III. Developments in the emerging market economies

Highlights

Growth fell in almost all emerging market economies in 2001 as a result of the downswing in the industrial countries, the accompanying decline in world trade, volatile financing conditions and lower commodity prices (Table III.1). Despite widespread easing of monetary and fiscal policies, the withdrawal of external stimulus was only partly offset by the growth in domestic demand. The slowdown was pronounced in Latin America, partly owing to uncertainties related to the Argentine crisis. East Asia was hurt by the sharp drop in world demand for electronics and the Middle East by lower oil prices. Growth in Africa accelerated, however. Inflation slowed in most emerging market economies, but rose in countries whose currencies depreciated more rapidly last year. Current account imbalances generally narrowed.

Private capital flows to emerging markets increased slightly in 2001, but their overall level remained low. Foreign direct investment (FDI) accounted for the bulk of the increase in flows and continued to be directed to larger countries. Bank lending on the whole declined further but turned positive in several countries towards the end of 2001. Equity flows were affected by generalised uncertainties in financial markets, outflows from crisis-afflicted Argentina and Turkey, and the global shock of 11 September. Bond flows remained stable, although investors increasingly discriminated between better performing and crisis economies.

In late 2001 and early 2002, indicators of activity in many emerging market economies strengthened. In particular, increasing evidence of a turnaround in the United States has led to significant upward revisions of growth forecasts for Asian countries with large high-tech export sectors. Commodity prices have also recovered. However, in several Latin American countries political uncertainty has unsettled financial markets.

International linkages and domestic performance

Growth linkages have strengthened in recent years

The simultaneous slowdown of growth in industrial and emerging market economies in 2001, coming after two years of concurrent expansion (Graph III.1), has highlighted the importance of international economic and financial linkages. Co-movements of output of the industrial and emerging economies have generally strengthened over time. In part this is fortuitous since the industrial country slowdown in the early 1990s was not synchronous (see Chapter II), diluting the impact on emerging economies. Since the mid-1990s, however, output fluctuations in all three major emerging market regions do seem to have become more closely synchronised with those in

Growth and current account balances

	Real GDP[1]				Current account balance[2]			
	Average 1994–99	2000	2001	2002	Average 1994–99	2000	2001	2002
Asia[3]	6.9	6.7	5.0	5.7	1.3	3.4	2.4	2.0
China	9.4	8.0	7.3	7.3	2.1	1.9	1.5	1.1
Hong Kong SAR	2.7	10.5	0.1	1.8	–0.2	4.8	5.3	5.9
India	6.6	4.0	5.4	5.7	–1.1	–0.9	–0.5	–0.4
Korea	5.6	9.3	3.0	5.6	0.8	2.5	2.0	1.4
Singapore	5.3	10.0	–2.0	4.0	19.7	23.6	20.9	18.9
Taiwan, China	5.9	5.7	–1.9	3.0	2.6	2.9	6.7	5.5
Indonesia	2.1	4.8	3.3	3.4	–1.1	5.2	3.6	2.7
Malaysia	5.6	8.5	0.4	4.2	–0.3	10.6	8.2	7.2
Philippines	3.8	4.0	3.2	3.6	–0.8	12.2	6.3	5.3
Thailand	2.5	4.4	1.8	3.4	–1.4	7.5	5.4	4.8
Latin America[3]	2.9	4.5	0.6	0.5	–3.1	–2.3	–2.9	–1.7
Argentina	2.9	–0.5	–4.5	–12.2	–3.7	–3.6	–1.6	9.6
Brazil	2.8	4.5	1.4	2.1	–3.2	–4.1	–4.6	–4.0
Chile	5.6	5.4	2.8	2.9	–3.5	–1.5	–2.0	–1.6
Colombia	2.1	2.8	1.6	2.0	–4.3	0.4	–2.0	–2.8
Mexico	3.1	6.9	–0.3	1.7	–3.0	–3.1	–2.9	–3.0
Peru	5.1	3.1	0.2	3.3	–5.8	–3.0	–2.2	–1.6
Venezuela	0.3	3.2	2.8	–2.6	3.5	11.0	2.5	2.8
Central Europe[4]	2.8	3.8	3.5	3.2	–3.4	–4.9	–4.4	–4.3
Czech Republic	1.6	2.9	3.5	3.2	–4.0	–4.5	–4.7	–4.2
Hungary	3.2	5.2	3.8	3.5	–4.9	–3.2	–0.9	–2.8
Poland	5.6	4.0	1.1	1.3	–2.2	–6.3	–4.0	–3.9
Russia	–3.3	8.3	5.0	3.7	2.9	18.5	11.0	7.2
Turkey	2.3	7.5	–7.4	2.2	–0.4	–4.8	2.3	–0.3
Israel	4.5	6.4	–0.6	1.7	–3.9	–1.3	–2.7	–1.7
Saudi Arabia	1.1	4.5	2.2	1.2	–3.4	8.3	4.7	–1.3
Africa	3.3	2.9	3.7	3.4	–2.9	0.2	–0.6	–2.8
CFA zone	4.1	2.3	4.7	5.3	–5.4	–4.1	–5.7	–5.7
South Africa	2.6	3.4	2.2	2.2	–1.1	–0.4	–0.1	–0.7
Memo: G7 countries	*2.8*	*3.6*	*1.0*	*1.7*	*–0.2*	*–1.6*	*–1.5*	*–1.0*

