to more competitive economies and trade liberalisation has opened domestic markets to more foreign competition, even if imports still account for only a small fraction of total expenditure. Indexation mechanisms have also been removed as low inflation has become established. Moreover, since most countries now allow their currencies to float, and exchange rates

**Inflation and output gaps in Latin America**




[1] Annual percentage change. [2] Consumer price index. [3] Wholesale price index.
Sources: IMF; national data; BIS calculations. Graph III.8

have indeed been moving in both directions, firms may become more cautious in revising their prices in response to exchange rate changes. Finally, aware of the risks of a rebound of inflation, the authorities in most countries have kept interest rates at relatively high levels and also refrained from using fiscal policy to ease the recession. Such prudent policies probably helped to dampen expectations of inflation and, by partially reversing nominal depreciation, may also have facilitated the control of actual inflation.

*Large external imbalances*

Large current account deficits …

Although output declined or stagnated in the region, current account deficits remained at high levels, notably in Argentina and Brazil, where they continued to exceed 4% of GDP. While external imbalances narrowed significantly in Chile and Colombia, they remained rather high in Mexico and other countries, particularly given the stage of the economic cycle and relatively favourable global conditions. An important factor was that several countries were severely affected by the slow recovery or continued decline of non-oil commodity prices. Moreover, despite their immediate contribution to financing current account imbalances, FDI inflows in the form of greenfield investment may have led to a widening of those imbalances. For instance, foreign investment in the assembling companies that conduct most of the trade between Mexico and the United States leads directly to higher imports of capital goods. In addition, such inflows tend to increase domestic income and thus raise imports further. Foreign investment in the non-tradable sectors might also be accompanied by wider current account imbalances to the extent that firms earn profits without having increased either export or import-substituting capacity.

… raise concerns about sustainability of FDI inflows …

Another, and perhaps more important, issue is whether FDI flows are sustainable at the level experienced in the last few years. Privatisation-induced inflows have been important in Argentina, where they represented half of total flows last year. However, there are obvious limits to this process and, in Brazil, the share of FDI associated with privatisation actually fell in 1999. Mergers and acquisitions were important as well and may have been boosted by the fact that local companies appeared less expensive due to the lower exchange rate. But FDI flows into Latin America have also been driven by structural reforms allowing foreigners to invest in an increasing number of sectors, the effects of which might well be felt for several years. Moreover, in cases where the initial entry of foreigners came through privatisation, mergers or acquisitions, these moves were often followed by expansions of the capital stock.

… and exposure to foreign interest rates

Notwithstanding the relative ease with which current account deficits were financed, the further rise in foreign debt/GDP ratios last year implies that most Latin American countries remained highly exposed to changes in international financial conditions, including higher interest rates in the industrial countries.

## Africa

Structural weaknesses contribute to lower growth

Despite the pickup in global demand and the associated improvement in financial conditions, economic growth in Africa slowed to some 2½%, from more than 3% in 1998. Once again, Africa's basic structural weakness (ie its low degree of integration in the world economy and excessive reliance on agriculture and exports of primary commodities) has made its macroeconomic performance relatively insensitive to changes in global demand conditions but highly vulnerable to terms-of-trade movements. In addition, because of poor governance, a rudimentary financial structure and low saving, the resistance to domestic shocks is weak and, as a result, variations in growth rates across countries are typically much larger than for other groups of emerging market economies. For instance, higher prices for industrial commodities, themselves a product of higher global growth, supported real income in many African countries in 1999. However, civil strife and loss of monetary control in Angola and the Democratic Republic of Congo, deflation in Burkina Faso and Chad and adverse weather conditions in other countries (eg Morocco) all took their toll on output, causing average GDP growth in Africa to decline.

Progress in reducing inflation

With growth lower than expected, many countries made further progress in reducing inflation. Disregarding the two countries which lost monetary control, average inflation fell to around 7% and the median rate to only 4%, the lowest for the 1990s. As in the past, inflation was lowest in the CFA countries; in fact, half of the countries in this group experienced either falling prices or price increases of less than 1%. By contrast, in Malawi and Zimbabwe inflation rose to 45% and 60% respectively, while Zambia, Ghana and Sudan recorded inflation rates ranging up to almost 30%.

