III. The spreading crisis in emerging markets

Highlights

Most emerging market economies suffered a major slump in commodity prices in 1998 and faced very unsettled conditions in international financial markets. Especially after mid-year, the perceived riskiness of investing in the emerging world increased markedly, causing creditor banks and other investors to scale back drastically their financial exposures. Whereas until mid-1998 the financial crisis had been contained mainly within Asia, it subsequently spread rapidly to Russia and parts of Latin America.

Adjustment to the crisis in Asia was associated with severe output contractions. As the year progressed, however, a degree of financial stability returned and the decline in output in the most affected economies tended to level off. How strong the recovery will be remains to be seen. Excess capacity built up over a number of years is dampening investment. Moreover, external demand growth has remained weak, in part because of the depressed state of many regional export markets, most notably Japan. Some uncertainty also surrounds the prospects for China's economy.

At the root of the Russian crisis of August 1998 were a number of major economic and financial weaknesses. Many of the basic elements of a market economy are not in place; the public finances are in urgent need of reform; and financial institutions have yet to assume their central role in the intermediation process. Elsewhere in eastern Europe transition is at a more advanced stage and contagion from the Russian crisis was limited.

The most notable victim of the flight to quality and liquidity in late 1998 was Brazil. As so often in the past, a tightly managed exchange rate regime, combined with growing domestic and external macroeconomic imbalances, proved unsustainable. Most other Latin American countries also experienced a more hostile climate in international goods and financial markets and were forced to turn to more restrictive policies.

Key influences on developments in emerging market economies

The financial turmoil which erupted with the floating of the Thai baht in mid-1997 has since spread to a large number of emerging market economies. The crisis has gone through a series of stages (Table III.1), linked by several, often complex channels of transmission and contagion. Vulnerable corporate and financial sectors, weak public finances, widening current account deficits and inconsistent policy frameworks have been the basic causes of difficulties in most countries. As many emerging market economies have become more integrated in the global financial system, abrupt reversals in the flow of capital have almost always served to both trigger and exacerbate domestic problems. In turn, deep recessions were provoked and exchange rates fell sharply in the countries affected, with significant effects on international trade prices and

Principal stages of the emerging market crisis

1997	
July	Floating of the Thai baht (2 July).
August	Floating of the Indonesian rupiah (14 August). Approval of an IMF-led support package of $20.1 billion for Thailand (20 August).
October	Equity markets in Asia, Latin America and Russia fall sharply. Strong exchange rate pressure builds in Brazil, Hong Kong, Korea and Taiwan.
November	Approval of an IMF-led support package of $40 billion for Indonesia (5 November).
December	Approval of an IMF-led support package of $57 billion for Korea (4 December). Floating of the Korean won (6 December). Oil price records 30% fall over the year.
1998	
January	Russian rouble is pegged to the dollar with a ±15% fluctuation band (1 January). Indonesian corporate debt "pause" (27 January). Restructuring agreement covering $24 billion between Korea and its external creditors (29 January).
February	Currency board proposed by Indonesia.
May	Presidential change following riots in Indonesia (21 May). Russian refinancing rate reaches 150% by month-end.
June	Indonesia and a steering committee of creditors agree to restructure $70 billion of foreign private debt (4 June). New agreement signed between the IMF and Indonesia (24 June). South African rand comes under intense pressure and depreciates sharply. Brazilian interest rates return to levels of early October 1997 (26 June).
July	IMF-led support package for Russia of $22.6 billion in 1998–99 ($4.8 billion made available on 20 July).
August	Yen reaches an eight-year low (11 August). Hong Kong authorities intervene in equity market (14 August). Russia changes exchange rate regime, suspends payments on short-term government debt and imposes moratorium on commercial debt payments to non-residents (17 August).
September	Russia stops supporting the rouble (1 September). Malaysia pegs its exchange rate to the dollar and imposes stringent capital controls (1–2 September). In Latin America, equity markets fall sharply and exchange rates come under pressure: Colombia raises its exchange rate band by 9% (2 September); Brazilian interest rates double to nearly 50% (10 September); Mexican short-term interest rate peaks at 48% (11 September); Chile widens its band and increases interest rates (16 September). China tightens foreign exchange regulations (27 September).
Sep/Oct/Nov/Dec	Series of interest rate reductions in the major currency blocs.
October	Following presidential elections, Brazil announces a three-year fiscal adjustment programme (20 October).
December	Approval of an IMF-led support package of $41.5 billion for Brazil, including a $13.3 billion BIS loan backed by 19 industrial country central banks (2 December).
1999	
January	Floating of the Brazilian real (15 January). Dollarisation issue raised by Argentine central bank (21 January). International rating agency upgrades Korean sovereign debt to investment grade (25 January).
March	New IMF programme for Brazil (8 March). First reduction in Brazilian interest rates since floating (25 March).

Table III.1

merchandise flows. This created yet further channels through which the crisis was transmitted throughout the emerging world and even beyond.

Capital flows

Drying-up of private capital in 1997–98

An extended period of easy access by emerging market economies to international financing came to an abrupt end in the second half of 1997. Private sector capital, which flowed into emerging market economies at a rate of $140 billion in 1996, shrank to $40 billion as the first waves of financial turmoil hit the developing world in 1997, and dried up completely last year (Table III.2). In part, the financing gaps left by reduced private sector involvement were filled by rising inflows of official funds. At over $120 billion, foreign direct investment inflows have remained buoyant over the last two years, suggesting that confidence in the longer-term prospects of most emerging market economies has remained intact.

Reversal in bank credit flows to Asia

Annual aggregate data on private financial flows, however, mask trends in cross-border bank credit and international debt issuance which varied greatly over time as well as across regions (see also Chapter VII). Table III.3 reveals the sharp reversal in bank lending and securities flows experienced in Asia in the second half of 1997. By year-end, bank claims on the five Asian economies most directly affected by financial turmoil (Indonesia, Korea, Malaysia, Thailand and, to a lesser extent, the Philippines) had shrunk at nearly twice the rate at which they had risen in 1996 and early 1997 – from close to +5½% of GDP in 1996 to –10% in late 1997. Creditor banks continued to reduce their exposure

Capital flows and reserves in emerging market economies

	1990–95	1996	1997	1998
	in billions of US dollars, at annual rates			
	Net private capital inflows			
Asia[1]	33	81	–45	–69
Latin America[2]	35	70	77	57
Eastern Europe[3]	5	10	11	21
Russia	–9	–25	– 7	–12
	Net official capital inflows			
Asia[1]	14	4	37	29
Latin America[2]	6	–12	– 5	12
Eastern Europe[3]	1	– 1	– 1	– 2
Russia	8	9	5	7
	Net increases in reserves			
Asia[1]	41	58	15	66
Latin America[2]	15	25	13	–10
Eastern Europe[3]	6	1	2	9
Russia	2	– 3	2	– 5

Note: Capital flows are calculated as the difference between the current account and the changes in reserves; private flows are calculated as a residual from an estimate of official flows.

[1] China, India, Indonesia, Korea, Malaysia, the Philippines, Singapore, Taiwan and Thailand. [2] Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela. [3] The Czech Republic, Hungary and Poland.

Sources: IMF; Institute of International Finance (IIF). Table III.2

to the region at a rapid pace in the first half of 1998. However, as the year progressed, current accounts swung into surplus and evidence emerged that the crisis might be contained. As a result, the financial climate facing the crisis-hit Asian economies became somewhat less gloomy. Albeit with some delay, possibly reflecting the longer lead times needed for issuing securities than for arranging bank credits, net issuance of international securities presented a picture similar to that of bank lending. New issues weakened significantly in late 1997 and early 1998, and in the second half of 1998 net issuance turned negative, as investors turned away en masse from lower-rated paper. Improving sentiment, however, allowed some countries, most notably the Philippines, to regain access to international capital markets in early 1999.

Pattern of flows to Latin America …

The data in Table III.3 also present a qualified and in many respects surprising picture for Latin America. Flows of bank credit to Latin America remained strong even as the crisis spread rapidly throughout Asia in the second half of 1997. Although bank claims on Brazil fell in late 1997, this interruption proved to be brief. Indeed, in the first half of 1998 the country recorded a period of particularly buoyant inflows of bank credit, equivalent to over 2% of GDP. Only around mid-year, following the Russian crisis, did bank flows change direction, with outstanding bank claims dropping precipitously in the second half. Similarly, a net contraction in the issuance of Latin American

International bank and securities financing of emerging market economies

	Average 1990–95[1]	1996	1997			1998		
			First half	Q3	Q4	First half	Q3	Q4
	in billions of US dollars, at an annual rate							
	International bank lending[2]							
Asia[3]	37	80	74	– 8	–109	–103	–94	–32
of which: China	7	13	13	21	– 1	– 6	–25	4
Crisis countries[4]	28	58	49	–39	– 96	– 96	–59	–43
Latin America	1	29	27	43	40	30	–32	–24
of which: Argentina	0	5	4	10	12	3	5	–11
Brazil	0	17	13	18	– 1	17	–32	–18
Mexico	0	0	3	– 5	8	2	– 4	6
Eastern Europe[5,6]	0	2	4	8	6	7	4	2
Russia[6]	–2	7	8	17	6	12	–43	– 6
	Net issuance of international debt securities							
Asia[3]	15	43	40	44	13	10	–15	– 3
of which: China	2	2	7	2	1	0	– 4	2
Crisis countries[4]	11	38	28	36	10	7	–16	– 5
Latin America	13	41	48	76	– 3	50	– 1	– 8
of which: Argentina	6	11	13	26	2	20	5	2
Brazil	4	12	15	19	– 6	16	– 8	–12
Mexico	2	13	13	11	– 2	3	0	2
Russia	0	0	9	5	6	11	25	– 1

[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. [6] Data are available only from 1994.

Source: BIS. Table III.3

international debt securities affected the region only in the last two quarters of the year.

… and Russia

In spite of widely recognised vulnerabilities, Russia also continued to attract foreign financing for most of the period leading up to its financial crisis in August 1998. Bank lending remained as buoyant in the first half of 1998 as it had been throughout 1997, while debt issues soared. When the crisis broke in August, however, inflows dried up, with bank claims shrinking at an annualised rate of almost $43 billion in the third quarter. By year-end, net issuance of securities had come to a standstill.