Note: Figures for 2002 are based on May 2002 consensus forecasts and *World Economic Outlook.*

[1] Annual percentage changes. [2] As a percentage of GDP. [3] Average of the countries shown, based on 1995 GDP and PPP exchange rates. [4] Average of Bulgaria, Croatia, the Czech Republic, Hungary, Poland, Romania, Slovakia and Slovenia.

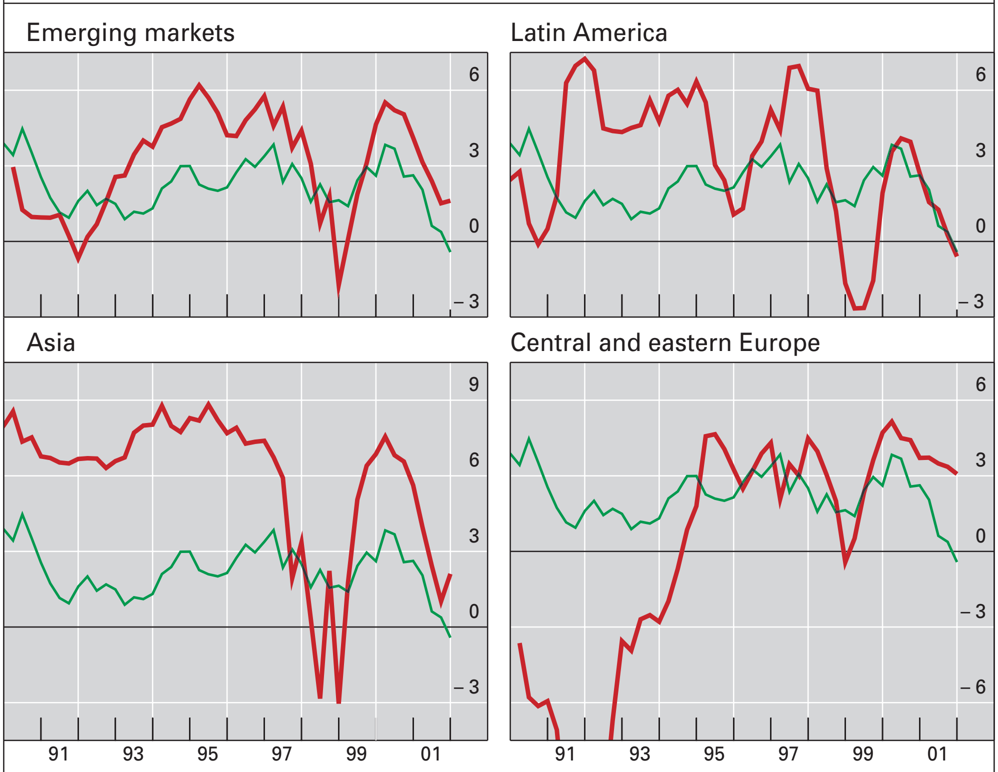
Sources: IMF; OECD; © Consensus Economics; national data; BIS estimates. Table III.1

industrial countries. This is particularly evident for central and eastern Europe, for which the correlations have become stronger and the lags shorter, reflecting the profound transformation and integration with western Europe following the start of the transition in 1990.

Simple regressions for the 20 largest emerging market countries suggest that a 1 percentage point increase in aggregate real GDP growth in the United States, the European Union and Japan is associated with higher growth in the emerging market economies of ⅓ percentage point. In addition, a

Real GDP

Annual percentage changes



Note: The green line represents real GDP growth in the industrial countries. In central and eastern Europe, GDP declined by nearly 20% in the fourth quarter of 1991.