Marked growth divergences across regions

The divergences in economic performance could also be observed across regions last year (Graph III.9). For instance, lower growth in the northern region was mainly due to the significant slowdown in Morocco, while the relatively high growth recorded by the western region can be attributed to a pickup in Ghana which more than offset the weaker performance in Côte d'Ivoire. The slowdown in the central region is, however, puzzling as three of Africa's oil-exporting countries (Cameroon, Gabon and Nigeria) are in that area. In other cases, a significant degree of heterogeneity within regions causes differences in country performances to "even out". For instance, the eastern region experienced a marked improvement in output performance as the resumption of growth in Ethiopia more than offset the effects of the persistent weakness of agricultural commodity prices in Kenya, Tanzania and Uganda. Similarly, the low growth in the southern region can mainly be attributed to the deteriorating performance of Zimbabwe and continuing slow growth in South Africa.

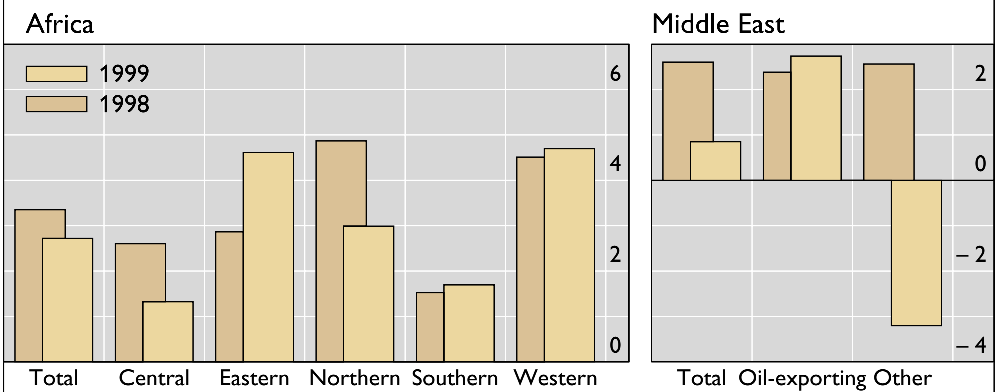
The need for higher and more labour-intensive growth in South Africa

During the 1990s, *South Africa's* GDP growth averaged only 1% while the rate of unemployment increased to nearly 40%. Even though the actual jobless rate is somewhat lower, as many unemployed work in the informal sector or take unregistered contract work, several years of high and stable growth would seem necessary to reduce unemployment and generate a more equal distribution of income. To ensure higher output and employment growth, it is crucial that the investment/GDP ratio be raised substantially from the current level of only 15%, but also that there be some moderation of real wages to induce firms to install more labour-intensive equipment. While the introduction of an inflation targeting framework for monetary policy could help to reduce inflation and inflation uncertainty, this is probably not sufficient to make South Africa more attractive to foreign direct investment. In the last decade South Africa actually recorded a net FDI outflow as greenfield investment in particular has been discouraged by sluggish productivity growth and relatively high unit labour costs.

Obstacles to FDI inflows

Lack of competitiveness may, however, not be the only reason why the worldwide surge in FDI flows into emerging market economies has largely bypassed South Africa, and indeed the continent as a whole. Political uncertainty and weak legal systems are even more important problems in some countries. Greater diversification of production and export structures

## Real GDP growth in Africa and the Middle East[1]




Central: Burundi, Cameroon, Chad, Gabon and Nigeria. Eastern: Ethiopia, Kenya, Madagascar, Mauritius, Tanzania and Uganda. Northern: Algeria, Mauritania, Morocco, Sudan and Tunisia. Southern: Angola, Botswana, Malawi, Mozambique, South Africa, Zambia and Zimbabwe. Western: Benin, Burkina Faso, Côte d'Ivoire, Gambia, Ghana, Mali, Niger, Senegal and Togo. Oil-exporting: Bahrain, Egypt, Iran, Kuwait, Libya, Oman, Qatar, Saudi Arabia and the United Arab Emirates. Other: Israel, Jordan and Turkey. Total: All countries in the region.