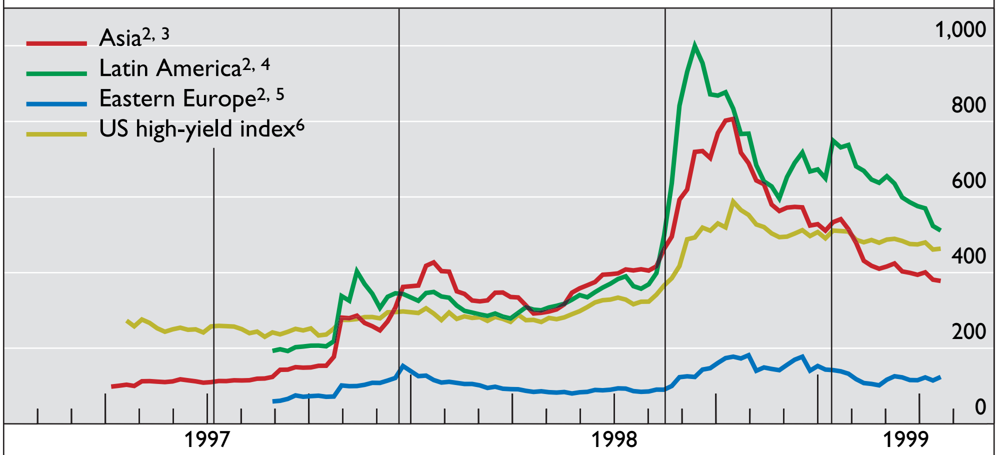
Emerging market bond spreads widen and become more volatile …

Market uncertainty was also mirrored in the pronounced volatility of prices of international securities. A first phase of this process started in mid-1997. As the depth of the South-East Asian crisis and its power of contagion became clearer, engulfing Korea and affecting Hong Kong and Taiwan, all considered more advanced economies, spreads on international securities in secondary markets ratcheted up (Graph III.1) and volatility increased sharply (Table III.4). Although spreads did not stay at the high levels of late 1997 and early 1998, neither did they return to pre-crisis levels in the ensuing months. Moreover, volatility remained high in the face of unexpectedly deep recessions in much of Asia, political and social unrest in Indonesia and growing evidence that countries as dissimilar and distant as Chile and South Africa were also being affected.

… especially after mid-1998

By mid-1998, a new phase of more generalised risk aversion had emerged (discussed in greater detail in Chapter V). A confidence crisis erupted with the announcement of the Russian moratorium on the servicing of domestic debt securities and on the repayment of corporate and bank debt to foreign creditors. Secondary market spreads on Russian international securities soared to levels which implied a de facto loss of market access. By early October, spreads for most Asian and Latin American emerging market economies had

Bond spreads in emerging markets[1]



Note: The vertical lines mark the start of the crises in Thailand, Korea, Russia and Brazil respectively.

[1] Over benchmark US Treasury bonds, in basis points. [2] Unweighted average. [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.

Source: Datastream. Graph III.1

Daily mean and volatility of emerging market bond spreads*						
	January 1997–June 1997		July 1997–June 1998		July 1998–March 1999	
	Mean	Standard deviation	Mean	Standard deviation	Mean	Standard deviation
	in basis points					
Asia	104	0.07	268	1.02	542	1.26
Latin America	–	–	289	0.67	664	1.64
Eastern Europe	–	–	90	0.20	131	0.30

* Over benchmark US Treasury bonds. Table III.4

risen to over 800 basis points. Spreads on lower-rated US corporate paper, which until then had been little affected by the emerging market crisis, also moved up. Sentiment improved, however, once the deleveraging process in international markets had largely run its course, an internationally supported adjustment programme for Brazil had been announced, and some of the pressure in international bond markets had been defused by a series of interest rate cuts in the United States. By early 1999, yield spreads on Asian securities had narrowed again to the levels recorded prior to the Russian crisis. Spreads charged on Latin American paper also fell, but remained significantly above their pre-Russian crisis levels.

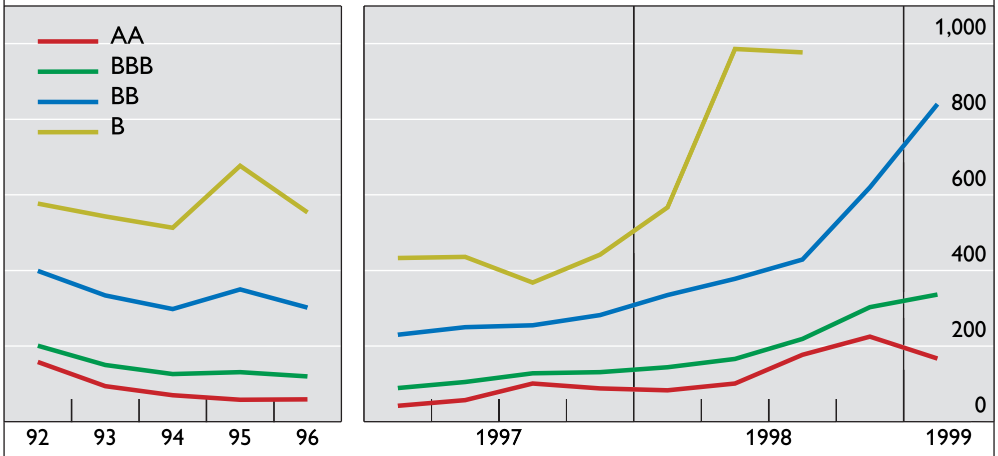
Limited impact of the floating of the Brazilian real

Although the devaluation of the Brazilian real in January 1999 was a milestone in the evolution of the emerging market crisis, it did not trigger a renewed rise in bond spreads. In contrast with the events in August, the abandonment of Brazil's managed exchange rate regime occurred at a time when exposures, especially those of leveraged players, had already been adjusted to reflect greater risk aversion in international markets. Moreover, the devaluation was better anticipated as it followed a protracted period of reserve losses and growing fiscal imbalances. Also contributing to the more limited impact of the Brazilian crisis on investor confidence was the belief that continued IMF support to Brazil was likely even after the devaluation and the recognition that the country did not have the deep-seated political, social and banking sector problems seen in Russia. Reflecting limited contagion, both Argentina and Mexico were able to issue a significant volume of debt securities in international financial markets in the first quarter of 1999.

Risk assessments in primary markets

Behind the general picture of wide swings in investor sentiment, as reflected by the average yield spreads in secondary markets, a significant differentiation in debtor perceptions can be observed in recent years. Graph III.2, which plots the estimated spreads on new bond issues for various classes of emerging market borrowers, suggests a number of distinct patterns. First, following the resolution of the Mexican peso crisis, there was a general realignment of the spreads paid by borrowers with different risk profiles, reflecting mainly a reduction in the premia charged to higher-risk borrowers. The Asian crisis brought this narrowing of relative spreads to a halt, with less creditworthy borrowers being forced to pay sharply higher rates. In contrast, better-rated borrowers experienced little or no widening of spreads in the run-up to the Russian crisis. The Russian crisis triggered a broad-based

Spreads on emerging market bonds, by credit rating *



* Estimated credit spread on a 10-year rated bond issued by emerging market economies over the benchmark industrial country government bond, in basis points.

Source: Kamin and von Kleist, BIS Working Paper (forthcoming). Graph III.2

reassessment of risk: in its wake even the most creditworthy borrowers had to pay a significantly higher premium over the benchmark rate, as liquidity considerations aggravated the impact of credit risk factors. By early 1999, however, a partial reversal of this increase could be observed.

Influence on capital flows of pegged exchange rate regimes …

A striking feature of private sector capital flows in recent years has been the pace at which they surged into countries with significant structural or macroeconomic vulnerabilities – almost up to the eve of a financial crisis – and their subsequent abrupt reversal. In several instances, the choice of the exchange rate regime played an important role. Exchange-rate-based stabilisation programmes may distort both investor and debtor behaviour. The high domestic interest rates that are often required to support pegged exchange rate regimes encourage residents to engage in unhedged foreign currency borrowing and non-residents to acquire domestic currency assets. Quasi-fixed exchange rate regimes as the linchpin of macroeconomic policies, and high domestic interest rates in the face of growing fiscal imbalances, characterised both Brazil and Russia in the first half of 1998. In several Asian economies, a similar pattern had been observed up to 1997, with external imbalances playing the role which fiscal deficits had in Brazil and Russia.

… and official support operations

Another important factor may have been the arrangement of large official support packages, starting with the 1994/95 Mexican crisis. As official financing allowed countries to meet their debt servicing obligations, perceptions of country risk were dulled and a false sense of security crept into the lending decisions of international banks and investors. In particular, international bonds came to be perceived as carrying limited default risk. Sometimes, explicit or implicit loan guarantees extended not only by governments in debtor countries, but also by those in creditor countries, enabled banks to further downplay country and credit risks.

Changed perceptions in the wake of the Russian crisis

The profound impact of the Russian crisis on international financial markets suggests an abrupt reassessment of risks by market participants. In particular, country risk perceptions changed with the realisation that default remained an option for debtor countries and that official assistance would not always be forthcoming automatically. The sudden reversal in capital flows in the second half of 1998 may have contained one further complex element. Calls for private sector burden-sharing, which became increasingly loud in the wake of the large Mexican and Asian official rescue operations, may have induced creditors to cut back country exposures as soon as the need for official assistance was hinted at. The sharp drop in bank credits to Brazil in the third quarter of 1998 has indeed been interpreted by some as a pre-emptive move by banks fearing they would otherwise be forced into rolling over existing credits, or providing new ones, within the context of the anticipated IMF adjustment programme.

Merchandise trade developments

Key influences on trade include the commodity price slump …

Commodity prices suffered heavy downward pressure in 1997–98 (see Chapter II). Dollar prices for oil fell by 30% in the course of 1998, prompting a renewed attempt by producers in March 1999 to curtail production. Prices of non-fuel commodities exported by developing countries declined by nearly 15% in 1998, the largest drop registered in the last two decades. Although the erosion of commodity prices also implied some relief in the form of falling import prices, most developing countries suffered significant terms-of-trade losses last year. These ranged from 5½% in Latin America to more than 9% in the Middle East and over 10% in Africa.

For many countries, weak commodity prices aggravated an already difficult economic and financial environment. Table III.5 shows how much Indonesia, Mexico, Nigeria, Russia, Saudi Arabia and Venezuela depend on oil for generating fiscal revenues and export earnings. The table also illustrates Chile's reliance on copper, whose price fell by over 30% in dollar terms in

Impact of commodity prices on selected economies

	Commodity exports as % of total exports	Commodity revenue as % of government revenue	Change in commodity exports as % of GDP	Change in fiscal revenues from commodities as % of GDP	*Memorandum items:* Change in reserves[1]	*Memorandum items:* Change in exchange rate[2]
	1997		1998			
Oil						
Indonesia	13	19	–3.9	– 1.7	*39.2*	*–71.4*
Mexico	10	36	–1.0	– 1.4	*11.8*	*–13.3*
Nigeria	98	63	–8.0[3]	– 0.9	*–13.9*	*– 1.3*
Russia[4]	17	25	–1.3	– 2.4	*–40.1*	*–41.9*
Saudi Arabia	68	78	–3.7	–10.8	*1.2*	*0.0*
Venezuela	79	56	–6.5	– 6.5	*–17.1*	*–10.8*
Copper						
Chile	42	4	–2.2	– 0.6	*–11.4*	*– 8.9*

[1] Percentage change in foreign exchange reserves. [2] Percentage change in US dollar/local currency. [3] GDP converted into US dollars using the average of the official rate and the autonomous market rate. [4] Crude oil only.