Sources: IMF, *International Financial Statistics*; national data. Graph III.1

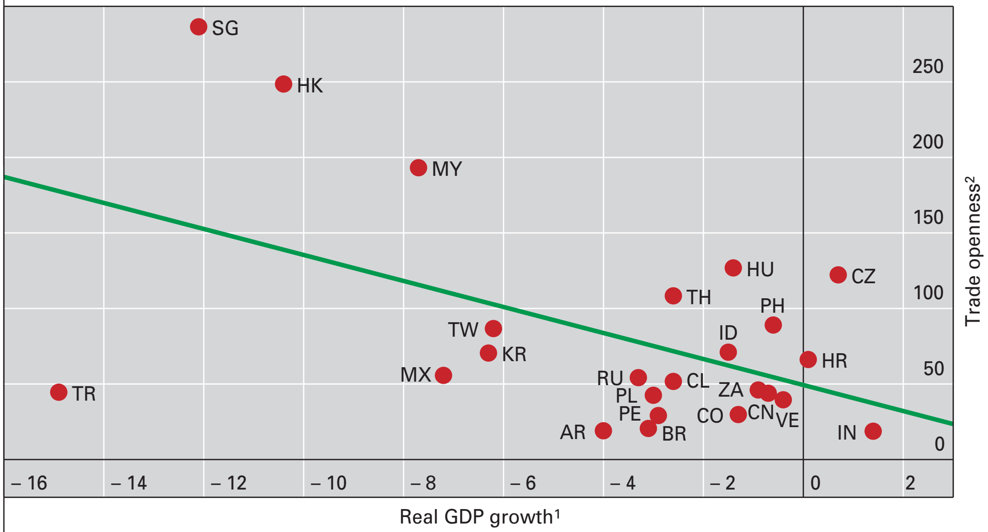
1 percentage point decline in Libor appears to increase growth in the 20 largest emerging economies by nearly ¼ percentage point. The growth rates of industrial production in the advanced and emerging economies are even more strongly correlated (elasticity of nearly 0.75), particularly between the Asian economies and the United States and Japan, and between central and eastern Europe and the European Union.

Growth and trade linkages

Slowdown depended on the degree of trade openness …

The slowdown in the industrial countries caused world trade to decline last year, following an expansion of over 12% in 2000. As a result, real output in those emerging market economies that are highly open decelerated sharply. In Singapore, Hong Kong SAR (hereinafter Hong Kong) and Malaysia, the decline was as much as 8–12 percentage points (Graph III.2). Mexico is another country with strong trade linkages with industrial economies. There, after growing by an impressive 7% in 2000, real GDP contracted by 0.3% in 2001, largely reflecting the fall in US import demand. Korea and Taiwan, China (hereinafter Taiwan) also experienced sharp swings in output growth because of falling US import demand. In contrast, growth in the more closed economies of India and China remained relatively high, driven primarily by domestic factors. Domestic factors also played a major role in Brazil, Indonesia and Poland (see below).

Growth slowdown and trade openness



AR = Argentina; BR = Brazil; CL = Chile; CN = China; CO = Colombia; CZ = Czech Republic; HK = Hong Kong SAR; HR = Croatia; HU = Hungary; ID = Indonesia; IN = India; KR = Korea; MX = Mexico; MY = Malaysia; PE = Peru; PH = Philippines; PL = Poland; RU = Russia; SG = Singapore; TH = Thailand; TR = Turkey; TW = Taiwan, China; VE = Venezuela; ZA = South Africa.

[1] Percentage point change between 2000 and 2001. [2] Sum of exports and imports as a percentage of GDP; average over 2000–01.

Sources: IMF, *International Financial Statistics*; national data. Graph III.2

The performance of the emerging market economies was also significantly influenced by the direction and composition of trade last year. Asian and several Latin American economies with strong bilateral trade ties with the United States (Table III.2) experienced an unusually sharp decline in

… and relative reliance on US market

Major export markets and products[1]

	Asia[2]	Latin America[3]	Central and eastern Europe[4]	Africa and Middle East[5]	All emerging market countries
Export markets[6]					
United States	21	39	4	16	20
Japan	13	4	1	4	6
Euro area	16	16	60	44	34
Intraregional	31	17	16	3	17
Others	19	24	19	33	24
Products[7]					
Food	8	24	8	14	14
Agriculture	2	4	3	3	3
Fuels	5	21	8	38	18
Metals	2	15	5	5	7
Manufactures	82	36	74	39	58
High-tech	40	18	17	6	20

[1] As a percentage of total exports; for country groups, unweighted average. [2] China, Hong Kong SAR, India, Indonesia, Korea, Malaysia, the Philippines, Singapore, Taiwan (China) and Thailand. [3] Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela. [4] Bulgaria, Croatia, the Czech Republic, Hungary, Poland, Romania, Russia, Slovakia and Turkey. [5] Algeria, Egypt, Israel, Kenya, Morocco, Nigeria, Saudi Arabia, South Africa and Tunisia. [6] 2000. [7] 1999.