[1] In percentages; the standard deviations (across all countries) are 3.00 (1998) and 3.32 (1999); weighted averages of the countries listed, based on 1995 GDP and PPP exchange rates.

Sources: IMF, *World Economic Outlook*; BIS estimates. Graph III.9

## Monetary indicators for Africa[1]

| | Broad money | | Credit to the government | | Credit to the private sector | | | |
|---|---|---|---|---|---|---|---|---|
| | as a percentage of GDP | | | | | | as a percentage of total domestic credit | |
| | 1992–94 | 1995–98 | 1992–94 | 1995–98 | 1992–94 | 1995–98 | 1992–94 | 1995–98 |
| Central | 20 | 15 | 18 | 6 | 9 | 9 | 33 | 58 |
| Eastern | 36 | 39 | 15 | 12 | 17 | 22 | 47 | 66 |
| Northern | 65 | 59 | 28 | 19 | 21 | 29 | 34 | 44 |
| Southern | 40 | 43 | 2 | 2 | 48 | 53 | 84 | 85 |
| Western | 23 | 22 | 9 | 9 | 15 | 12 | 64 | 61 |

Note: For an explanation of the country groupings, see Graph III.9.
[1] Annual average for the three- and four-year period respectively.
Sources: IMF; national data; BIS estimates. Table III.8

would also render African economies more attractive as host countries for FDI. Moreover, the lack of financial depth and the smallness of markets continued to impede the necessary mobilisation of both foreign capital and domestic saving. Thus financial sectors in Africa have remained small compared with the more advanced Asian and Latin American economies. Taking the ratio of broad money to GDP as a measure of the depth of the financial system, only Algeria, Kenya, Mauritius, Morocco, South Africa and Tunisia have relatively developed systems (Table III.8). Moreover, the rise in financial intermediation, as measured by credit to the private sector relative to GDP, has been only modest.

Structural impediments to financial sector development

While the establishment of a well functioning financial system could play a key role in attracting foreign investment, Africa is confronted with several structural and political problems in this respect. First, the economic structure of most countries (a high share of agriculture with investment largely self-financed) tends inherently to produce a low degree of financial intermediation. Second, large state-owned banks have hampered the development of a more efficient and competitive financial sector. Third, up to the mid-1990s, African countries typically favoured the "real" sector of the economy through preferential credits to selected activities. During the second half of the 1990s, policies did shift increasingly towards financial liberalisation, including interest rate deregulation, the granting of independence to central banks, the chartering of new banks and, as a consequence, a larger role for financial institutions in allocating capital. However, the effects of these reforms have been relatively limited to date.

## Middle East

The instability of oil prices over the past decade undoubtedly depressed economic growth and investment in the Middle East. However, in more recent years, there were signs of recovery, notably in countries where a shift towards more market-oriented policies could be observed. For instance, following the adoption of a unified exchange rate in the early 1990s and the introduction of

Reform policies improve performance in Egypt

wide-ranging structural reforms, *Egypt* achieved average growth of about 5% in the last five years while, over the same period, the rate of inflation gradually declined to 3%. *Saudi Arabia* has also announced measures directed at opening the economy to foreign investment and diversifying away from oil. However, the improvement in the overall economic performance recorded last year can mainly be attributed to the strength of oil prices which helped to reduce the fiscal deficit to about 6% of GDP and the current account deficit to 3%.

Output shocks in Turkey …

The *Turkish* economy suffered three major shocks in 1999: the loss of important export markets, the withdrawal of foreign capital in the wake of the 1998 Russian debt moratorium, and the earthquake in August which caused huge damage to the economy. High real interest rates, aimed at reducing inflation, exacerbated the recessionary tendencies in the first half of 1999 and real output dropped by an estimated 5%. Economic activity in *Israel* was also rather weak during the first half of 1999. However, the announcement of fiscal restraint and a 3–4% inflation target for the next two years, in conjunction with stronger global demand, seemed to have a favourable effect on expectations and confidence. As a result, the second half saw GDP growth rising to a 5% annual rate, driven by exports and consumption. Moreover, despite the surge in activity, the rate of inflation declined to only 1.3% by end-1999.