Sources: IMF; IIF; national data; BIS estimates. Table III.5

Destination of exports of emerging market economies in 1998

	European Union	Japan	Other Asia	United States	Latin America
	percentage share of total exports				
Asia	16	10	38	22	3
of which: China and Hong Kong	15	10	40[1]	23	3
Crisis countries[2]	15	11	37[1]	20	3
Latin America	14	3	4	46	22
of which: Argentina	17	3	9	7	50
Brazil	24	4	7	18	29
Chile	24	14	19	15	22
Mexico	4	1	1	82	7
Eastern Europe[3]	64	1	2	4	1
Russia	33	3	8	7	3

[1] Includes trade between the countries themselves. [2] Indonesia, Korea, Malaysia, the Philippines and Thailand. [3] The Czech Republic, Hungary and Poland.

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

the second half of 1997. Often, earnings from commodity exports dominate the trade account, while the bulk of government revenues is linked to the production and sale of a particular commodity. In several cases, commodity-price-related losses came on top of already wide external and fiscal imbalances which in the prevailing climate of investor uncertainty sometimes proved difficult to finance and put exchange rates under pressure. In Saudi Arabia, for instance, both the current account and the fiscal deficit widened to 9% of GDP last year. Partly as a result of these growing imbalances and the then prevailing negative outlook for oil prices, the Saudi riyal came under heavy pressure in mid-1998 and again in early 1999.

… weak Japanese import demand …

Another key influence on trade developments last year was very weak import demand in Japan. Although they have been able to develop a fairly balanced regional pattern of exports, for most Asian emerging market economies the importance of Japan as a final export destination and as an

Trade determinants

	Cyclical swing[1]	Price swing[2]	Growth in net exports[3]
Asia			
China	– 1.7	3.7	0.8
Crisis countries[4]	–15.5	–36.2	28.0
Latin America			
Argentina	– 0.6	10.8	0.8
Brazil	– 2.9	– 0.5	8.9
Mexico	– 0.3	16.0	7.6

[1] Change in real GDP growth rates between 1996 and 1998. [2] Change in the real effective exchange rate between 1996 and 1998. [3] Export minus import volume growth in 1998. [4] Weighted average of Indonesia, Korea, Malaysia, the Philippines and Thailand using weights based on 1990 GDP and PPP exchange rates. Table III.7

engine of intraregional trade is likely to have been a major obstacle to a speedy recovery of trade and to output growth in general (Table III.6). By contrast, Latin American and eastern European countries saw more buoyant export markets.

… and major changes in cyclical and price conditions

Finally, the financial crises in Asia in the second half of 1997 transformed the underlying determinants of merchandise trade. Unprecedented recession and sizable gains in competitiveness marked many Asian economies last year, in contrast to trends in other emerging market economies, where cyclical conditions changed little and real effective exchange rates rose (Table III.7). Income, price and substitution effects due to these changes caused Asian trade balances to move sharply and are likely to continue, given the shifts in competitiveness and cyclical positions brought about by the more recent crises in Russia and Brazil.

Adjusting to the crisis in Asia

Recent developments

Deep recessions …

The recessions triggered by widespread financial turmoil in Asia were severe (Table III.8). Output declined by 8½% in the five crisis-hit economies last year, a drop without precedent in more than 40 years. Economies less affected by the financial turmoil, such as Singapore and Taiwan, experienced a period of uncharacteristically low growth, while the successful defence of Hong Kong's dollar peg came at the expense of a sharp output contraction.

… and demand contractions

The depth of the crisis in 1998 was visible in many other respects. In most countries, domestic demand collapsed. Fixed investment spending crumbled as enterprises faced conditions of excess capacity and sought to restore balance sheets which had become unsustainable under the weight of excessive leveraging. In Korea, for instance, fixed investment shrank by over one-quarter last year. Consumer spending also weakened sharply, as income prospects deteriorated in an environment of labour shedding, cost cutting and asset price deflation.

Unemployment rises …

Unemployment, which until the crisis had been merely a natural complement to rapidly changing and dynamic economies, rose to levels which were especially painful against the backdrop of undeveloped social safety nets. In Korea the unemployment rate rose to 8½% in early 1999, compared with just 3% in 1997, and in Hong Kong it doubled to 6%.

… and trade accounts swing into surplus

The reversal in the trade accounts presented particularly vivid evidence of the sharp adjustments which were taking place in the domestic economy. Table III.9 documents the compression of import demand in most Asian economies, reaching over 30% in Indonesia, Korea and Thailand. Exports also fell in value terms, albeit much less than imports, mainly as a result of very weak export prices for commodities and for manufactured goods in excess supply. Also contributing to the sluggishness were output disruptions, a scarcity of trade financing and, as noted above, Asia's geographical pattern of trade. Gains in competitiveness, however, boosted export volumes somewhat. These trends in merchandise trade caused sizable trade surpluses to emerge where

Growth, inflation and current account balances

	Real GDP			Consumer prices			Current account balance		
	1991–96	1997	1998	1991–96	1997	1998	Average 1991–96	1997	1998
	annual percentage changes						as a percentage of GDP		
Asia[1]	8.6	6.4	1.8	10.1	4.0	7.7	– 0.4	0.5	3.3
China	11.6	8.8	7.8	13.7	2.8	–0.9	0.7	3.3	3.1
Hong Kong	5.2	5.3	– 5.1	8.7	5.7	2.6	1.7[2]	–3.5[2]	0.3[2]
India	5.5	5.1	5.8	9.7[3]	5.2[3]	7.1[3]	– 1.2	–1.7	– 2.4
Korea	7.4	5.0	– 5.8	6.0	4.4	7.5	– 2.1	–1.8	12.5
Singapore	8.3	8.0	1.5	2.4	2.0	–0.3	13.9	15.4	17.8
Taiwan	6.5	6.8	4.8	3.6	0.9	1.7	3.7	2.7	1.9
Indonesia	7.3	4.9	–13.7	8.8	6.2	58.4	– 2.5	–2.3	4.5
Malaysia	8.6	7.8	– 6.7	3.9	2.7	5.3	– 6.3	–4.9	11.7
Philippines	2.8	5.1	– 0.5	10.1	5.0	9.0	– 3.7	–5.3	2.0
Thailand	7.9	–1.3	– 8.0	5.0	5.6	8.1	– 6.8	–2.0	12.3
Latin America[1]	3.7	5.4	2.0	135.6	13.8	10.8	– 2.2	–2.9	– 4.4
Argentina	5.7	8.6	4.2	26.2	0.5	0.9	– 2.0	–2.9	– 4.5
Brazil	3.8	3.6	0.2	505.5	6.0	3.8	– 1.2	–4.2	– 4.5
Chile	8.5	7.6	3.4	12.7	6.1	5.1	– 3.4	–5.3	– 6.3
Colombia	4.2	3.0	0.6	24.1	18.5	20.0	– 3.0	–5.9	– 6.7
Mexico	2.1	7.0	4.8	20.2	20.6	15.9	– 4.5	–1.9	– 3.8
Venezuela	2.8	5.9	– 0.7	52.4	50.0	35.8	2.5	5.3	– 1.8
Eastern Europe[1]	1.3	5.1	3.1	30.8	14.1	11.9	– 2.4	–4.2	– 3.9
Czech Republic	–0.3	1.0	– 2.7	18.3	8.5	10.7	– 2.8	–6.3	– 1.9
Hungary	–1.8	4.6	5.2	25.1	18.3	14.2	– 4.6	–2.1	– 4.8
Poland	2.8	6.9	4.8	38.0	15.1	11.7	– 2.1	–4.0	– 4.4
Russia	–8.2	0.8	– 4.6	263.4[4]	14.8	27.6	2.9	0.8	0.0
Israel	5.8	2.7	2.0	12.6	9.0	5.4	– 4.8	–5.1	– 2.3
Saudi Arabia	2.1	1.9	– 0.7	2.1	0.1	–0.4	–10.5	0.2	– 8.9
Africa	2.1	2.8	3.3	39.4	13.6	6.7	– 9.8[5]	–4.7[5]	–15.3[5]
South Africa	1.2	1.7	0.1	10.6	8.6	6.9	0.1	–1.5	– 2.0

Note: Data for 1998 are partly estimated.

[1] Weighted average of the countries shown, based on 1990 GDP and PPP exchange rates. [2] Balance of goods and non-factor services. [3] Wholesale prices. [4] 1993–96. [5] As a percentage of exports of goods and services. Table III.8

previously large deficits had existed. This turnaround was equivalent to one-quarter or more of merchandise trade in the crisis-hit countries.

Asset price deflation

Deflation of previous asset price bubbles generally accompanied the crisis in the real economy. Expressed in dollar terms, equity prices in most economies had fallen by early September 1998 to less than half their peak levels in 1997 as investors withdrew from local stock markets and corporate profitability evaporated (Graph III.3). Dramatic corrections in property prices also took place (Table III.10). With large and often still growing supplies of real estate confronting falling demand, property prices and rental values fell almost uninterruptedly last year. Preliminary observations suggest that the weakness continued in early 1999.

Merchandise trade developments in Asia and Latin America							
	Export growth[1]			Import growth[1]			1998 trade balance change as % of average trade[2]
	Average 1990–96	1997	1998	Average 1990–96	1997	1998	
	in percentages						
Asia							
China	17.0	21.0	0.4	14.0	2.3	– 1.3	1.6
Hong Kong	13.9	4.1	– 7.5	15.7	5.1	–11.5	5.6
India	11.3	3.6	– 4.1	9.8	9.7	2.9	– 6.8
Korea	11.3	5.0	– 2.2	14.1	– 3.8	–35.5	42.7
Singapore	16.1	0.0	–12.0	15.1	0.8	–21.4	12.3
Taiwan	7.9	5.3	– 9.3	10.2	11.8	– 8.4	– 1.6
Indonesia	12.3	7.3	– 8.8	15.0	– 2.9	–34.4	25.4
Malaysia	17.8	0.7	– 6.8	20.1	0.8	–25.8	22.7
Philippines	15.1	22.9	16.3	17.6	12.0	–16.4	33.7
Thailand	16.0	3.3	– 5.8	16.3	–13.1	–31.6	34.0
Latin America							
Argentina	14.6	10.8	– 1.7	33.2	28.1	3.1	– 4.8
Brazil	5.1	10.9	– 3.5	17.7	16.6	– 7.4	5.0
Chile	10.4	10.8	–12.0	14.3	10.4	– 4.5	– 7.5
Colombia	9.6	8.8	– 7.0	17.0	12.4	– 0.5	– 5.6
Mexico	23.7	15.0	6.4	21.2	22.7	14.1	– 6.9
Peru	8.4	15.5	–15.8	21.5	8.3	– 4.6	– 7.7
Venezuela	9.5	0.4	–25.3	6.1	45.6	17.2	–48.6

[1] Yearly percentage change of export/import values expressed in US dollars. [2] Average of merchandise exports and imports.