… but a rebound in Israel

## Central and eastern Europe

### *Output and foreign trade developments*

Quick recovery in Poland and Hungary …

While Russia recovered more quickly from the financial crisis of mid-1998 than had generally been expected, the crisis, combined with the fallout from the Kosovo war, had negative effects on neighbouring countries. The Hungarian and Polish economies recovered rapidly from the slowdown, with growth rates of 4–4½%. In Hungary, the industrial recovery was driven by the electronics sector and strong growth in exports (Graph III.10). Industrial production was also a major source of strength in Poland while real earnings growth, combined with continued brisk lending to households, supported consumption growth.

… while others suffer output losses …

The recession in the Czech Republic actually started with the currency crisis of 1997 and was later exacerbated by fiscal restraint. Unemployment rose rapidly, causing nominal wages as well as market prices to moderate or decline. Being still very dependent on exports to Russia, output in the Baltic states slowed by up to 4%. The Romanian economy, suffering from a host of domestic problems, contracted by 4% in 1999 and Croatia by 2%. In contrast, Bulgaria seems to have been relatively little affected by the crises in neighbouring countries and continued to reap the benefits of its currency board, including output growth of 2½%, a fall in inflation to only ¼% and lower interest rates. Equally surprising were the solid growth performance and relatively stable macroeconomic conditions in most CIS countries, many of which benefited from low imported inflation and the higher oil price.