Sources: IMF; IIF; national data. Table III.9

Against the backdrop of deep recession, bank credit to the private sector dried up in the course of 1998. By year-end, credit was shrinking rapidly in Indonesia, the Philippines and Thailand, with declines being only slightly less pronounced in Hong Kong and Korea. In Malaysia, credit growth remained positive throughout 1998, although falling well short of the government target. In early 1999, credit started contracting in Malaysia as well.

Bank credit contraction

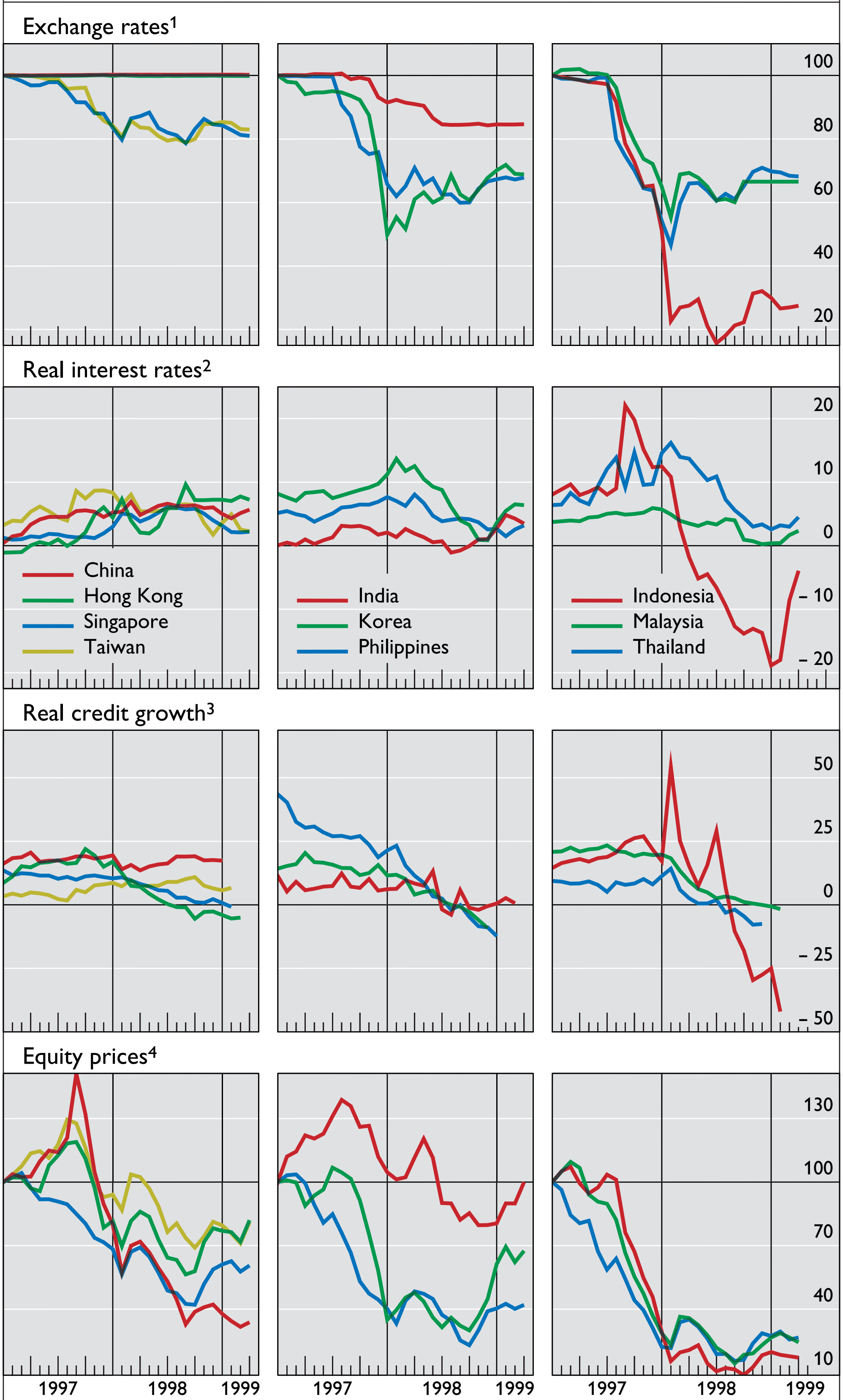
Despite the generally depressed picture, there were a number of more positive developments, especially after mid-1998. First, signs that the economic contraction was coming to an end emerged in late 1998 when, with the exception of Indonesia, the earlier sharp declines in industrial output appeared to bottom out (Graph III.4). In Korea, where decisive policy adjustments to the crisis were implemented at an early stage, industrial production even rose strongly in the final quarter of last year. Moreover, forecasts for 1999 growth tended to be revised upwards from end-1998. The impression of crisis containment was reinforced by a small revival of external trade in several economies in late 1998. Equity prices recovered strongly in the final months of the year.

More positive factors include recent trends in industrial production …

A second positive development was the surprisingly subdued reaction of inflation to exchange rate depreciation in much of the Asian region.

… the limited inflation response to depreciation …

Financial market developments in Asia



[1] US dollars per unit of domestic currency, December 1996 = 100. [2] Three-month interest rates deflated by the annual rate of inflation, in percentages. [3] Annual changes in domestic credit to the private sector deflated by the annual rate of inflation, in percentages. [4] In US dollar terms, December 1996 = 100.

Graph III.3

Property value indicators in selected Asian cities						
	Office vacancy rates		Change* in end-1998 office rental values over		Change* in end-1998 rental values for retail stores over	
	December 1997	December 1998	1997	1998 Q3	1997	1998 Q3
	end-of-period figures, in percentages					
Bangkok	23.6	29.7	–20.3	– 5.8	–27.6	–3.8
Hong Kong	6.4	16.6	–37.1	– 9.9	–50.7	–3.8
Jakarta	8.9	22.1	–11.4	– 7.7	–47.6	0.0
Kuala Lumpur	3.7	15.5	–29.1	– 2.5	–31.1	–7.4
Singapore	8.0	12.3	–19.1	–11.9	–25.1	–8.9

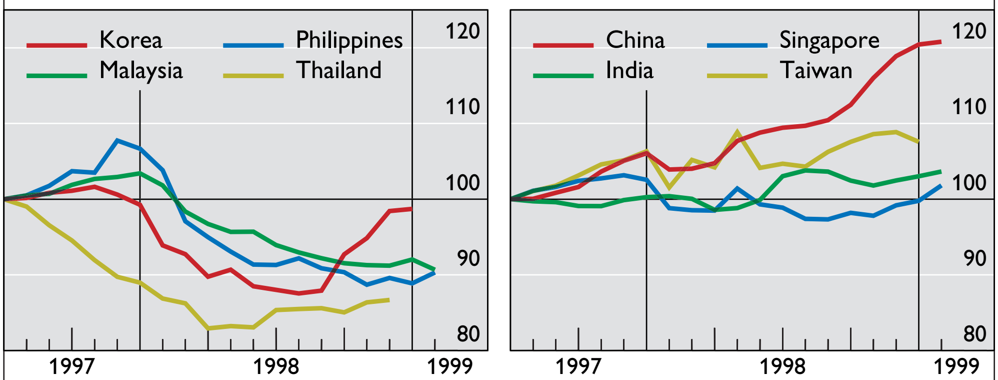
* In local currency.
Source: Jones Lang LaSalle. Table III.10

Depreciation in Malaysia, Korea, the Philippines and Thailand amounted to about 60% between mid-1997 and mid-1998, but consumer price inflation edged up only to at most 10% in each of these countries. Even in Indonesia, the upturn in inflation was significantly more modest than the rate of currency depreciation. As already detailed in last year's Annual Report, the limited pass-through of devaluation into prices owed much to depressed demand conditions, labour cost flexibility and the downward pressure on prices stemming from large inventories of unsold goods or real estate.

… and exchange rate stabilisation

One important additional reason for the benign inflation developments may have been a growing perception that the sharp currency depreciations in the second half of 1997 and early 1998 would not be sustained. Dollar exchange rates of most Asian currencies indeed stabilised, with some recovery taking place late in the year. As exchange rates did not return to pre-crisis levels and inflation was contained, about one-half of the competitiveness gains realised in the wake of the mid-1997 crisis was preserved in Malaysia, the Philippines and Thailand. The substantial strengthening of the Korean won in 1998 resulted in a significant real appreciation, albeit not to the levels recorded just prior to the outbreak of the Asian crisis. The strengthened

Industrial production in Asia *



* Three-month moving averages, June 1997 = 100. Graph III.4

competitive position in much of Asia offers hope of a recovery of exports, given sufficiently strong demand in key markets.

Policy stances as the crisis unwound

As stability returned to foreign exchange markets in the course of last year, the case for easier monetary and fiscal policies in Asia strengthened, not only to stimulate domestic demand but also to facilitate bank and corporate restructuring.

Relaxation of monetary policy ...

Monetary policy easing resulted in a significant decline in short-term interest rates in almost all countries, often to below pre-crisis levels. There has been some debate about the scope for further monetary easing. By early 1999, real short-term interest rates in many economies were still significantly positive even though activity remained sluggish and bank restructuring might have benefited from an easier stance (see below). One important consideration in many countries was that too rapid a relaxation could erode the new-found sense of stability in the foreign exchange market. Moreover, given that interest earnings are an important part of personal income in many of the high-saving Asian economies, a sharp cut in interest rates might weaken household confidence. Finally, in view of the depth of the crisis and the disruptions it had caused to the structure of the economy and the process of financial intermediation, it was difficult to make an assessment of the likely impact on the real economy of the significant interest rate reductions already observed by the start of 1999.

... and easing of fiscal policy

The adoption of easier fiscal policies was another common feature last year. In several Asian economies, public finances showed significant deficits in 1998 (Table III.11). Fiscal targets for countries following IMF adjustment programmes were also softened considerably: initially, balanced central government positions were targeted for Indonesia, Korea and Thailand in 1998 but by mid-year allowance was made for deficits of 3–8% of GDP. The emergence of fiscal deficits obviously reflected to a large extent the deep recession, while discretionary easing of fiscal policy tended to be relatively small. Indeed, some governments even found it difficult to increase spending to levels envisaged in revised programmes. Given an earlier history of tight fiscal discipline and low public sector indebtedness in most economies, relatively large deficits are probably appropriate for a limited period. Even so, the need to bear the fiscal cost of extensive corporate and financial sector restructuring may mean that deficits should be reduced in the medium term and that direct cyclical support to the economy has to remain modest.

Equity market intervention in Hong Kong

Although they shared the general thrust of fiscal and monetary policies observed virtually throughout the region, Hong Kong and Malaysia also took policy measures last year that were more unconventional. On several occasions in 1997 and 1998, Hong Kong experienced strong and simultaneous pressure in its foreign exchange and equity markets which increasingly came to be seen as a manifestation of market manipulation rather than a reflection of weakening fundamentals. According to the authorities, a speculative "double market play" was attempted in mid-1998, with investors taking substantial short positions in both the equity market and the Hong Kong dollar. Given Hong Kong's

Fiscal balances in emerging market economies[1]				
	Surplus (+)/deficit (–)			Interest payments
	Average 1994–96	1997	1998[2]	1998[2]
	as a percentage of GDP			
Asia				
China	–1.0	–0.8	–1.2	1.0
Hong Kong	0.7	5.7	–1.6	–
Indonesia	0.7	–0.9	–3.4	2.3
Korea	0.4	–1.5	–4.2	0.8
Malaysia	3.7	6.3	–1.7	2.5
Singapore[3]	13.2	9.6	16.4	2.4
Thailand	2.3	–0.7	–2.4	0.7
Latin America				
Argentina	–1.4	–1.4	–1.1	1.9
Brazil	–2.4[4]	–4.3[4]	–7.5[4]	8.0
Chile	2.2	1.9	0.4	0.7
Colombia	–2.0	–4.2	–5.5	3.2
Mexico	0.0	–0.5	–0.7	3.6
Peru	–0.2	–0.9	0.9	1.7
Venezuela	–1.3	1.9	–4.0	2.6

[1] Definitions of the public sector differ across countries. For China, data refer to the State Budget; for Hong Kong and Korea, to the consolidated central government; for Brazil, Malaysia and Mexico, to the public sector; for Argentina, to the non-financial public sector; for Chile, Colombia, Peru, Singapore, Thailand and Venezuela, to the central government. [2] Partly estimated. [3] High interest payments in Singapore reflect the issuance of public debt, mainly for the purpose of developing the local bond market and providing benchmark paper. [4] Operational concept, i.e. excluding the inflation component of interest payments on domestic debt.

Sources: IMF; IIF; national data. Table III.11

currency board regime, the resulting exchange rate pressure would force domestic interest rates up, thus providing speculative profits as equity prices fell in consequence. To defeat such a strategy, large official purchases (amounting to about US$ 15 billion, or 6% of market capitalisation at that time) were made in the equity and futures markets in August. The intervention resulted in an easing of interest rates and a levelling-off of the drop in equity prices. To allay fears concerning the maintenance of their traditional free market approach, the authorities then committed themselves to managing the equity holdings at arm's length and to selling them off gradually. Moreover, a number of arrangements were made in September to reduce both the volatility of interest rates and the susceptibility of local financial markets to market manipulation.

Capital controls in Malaysia

With the aim of facilitating an easing of macroeconomic policies, Malaysia pegged the ringgit to the US dollar in September 1998 and introduced stringent controls (subsequently modified in early 1999) to curb capital outflows and limit offshore transactions in the domestic currency. The measure cost Singapore one-quarter of its equity trading and a substantial amount of foreign currency business. In addition, some prudential regulations on loan classifications were relaxed. Equally unconventional was the instruction given to banks to increase their lending by 8% during the course of 1998.

Malaysia's recourse to capital controls has given further impetus to the debate on whether full-scale capital account liberalisation is premature for most emerging market economies. In particular, support has grown in recent years for measures to slow the inflow of short-term capital until markets, institutions and regulatory frameworks have been sufficiently strengthened. Measures to contain capital inflows, especially when implemented through the use of market-based instruments, such as reserve requirements which tax shorter-term inflows more heavily, can be useful. If carefully designed, they may help avoid a domestic lending boom and the asset price bubble which is often associated with it, while allowing a liberal attitude to be maintained towards longer-term inflows such as foreign direct investment.

Dangers of imposing controls on outflows

Much less acceptance has been won for the imposition of controls on capital outflows, in particular where a more liberal regime is already in place. A frequent argument in favour of such controls is that they can give the authorities the necessary room to formulate and implement adjustment programmes that could help restore investor confidence. The counterargument is that controls can also be abused, either to maintain an inappropriate policy stance for too long, or to delay the restructuring of a weak financial sector. Moreover, the effectiveness of capital controls on outflows declines as loopholes are found and exploited. To plug them, a process is often set in motion of ever more complex and broad-ranging controls, to the point where useful economic activity may be severely damaged. Another counterproductive aspect is that the introduction of controls on outflows may send a negative signal discouraging capital inflows at a critical moment. If this loss of confidence affects neighbouring economies that have similar problems (but have abstained from restrictions), capital controls in one country could be particularly harmful to others. Finally, the potential loss of confidence and policy credibility which controls on outflows could entail is likely to raise the cost of international borrowing for much longer than just the duration of the crisis.

China and India

In large part because of a high degree of insulation from global financial markets, the two most populous Asian countries were less affected by the crisis elsewhere in the region. Nevertheless, the crisis exposed areas of vulnerability and economic and financial conditions worsened.

Growth in China close to target despite signs of weakening

Official statistics suggest that output growth in China last year fell just short of the targeted 8%. However, various indicators pointed to a slowing trend in activity not yet revealed by the aggregate output statistics: unemployment rose; growing inventories of unsold goods put downward pressure on prices; energy production fell by nearly 4%, in part because of weak demand from enterprises; import and export growth dwindled; and the profitability of the state-owned enterprise sector worsened. To tackle the slowdown, public sector spending was boosted in the second half of the year. Spending on infrastructure was accelerated, state-owned enterprises were induced to increase investment and state-owned banks were pushed to expand lending for infrastructure and housing. Monetary policy became more expansionary, with interest rates being cut and measures taken to stimulate bank lending activity.

Stable yuan/dollar rate

The authorities maintained their policy of stabilising the yuan against the US dollar. They saw several compelling reasons for this. The trade and current accounts showed sizable surpluses and international reserves were large and buttressed by an extensive set of restrictions on capital flows. Moreover, the risk of triggering renewed speculation against the Hong Kong dollar was viewed as high and fears were widespread that a devaluation would set off a new round of competitive devaluations in the region and beyond. At the same time, however, capital outflows and unrecorded imports appear to have risen as last year's increase in foreign exchange reserves ($5 billion) fell a good deal further short of the surplus on the current account ($20 billion) and foreign direct investment inflows (about $40 billion) than in the two preceding years.

Financial sector concerns

The financial crisis in the region also brought the fragilities of China's financial system into focus. The presence of a large stock of non-performing loans held by the major state-owned banks and of inadequately regulated and supervised securities markets had become more widely recognised in recent years and had induced foreign lenders to show greater caution in the course of 1998. In late 1998 an investment corporation with substantial foreign liabilities was closed. Contrary to expectations, the central authorities did not accept any obligation to honour the corporation's unregistered external debt. Although this decision drove up the cost of foreign borrowing, it also represented evidence of the authorities' awareness of the moral hazard implications of a policy of indiscriminate external debt guarantees. Moreover, programmes for restructuring state-owned banks and tightening prudential regulations and supervision were formulated. However, the continued reliance on state-owned banks to prime activity inevitably creates some dilemmas for the authorities.

India

Continued strong growth marked India's economy last year. Inflation accelerated and the current account deficit remained significant against a backdrop of a weak export performance. The central government deficit widened to over 6% of GDP. In combination with financing gaps in other parts of the public sector, the heavy claim exerted by this fiscal imbalance on domestic saving continued to hamper activity in the private sector. To restore fiscal health, a medium-term consolidation strategy was announced in March 1999; the central bank responded by easing its monetary policy stance. The regional financial crisis also prompted the central bank to tighten prudential banking regulations. Financial reform, however, has remained incomplete, as has progress in a number of other important areas of structural reform.

Bank and corporate restructuring

As economic and financial difficulties deepened last year, several Asian banking systems came under heavy strain. By end-1998, non-performing loans were reported to have risen to over 10% – and in Indonesia and Thailand to up to 45% – of total loans, while significant losses were incurred by almost all banks in the crisis-hit countries.

Cost of a banking crisis depends on …

The macroeconomic cost of a banking crisis and of its resolution is often very high. Fiscal costs of earlier banking crises in the 1990s ranged between 4% (Norway and Sweden) and 17% (Venezuela) of GDP, even though non-performing loan ratios in most of these banking crises were well below the levels now recorded in Asia. Two aspects are important for assessing the macroeconomic cost of a banking crisis. First is the degree to which the public's confidence in its banking institutions can be preserved. Loss of such confidence may induce depositors to withdraw their assets, reducing the level of financial intermediation and the efficiency with which resources can be allocated. If assets are shifted abroad, a currency crisis may erupt or an existing one may deepen. A temporary loss of confidence in the domestic banking system occurred in Argentina in 1995, necessitating sharp policy adjustments which contributed to a sizable economic contraction. Similarly, a bank run complicated crisis containment in Indonesia in late 1997.

… confidence of bank customers …

… and the degree of credit contraction

The second important aspect is the extent to which credit may contract during the crisis. Given the crucial role of credit in economic activity, particularly in Asia, where it is very large relative to GDP, a sharp drop in lending may have significant macroeconomic effects. Even in a sound banking system, the demand for bank credit would decline as a natural reaction to the lack of investment opportunities after a boom. However, this credit contraction will be more severe when banks are burdened with large portfolios of non-performing loans made to finance heavy investment in real assets, as in Asia. If banks are closed, even solvent borrowers will lose "their" bank and will usually find it difficult to gain access to credit from other banks. If banks are kept afloat, they are likely to apply stiffer loan standards and ration credit. Such a credit crunch will further curtail aggregate demand, causing even greater problems for borrowers and banks. Following earlier banking crises, real bank credit in Mexico fell by one-half in two years, while in Finland and Sweden it shrank by over 20%. As noted above, bank credit in real terms started to contract in all crisis-hit economies last year.

Potential role of monetary policy easing

Rapid credit contraction in the context of a banking crisis raises the question of what monetary policy can do to offset it. Easing the stance of monetary policy would lower short-term interest rates and probably steepen the yield curve. This would help the situation by stimulating demand, as well as by widening banks' net interest margins. Such a policy was successfully adopted in the United States in the early 1990s. It may, however, be problematic in the small, open Asian economies to ease monetary policy even more than has been done so far, given the danger that an overly easy monetary policy stance may trigger renewed disorderly conditions in foreign exchange markets. Moreover, very low interest rates, and in turn much reduced carrying costs of bad loans, may relax pressure for effective financial sector restructuring.

Bank restructuring and recapitalisation in Asia

To deal with the severe banking crises, several restructuring and recapitalisation initiatives have been taken in Asia over the last two years. A number of common features have marked the initial stages of these bank restructuring programmes. First, preventing bank runs has usually compelled the authorities to extend guarantees covering bank deposits and to develop explicit deposit insurance schemes. Changes in the regulatory framework have been a second feature. Prudential regulations were tightened, although in some instances (Malaysia and, to a lesser extent, Thailand) temporary concessions were made to help banks deal with their acute financial problems.