… though not Bulgaria and the CIS countries

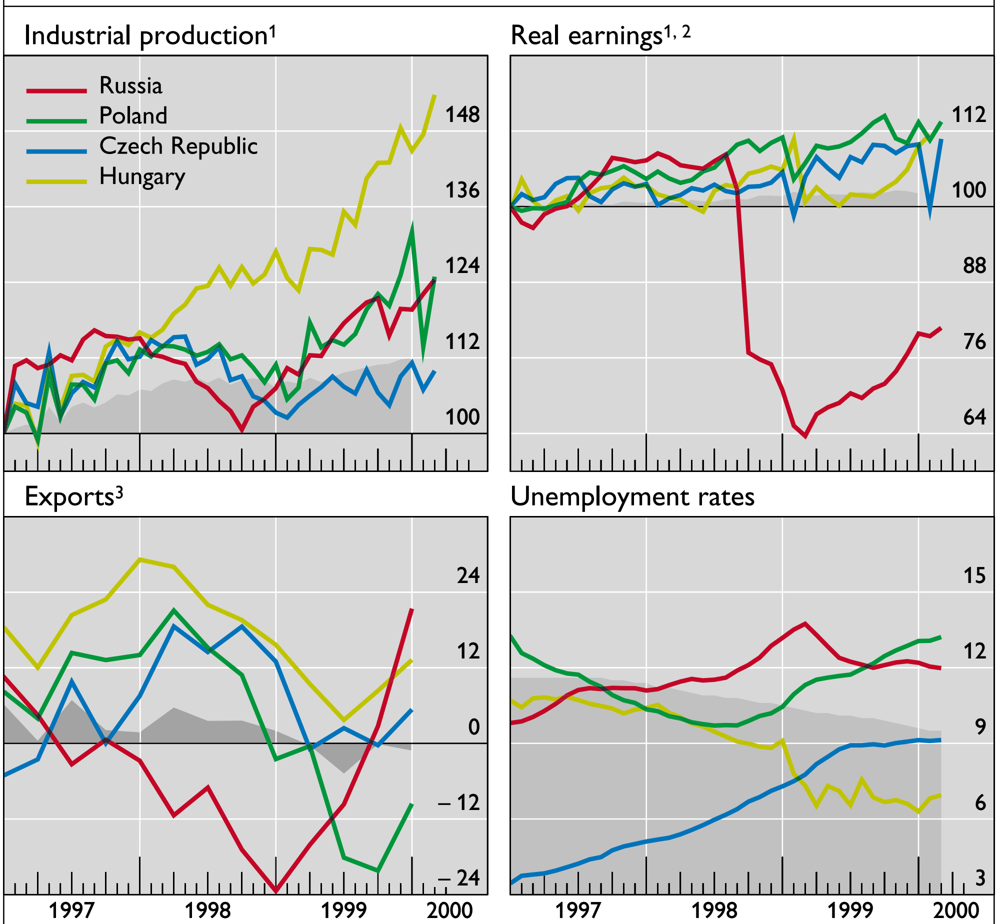
Uneven development in foreign trade

Owing to differences in the commodity composition and geographical distribution of exports, as well as variations in domestic demand growth, developments in foreign trade and current account imbalances were quite uneven last year. Hungary's exports had already started to recover by mid-1999 and its current account deficit declined. The Czech Republic also saw an improvement in its current account, though mainly due to weak import demand. In contrast, Poland's current account deficit widened to 8% of GDP owing to a major loss of competitiveness in export markets. Downward exchange rate pressures were generally less pronounced in the region than in 1997–98, even in the Baltic states, Slovakia and Croatia, where current account deficits remained at or above 6% of GDP (Graph III.11).

Stabilisation in Russia

The resumption of growth in *Russia* in 1999 was mainly due to favourable external developments. The substantial increase in the price of oil and import substitution effects induced by the large devaluation in August 1998 were reflected in a trade balance shift of $17 billion and a rise in GDP of 3.2%. Moreover, a revival of the manufacturing sector helped to halt the upward trend of unemployment. Other positive developments included better tax collection and the containment of inflationary pressure as fears of hyper-inflation waned and a less volatile rouble/dollar exchange rate became established. However, the containment of inflation has, in part, been at the