In addition, asset management corporations were established in most crisis-hit countries to take over part of the non-performing loan portfolio of financial institutions. Often, the motivation was to lessen the aversion towards new lending which banks increasingly demonstrated as their preoccupation with the management of bad debts grew. Strategies varied between trying to dispose of the impaired assets quickly and seeking to avoid fire sales. The former strategy was followed in Thailand, while the latter was adopted in Malaysia.

Finally, fears that the forced closure of one bank would precipitate a more systemic flood of bank insolvencies and aggravate the problem of credit rationing explain why relatively few banks had been allowed to fail by early 1999. Instead, policies focused on bank recapitalisation and bank mergers. A variety of recapitalisation schemes, often contingent on shareholder participation or improvements in operational efficiency and management changes, have been put in place over the last year and a half. Where necessary, a number of troubled banks were temporarily taken into state ownership. Takeovers of weak banks by larger, less weak banks were also encouraged (as in Korea and Thailand), although the systemic proportions of the banking crises often made it very difficult to find suitable buyers. Official attitudes towards takeovers by foreign banks also became much more favourable. In several countries, such as Indonesia and Thailand, barriers to foreign bank ownership were lowered or abolished altogether.

Corporate restructuring initiatives

In most countries, schemes for addressing bank problems were complemented with initiatives to help viable enterprises restructure their operations and deal with debt servicing obligations made much more onerous by reduced cash flows. By early 1999, many of these programmes had not gone far beyond their conceptual stage. In part this was because weaknesses in most countries' corporate legislation, in particular bankruptcy procedures, stood in the way of more rapid and effective debt rescheduling and corporate restructuring. In part it was also because weakened creditors were not willing to make concessions. Progress tended to be greatest in Korea, where an agreement in late 1998 between the government and the five major chaebol (conglomerates) promised rationalisation, greater specialisation of their operations and debt reduction. These promises, however, remain to be implemented.

The Russian financial collapse and its impact on eastern Europe

Stages of the Russian crisis

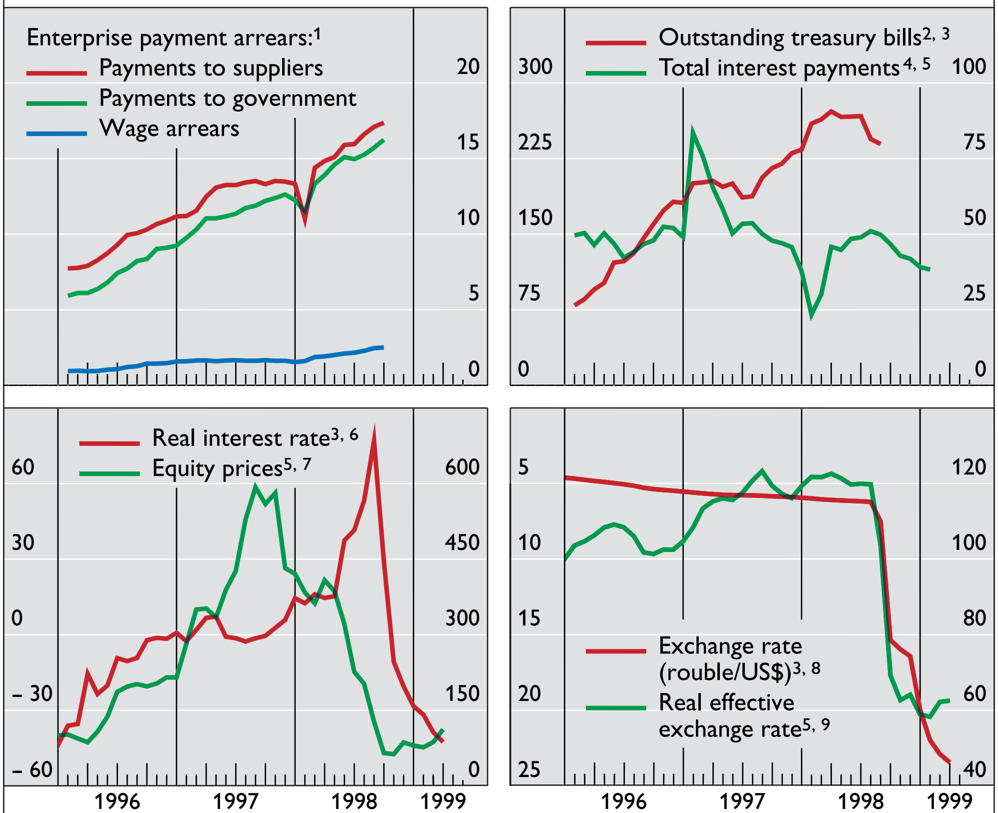
Difficulties in controlling public finances, the rising pace of short-term government debt issuance, falling commodity prices and real exchange rate appreciation cast increasing doubt on Russia's debt servicing capabilities in late 1997 and the first half of 1998. As a result, the exchange rate suffered repeated attacks which were met by successive increases in interest rates to

150% by end-May, even though inflation remained below 10%. To buttress rouble stability, which had been a centrepiece of monetary policy for some years, a two-year international financing package of almost $23 billion was offered to Russia in July with $4.8 billion being made available immediately by the IMF. However, given strong parliamentary opposition to key revenue-raising measures, implementing the adjustment programme proved difficult. With real interest rates very high, government debt servicing costs absorbed about one-half of budget revenue (Graph III.5). Reserve losses continued and an attempt to lengthen the very short-term maturity of marketable government debt effectively failed, leaving almost $20 billion of short-term rouble debt to be financed before the end of the year. In addition, equity prices reached new lows, domestic interest rates stayed high, and spreads on Russian eurobonds reached 2,000 basis points.

Policy responses

Faced with mounting domestic and external financing problems, the Russian authorities announced a radical policy shift in mid-August 1998. The main measures included the widening and subsequent abandonment of the exchange rate band, the suspension of trading in treasury bills combined with a mandated restructuring of government debt, and a 90-day moratorium on the repayment of corporate and bank debt to foreign creditors. The perception

Financial indicators for Russia



[1] Outstanding arrears as a percentage of GDP. [2] Rouble-denominated discount and coupon bonds as a percentage of the monetary base. [3] Left-hand scale. [4] As a percentage of total federal government revenue. [5] Right-hand scale. [6] Overnight rate deflated by the annual rate of inflation, in percentages. [7] In US dollar terms, December 1995 = 100. [8] Inverted scale. [9] In terms of relative consumer prices, December 1995 = 100.

Graph III.5

that the rules of the game between debtors and creditors had been fundamentally altered triggered an unexpectedly sharp reaction in international financial markets (discussed in Chapter V).

The government tried to weather the fallout from the August crisis by reverting to administrative measures which had been abolished in the past. Extensive restrictions were imposed on operations in the foreign exchange market, the government deficit was increasingly financed by direct borrowing from the central bank, and exporters were forced to surrender 75% of their export earnings. A highly vulnerable banking sector was kept afloat by direct credits from the central bank but a planned agency for the recapitalisation of banks failed to become operational. Without access to bank loans, enterprises were forced to rely still more heavily on their own financial resources, payment arrears and barter. Bank deposits were also widely blocked.

Fallout on the economy …

The crisis and the incomplete policy response pushed growth and inflation in opposite directions. Measured output plunged by 9% in the final quarter of 1998, bringing its level to about one-half that of 1989, while inflation soared to 100% in early 1999. Import demand bore the brunt of the adjustment, falling by over one-half in dollar terms in the final quarter of 1998. As raw materials continue to dominate Russia's merchandise trade, export volumes reacted little to the rouble devaluation, while export prices reflected the commodity price slump.

… and on external financing

By end-1998, Russia was failing to meet payments on its more than \$100 billion foreign currency debt inherited from the Soviet Union (Russian-era debt is estimated at a further \$60 billion), while the premium on Russian eurobonds stayed high, effectively shutting the country out of international capital markets. At end-March 1999, Russia and the IMF relaunched negotiations for a programme to help meet debt servicing obligations for 1999 of an estimated \$17½ billion. With official foreign currency reserves having fallen to \$6½ billion by end-March, calls for part of the inherited Soviet debt to be written off, not just restructured, became more insistent.

Basic weaknesses include incomplete structural change …

A number of fundamental weaknesses not sufficiently addressed in the transition process that started in 1992 were at the core of the Russian crisis. First, Russia has been unable to create some of the essential pillars of a market economy. The institutional framework for the legal enforcement of private contracts and effective competition is still rudimentary. In the real economy, structural reform has been incomplete. Unlike other transition economies, such as Poland, few dynamic, medium-sized companies have been founded to provide growth momentum, while the creation of large financial/industrial groups has tended to cement old structures. Nor has the progress made in privatisation been accompanied by the establishment of sound systems of corporate governance. Capital flight, partly reflecting asset stripping, has been high since the beginning of transition. Labour mobility has remained low and income differentials have fostered social discontent.

… unsound public finances …

A second major weakness has been public finances. Federal government deficits averaged 7½% of GDP in the period 1992–98. A system of fair and efficient tax collection has yet to be put in place, while the relationship between federal and state taxes and spending has remained obscure. Moreover, by building up payment arrears, the government has contributed to the growth of an arrears culture across all sectors of the economy (Graph III.5). Problems in the fiscal area have often been major hurdles to formulating and respecting IMF programmes.

… and limited financial intermediation

Finally, the role of financial intermediation in the real economy has been insufficiently fostered. Banks have relied on returns from financial arbitrage created by either the continuous devaluation of the rouble (prior to 1998) or the large acquisitions of high-yielding government paper (since 1993, when the government debt market was established). Often, these securities were financed by borrowing in foreign currency, leaving banks with large open foreign currency positions. By contrast, credit outstanding to the private sector has remained very modest at about 15% of GDP so that a credit culture has not evolved. Moreover, most Russian banks have failed to promote deposit-taking capabilities. Indeed, many were set up by large corporations explicitly in order to obtain relatively easy access to cheap central bank credit. Not surprisingly, domestic use of the rouble has grown little while dollarisation has continued to be a major feature of the economy.

Financial impact on eastern Europe is only temporary …

The Russian crisis had a significant though short-lived impact on the financial markets in eastern Europe. As big foreign investors, particularly mutual funds, liquidated large parts of their portfolios of eastern European shares, regional stock markets fell while pressure was put on most currencies. The country with the most developed and liquid capital market, Hungary, saw a 45% drop in share prices between end-July and end-September, wiping out all the gains of the preceding two years. Equity market declines were less dramatic elsewhere: foreign participation in the Polish and Slovak markets had always been relatively small and foreigners had already reduced their exposure to Czech equities by late 1996. As prices recovered after October 1998, equity markets in eastern Europe showed little loss for the year as a whole. The impact on the cost and volume of private capital flows remained limited as well. In comparison with other emerging market economies, spreads on eastern European bonds rose relatively little – by less than 100 basis points in the case of the Czech Republic, Hungary and Poland (Graph III.1). Nevertheless, higher rates and the reduced availability of credit effectively squeezed some governments and forced a number of large private sector enterprises to temporarily forgo direct borrowing abroad. However, there was no reversal in the flow of international bank credit (Table III.3), and modest issuance of international debt securities continued.