## Economic indicators for Russia and central Europe



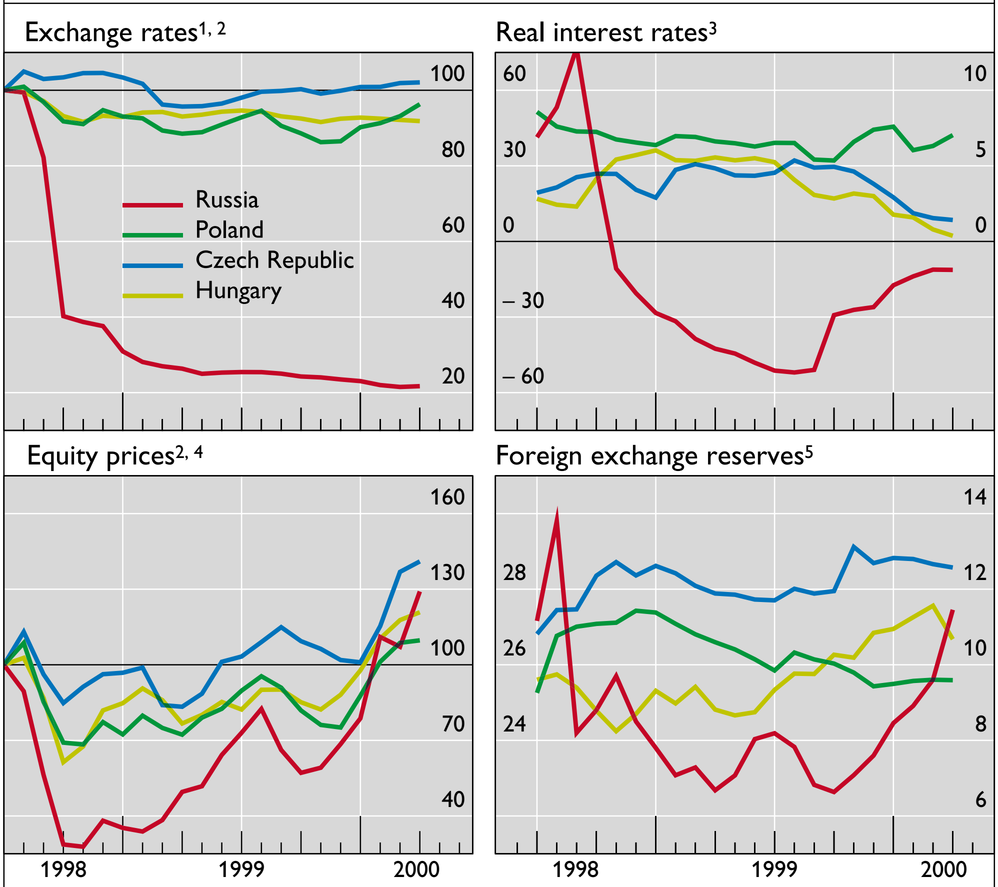

Note: The shaded areas indicate the respective data for the euro zone.

[1] December 1996 = 100. [2] Earnings deflated by the consumer price index. [3] Annual percentage change, in US dollar terms.

Sources: IMF; national data.

Graph III.10

Financial market developments in Russia and central Europe




[1] Euros per unit of domestic currency (for Russia, US dollars). [2] June 1998 = 100. [3] Short-term rates deflated by the annual rate of inflation, in percentages (for Russia, lhs). [4] In US dollar terms. [5] In billions of US dollars (for Poland, lhs).

Sources: IMF; national data. Graph III.11

expense of steeply falling real earnings and household incomes. By the end of 1998, real earnings had declined by about one third compared with the pre-crisis level and only a fraction of that loss was recovered last year.

*Inflation and the adoption of new monetary policy regimes*

Widening inflation gap vis-à-vis the euro zone

Although inflation in central Europe had continued to moderate under the influence of weak economic growth during the first half of 1999, the gap between central European and euro zone inflation rates started to widen again. In several countries, wage growth in excess of productivity was the major threat to price stability, while in others large currency depreciations or liberalisation measures were the principal inflationary forces. Partly in response to these developments, Poland implemented an inflation targeting framework for the conduct of monetary policy from the beginning of 1999, while the Czech Republic had already done so following the currency crisis of 1997.

The adoption of inflation targets in Poland …

*Poland* initially set a target range for CPI inflation of 8–8.5% for end-1999, with the longer-term aim of reducing inflation to below 4% by 2003. While the range was lowered in March 1999, the actual rate (9.8%) turned out to be higher than targeted, partly due to the rise in oil prices but also reflecting unexpectedly strong consumer demand. The central bank attempted to rein in inflationary pressure by raising policy rates by 3 percentage points while continuing to monitor the exchange rate. The zloty's already large fluctuation band was widened further from ±12.5% to ±15% in March 1999 and, consistent with the shift to an inflation targeting framework, the authorities decided to float the zloty in April this year. In contrast to the Polish experience, the net inflation target was significantly undershot in both 1998 and 1999 in the *Czech Republic*. The large gap between net inflation, which excludes the impact of changes in indirect taxes and administered prices, and headline inflation for a time threatened credibility as expectations of inflation appeared to lean more heavily on the latter. However, in response to the undershooting of the net inflation target and to weak economic growth, interest rates were lowered substantially last year with broad popular support.

… and the Czech Republic

Challenges to inflation targeting in transition economies

Due to their short exposure to a more market-oriented environment and to the process of transition itself, central European economies which chose to introduce an inflation targeting framework faced some specific challenges. Among these were the need to model the transmission mechanism of monetary policy and to estimate the impact of large movements in exchange rates on inflation and expectations of inflation. In addition, the time series data on output and productivity are relatively short, complicating the calculation of output gaps. Moreover, most transition economies have not yet fully liberalised all administered prices. The Czech government is committed to liberalising all regulated prices by the end of 2002 and such a move could add up to 3 percentage points per year to headline inflation. Although the central bank is targeting net inflation, this development could still lead to tighter monetary policy if inflation expectations and wage demands rise in consequence. Finally, consumption patterns have probably not yet settled, creating a risk of potential measurement errors in both headline and underlying price indices.