Financial turbulence in the wake of the Russian crisis weakened the Hungarian forint and the Polish zloty, which had previously been subject to upward pressure. Before the crisis, the inflow of short-term funds had pushed the zloty near the top of its trading band and the forint had been exposed to similar forces. With further real appreciation arrested, concerns lessened about a loss of external competitiveness. By October, the zloty had returned to the centre of its trading band and the central bank abandoned the idea of introducing tighter currency controls. Several countries in the region responded to the financial turbulence by raising short-term interest rates but the transmission to longer-term domestic interest rates was limited. The Polish and

Czech central banks therefore carried out previously planned interest rate cuts once stability had returned.

… as fundamental shifts have occurred

Limited contagion from the Russian crisis has been a testimony to the extent to which eastern European countries have reoriented their trade and financial links towards western Europe and the progress they have made in the transition to becoming modern market economies. A major transformation has taken place in eastern Europe's trade: nearly two-thirds of exports now go to the European Union, while only 5% go to Russia. Financial exposure of eastern European banks to Russia is also limited. Indeed, banks did not suffer pressure or see their share prices fall relative to those of other enterprises when financial turbulence hit the region in the middle of last year. Successful transition has led to strong growth rates in both Hungary and Poland in recent years. By contrast, the need for further restructuring in the corporate and financial sector tended to dampen activity in the Czech Republic last year. Although remaining higher than in EU countries, inflation in eastern Europe has come down steadily. Moreover, efforts have been made in Hungary and Poland to strengthen their banking systems, partly by accepting greater foreign competition. Reflecting the progress in transition, EU accession talks have started with several eastern European countries.

Remaining vulnerabilities

Some vulnerabilities nevertheless remain. Significant deficits on the fiscal and current accounts continue to be a major source of concern for many transition economies. In spite of progress in several countries, banking institutions remain fragile, as reflected in their low international ratings. Financial markets are still immature and supervision is in need of further reinforcement. Finally, the social safety net is still underdeveloped.

Developments in Latin America

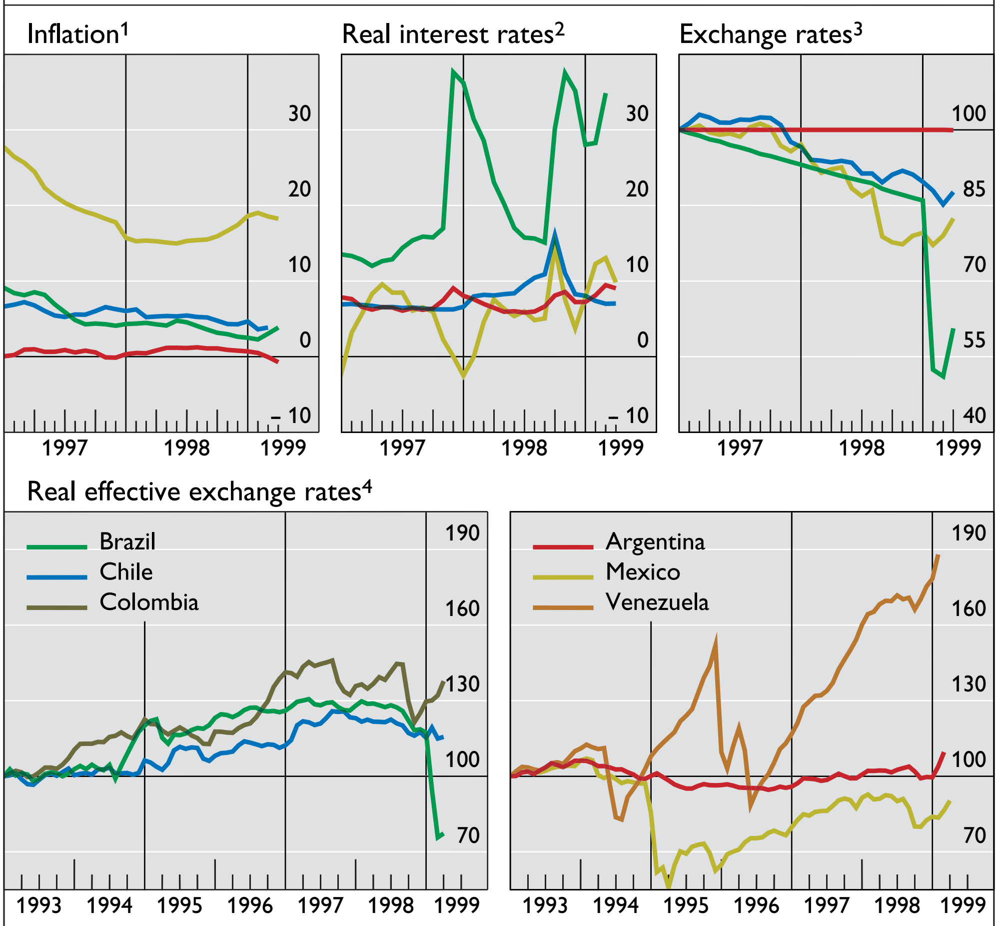
Underlying difficulties in Latin America …

Although Latin America was able to continue attracting sizable flows of capital in the wake of the Asian crisis, its potential susceptibility to financial turmoil was suggested by a number of underlying difficulties. First, external positions have been weak in recent years. Last year, trade and current account deficits again widened sharply in almost all countries. One important reason for the wide discrepancy between export and import growth throughout most of the 1990s has been steady appreciation of the real exchange rate in many countries (Graph III.6). More recently, the region has also been confronted with weak commodity prices, while the economic contraction in Asia has had a further adverse effect on the exports of some countries. A second area of vulnerability has been the region's low saving rate, which has forced it to rely heavily on external financing. Finally, several countries have experienced difficulties in containing public sector deficits. Partly reflecting weak commodity prices, high interest rates and slowing growth, the government finances in many countries deteriorated further last year.

… exposed by financial turmoil

The confidence crisis in international markets in mid-1998 aggravated these difficulties. As external financing slowed to a trickle in its immediate wake, prices of internationally traded Latin American bonds and domestic equities fell substantially, while heavy pressure was put on several currencies.

Inflation, real interest rates and exchange rates in Latin America



[1] Annual percentage change in consumer prices. [2] Short-term rates deflated by the annual rate of inflation, in percentages (for Mexico, by annualised inflation in subsequent months). [3] US dollars per unit of domestic currency, December 1996 = 100. [4] In terms of relative consumer prices, December 1992 = 100. An increase indicates an appreciation. Graph III.6

Countries with large fiscal deficits (such as Brazil and Colombia) or political uncertainties (Venezuela) were most directly affected. In response to the turbulence, sharp policy adjustments took place in the region, with the lead being taken by monetary tightening. Growth prospects quickly deteriorated and in the final quarter of the year annual GDP growth turned negative, compared with nearly 3% in the first half.

Some of the smaller economies in the region were also hit by natural disasters (due to El Niño and hurricane Mitch). In Ecuador, the adverse shocks were compounded by the absence of measures to deal with the fiscal imbalance and banking sector problems. The incomplete policy response in turn precluded access to financial support from the international community.

The Brazilian crisis

Macroeconomic imbalances in Brazil

The Asian crisis brought into focus a number of important macroeconomic imbalances in Brazil's economy. Although successful in achieving single-digit inflation, the Real Plan launched in mid-1994 depended heavily on high real interest rates for containing strong domestic demand growth. These high interest rates in turn contributed to an increase in the fiscal deficit (excluding the impact of inflation on interest payments) from an average of 2.4% of GDP in 1994–96 to nearly 8% in 1998 (Table III.11). The fiscal deterioration, however, also resulted from a fall in the primary surplus from 2% of GDP in 1994–96 to approximate balance in 1998. Moreover, the initial stages of the Real Plan were associated with significant real appreciation, contributing to a widening current account deficit.

Initial policy response in late 1997

These imbalances led to a first wave of strong exchange rate pressure immediately following the events in Asia in late 1997. The authorities responded with a sharp tightening of monetary policy and the announcement of fiscal measures to reduce the deficit by the equivalent of 2% of GDP during 1998. High interest rates and a relaxation of capital account restrictions led to renewed strong inflows of capital in early 1998 which helped rebuild international reserves (Graph III.7). Moreover, the central bank announced the beginning of a gradual move to a more flexible exchange rate regime over the following years. By contrast, promised fiscal adjustment proved difficult to achieve given that key measures could be implemented only after congressional approval.

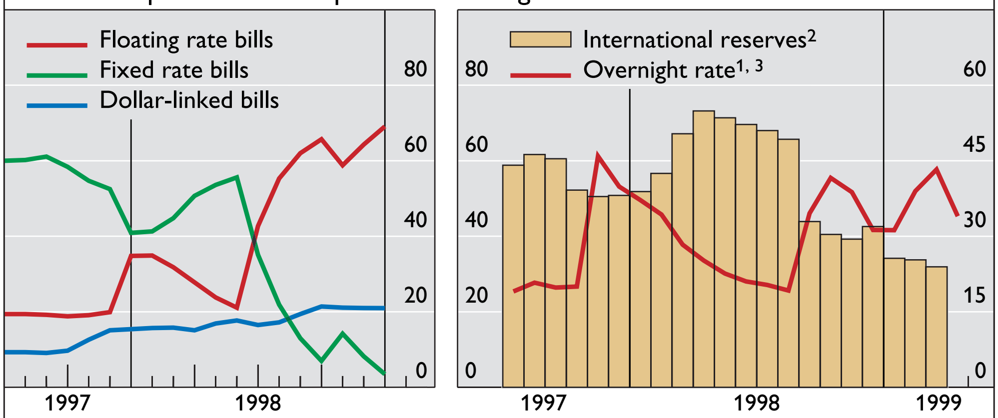
The Russian default had a deep impact on Brazil. Although fiscal weaknesses and external vulnerability were at the root of contagion, the heavy selling of Brazilian international bonds (in particular the very liquid Brady bonds), possibly to meet margin calls elsewhere, contributed significantly to the transmission of financial turmoil. As holders of relatively low-yield domestic government securities sold this paper to buy the higher-yielding Brazilian international bonds, capital outflows accelerated.

Crisis containment in late 1998

Pressure was contained through several measures. First, additional incentives in the form of interest rate and exchange rate guarantees were offered to holders of domestic government debt to avoid this debt being sold off on a large scale. The marked change in the composition of public debt, which had been initiated shortly before the developments in Russia, was pushed

Financial indicators for Brazil

Domestic public debt composition[1] | Foreign reserves and interest rate



[1] In percentages. [2] In billions of US dollars (left-hand scale). [3] Right-hand scale. The latest observation is for 19 April.

Graph III.7

further, with floating rate and dollar-linked treasury bills increasingly replacing traditional fixed rate bills (Graph III.7). Second, the authorities intervened heavily in the foreign exchange market. The extent of this intervention may be understated by the net change in the stock of international reserves, given that the privatisation of the telecommunications system was associated with strong inflows around mid-year and exchange rate support was also conducted through off-balance sheet operations in the futures and forward markets. Finally, the monetary authorities increased interest rates sharply.

Fiscal adjustment and official financial assistance

After the October presidential elections, a support package led by the IMF was announced which was heavily front-loaded and was conditional on extensive fiscal adjustment. Financial support was arranged for about $41½ billion. The IMF contributed $18 billion, while the World Bank and the IADB each committed $4.5 billion. In addition, a credit facility of $13.3 billion, coordinated by the BIS and backed by the central banks of 19 industrial countries, was offered to the central bank together with a parallel facility of $1¼ billion made available by the Japanese authorities. The agreement with the IMF and the first disbursement in early December improved the outlook only marginally. Spreads on Brazil's international debt remained high and capital outflows continued. Domestically, a refusal by Congress to approve a number of crucial fiscal measures and, later on, the lack of commitment of some important states to the fiscal adjustment process also cast doubt on the effectiveness of fiscal restraint.

Floating of the Brazilian real …

In early 1999, possibly triggered by a partial moratorium by a state government, pressure mounted and the authorities abandoned the long-standing exchange rate regime. The government attempted to engineer a limited and controlled devaluation, counting on two positive factors: first, the country had devalued with a large stock of foreign exchange reserves and an international support programme already in place; second, the corporate and banking sectors were not as highly exposed as their counterparts in Asia had been, since they had hedged their positions against sudden changes in interest rates and exchange rates. A major weakness, however, was the vulnerability of the government deficit to devaluation and high interest rates, given the large stock of dollar-linked and floating rate treasury bills, and the central bank's short position in the exchange rate futures and forward markets. In the event, the real depreciated by 40% in the two months following the adoption of the floating regime.

… raises the issue of dealing with the debt servicing burden …

Two issues aroused particular concern in the wake of the devaluation. The first was the potentially explosive dynamics of the internal debt/GDP ratio, should interest rates and debt servicing requirements fail to come down again. To allay fears of an unstable debt dynamic and so prevent a vicious circle of continuing downward pressure on the currency and upward pressure on interest rates, strict corrective action in the fiscal area was announced in March 1999. In addition to the measures already agreed with the IMF in November, further spending restraint and tax increases were proposed to bring the public sector primary surplus to over 3% of GDP in 1999.

… and limiting the inflation response

A second concern was the inflation response to the nominal depreciation. With inflation known to be very sensitive to exchange rate changes in Latin

America, price increases were expected to be large and quick in Brazil. However, a number of related factors acted to limit the immediate upturn in inflation. First, the deepening recession contained price pressures. Second, the economy had become more deregulated since the early 1990s, with significantly less reliance on indexation mechanisms. Finally, despite the clear negative implications for public finances, the authorities opted for a further tightening of monetary policy in order to help restore confidence. Overnight interest rates were allowed to rise from just under 30% in late 1998 to 45% by early March so as to slow or reverse the weakening of the exchange rate and thus limit its impact on inflation and inflation expectations. In the event, the exchange rate strengthened, allowing the central bank to start reducing interest rates from late March. Moreover, monthly inflation appeared to level off at 1.3% in March. As sentiment slowly improved, access to international markets was regained. The issue of a $2 billion sovereign bond was successfully completed in April, albeit at a still sizable yield spread.

Contagion in other Latin American economies

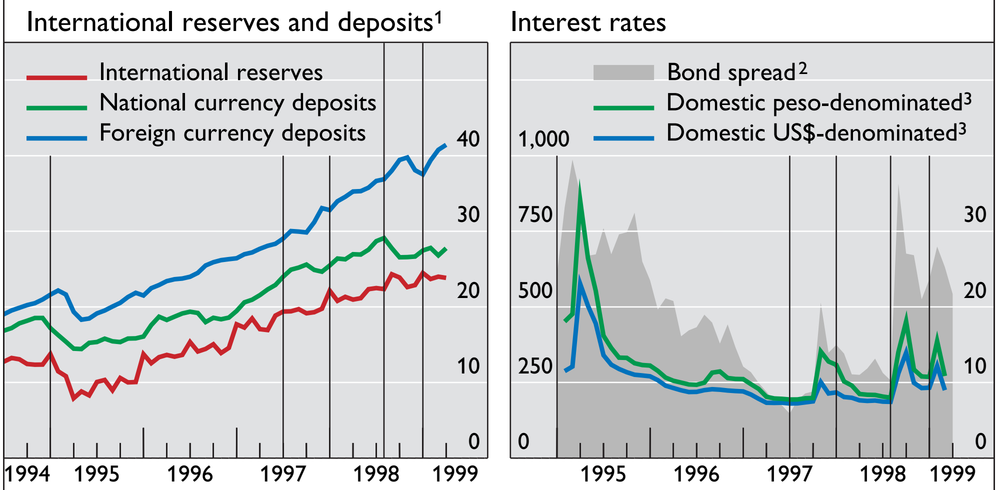
Impact on Argentina via trade …

In 1998 Argentina made further progress in fiscal consolidation and in strengthening its banking sector. The firm commitment to its currency board-type arrangement kept consumer price inflation at less than 1%. Annual GDP growth, however, declined sharply from over 7% in early 1998 to –½% by year-end and the current account deficit reached 4½% of GDP. Although Argentina is a relatively closed economy, the regional economic slowdown, in particular in Brazil, which absorbs one-third of Argentina's exports, depressed activity in several industries, including the automotive sector. Exchange rate adjustments within Mercosur further increased competitive pressures on Argentina's industry. This makes it even more important to promote greater flexibility in labour and goods markets as an alternative to currency adjustments.

… and financial variables

Some indicators suggest that Argentina has become somewhat more resilient to financial turmoil in other emerging market economies in recent years (Graph III.8). In contrast to the experience following the Mexican peso crisis, international reserves were little affected by the turbulence in Asia, Russia and Brazil. Bank deposits, which fell by 13% in the three months following the Mexican crisis, showed consistent growth up to August of last year. Nevertheless, the Russian crisis did have a significant impact on Argentina. In its wake, peso-denominated deposits fell by 9% while dollar-denominated deposits grew further, suggesting some heightened perceptions of currency risk. Moreover, for a short period spreads on international sovereign bonds increased to levels similar to those observed after the Mexican crisis. Short-term interest rates in both pesos and dollars also rose sharply. The floating of the Brazilian real again exerted temporary pressure on both spreads and interest rates, keeping them above the levels reached prior to the Russian crisis. Even at these high spreads, Argentina was nonetheless able to return to world capital markets in early 1999 faster than had been the case after earlier crises.

Financial indicators for Argentina



Note: The vertical lines mark the start of the crises in Mexico, Thailand, Korea, Russia and Brazil respectively.

[1] In billions of US dollars. [2] Of a long-term sovereign international bond over the benchmark US Treasury bond, in basis points (left-hand scale). [3] One-month prime rate, in percentages (right-hand scale).

Sources: Datastream; IMF; national data. Graph III.8

Dollarisation

The uncertain environment prompted the authorities to announce that they might consider dollarisation of the economy to boost confidence in their commitment to currency stability. Such a move raises several issues. If perceived as irreversible, dollarisation would have the immediate effect of eliminating the premium associated with currency risk (as measured by the interest rate differential between peso and dollar contracts within Argentina). However, it is not clear what would happen to the country risk premium (conventionally measured by the differential between interest rates on US Treasury debt issues and dollar-denominated Argentine debt issues). Interest rates on dollar contracts, both short- and long-term, have remained high in Argentina (Graph III.8), suggesting that Argentine borrowers, including the government, pay significant credit risk premia. An important factor behind these premia may be the country's high external debt. Still other questions raised by dollarisation are the availability of lender of last resort facilities and the sharing of seigniorage associated with currency issuance.

Mexico's policy responses ...

Financial turmoil also put pressure on Mexico. Although the economy has become much more diversified in recent years, the fall in oil prices to which the Asian crisis contributed still had a significant impact, especially on government revenues. A determined fiscal policy response followed, including three rounds of spending cuts during 1998. Moreover, capital inflows contracted abruptly following the developments in Russia, causing the exchange rate to fall sharply. The depreciation triggered an almost immediate inflation response which, in conjunction with an increase in some government-controlled prices, reversed the earlier declining trend in inflation and prompted the central bank to tighten monetary conditions (Graph III.6). By the beginning of 1999 inflation and inflation expectations were falling again. As monetary and fiscal policies were tightened, growth slowed appreciably.

… and bank restructuring

The outlook for the Mexican economy will depend not only on the performance of the US economy, but also on the pace of progress in improving the health of a still weak banking system. The volume of bank credit in real terms remains well below its pre-crisis level of 1994. Additional support for bank debtors was announced in late 1998, possibly to allay concerns that the high interest rates needed to contain exchange rate pressure might reverse the declining trend in non-performing loans. In addition, after a year-long dispute, an agreement was reached in Congress in late 1998, leading to the creation of a deposit insurance agency that will also be responsible for dealing with the non-performing loans taken off banks' books in recent years. If the much needed expansion of credit and equity in the banking industry is to be achieved, the implementation of this agreement is now necessary.

Chile

Chile was severely affected by the emerging market crisis. Copper prices fell sharply, exports to Asia slumped and export market growth in neighbouring countries weakened significantly as turmoil spread in Latin America. The central bank reacted swiftly to the deteriorating environment, increasing policy interest rates in early 1998 to curb the rapid growth of domestic demand, and again in September to contain the spreading of the crisis. Moreover, as the peso suffered downward pressure, the authorities intervened in the foreign exchange market well before the currency approached the lower limit of its target range. The reversal of capital flows also prompted them to reduce the share of capital inflows that has to be deposited in an unremunerated reserve account from 30% to 10% in June and then to zero in September. In late 1998 and early 1999, as inflation fell within its target range, the central bank gradually eased its policy stance to counter the pronounced slowing of the economy, whilst avoiding a further weakening of the exchange rate.

Colombia

In Colombia, political uncertainty in the run-up to the mid-1998 presidential elections and large fiscal and current account deficits put heavy pressure on the exchange rate and required a sharp tightening of monetary policy. After a brief period of calm following the elections, pressure on the exchange rate re-emerged in August, triggered this time by external developments. This prompted the authorities to adjust the exchange rate regime, effectively depreciating the band by 9%, and to increase interest rates to help maintain the new level. As more decisive fiscal action was taken in late 1998 and a series of credits from international financial organisations were approved, interest rates started to decline. In the event, tight monetary policy during most of last year led to a severe slowdown of the economy and record unemployment, although it also contributed to a drop in inflation by early 1999. The banking system also felt the effects of these contractionary trends: non-performing loans grew substantially, while profits declined sharply, particularly among state-owned banks. In response, the government announced measures to shore up the banking sector and recapitalise the deposit insurance agency.