Sources: IMF, *Direction of Trade*; World Bank. Table III.2

growth and export demand. The central and eastern European economies trade predominantly with the euro area, where the fall in imports was less pronounced. Consequently, their industrial production and exports remained relatively strong (Graph III.3).

Sectoral composition of trade also mattered

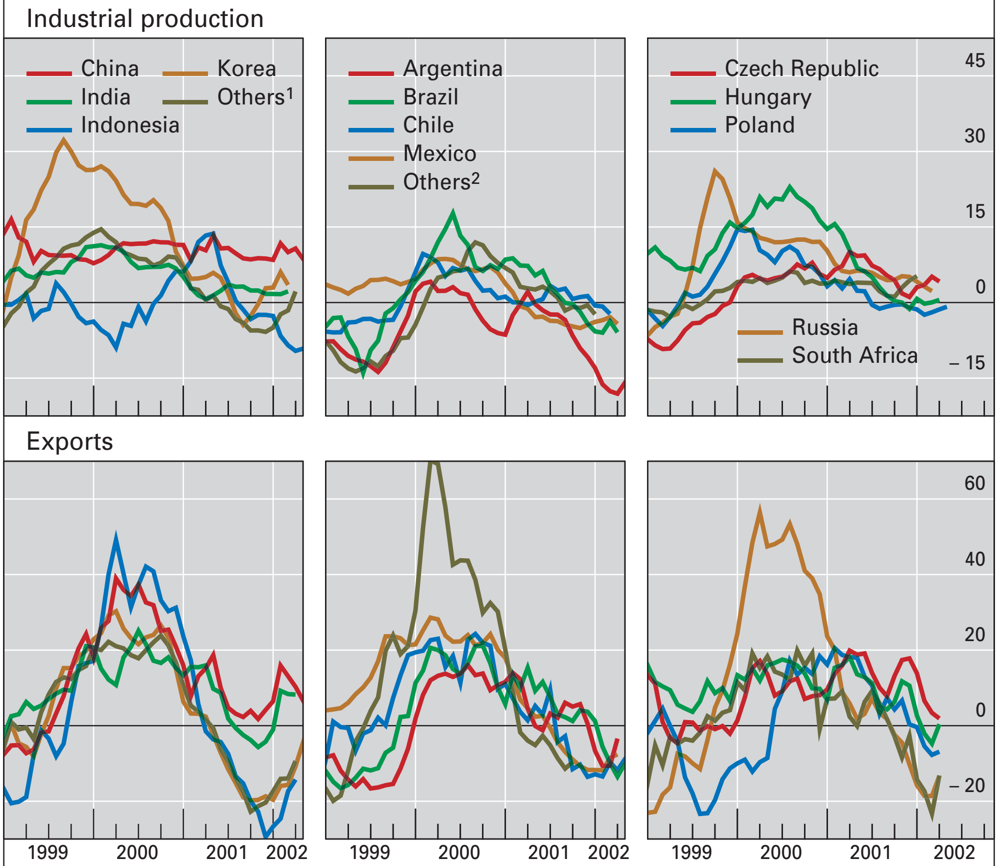
Asia's growth slowdown was largely driven by the drop in world demand for high-tech products, which account for 40% of its manufactured exports. As the income elasticity for Asian exports is estimated to be more than twice as large as that facing Latin American and African commodity exporters, the drop in industrial country import demand had a greater impact on Asian exports. For example, the dollar value of aggregate exports from Indonesia, Korea, Malaysia, the Philippines and Thailand declined by 11% in 2001 after rising by 19% in 2000. Exports from central and eastern Europe (notably machinery and equipment) were much less affected by the slump in demand for high-tech products.

Tourism revenues were hard hit

The tourism sector also suffered a major setback in 2001, especially in the aftermath of the 11 September terrorist attacks. The Caribbean region, African countries with sizeable tourism sectors, including Morocco, Tunisia, Egypt and Kenya, and many Asian destinations were hard hit.

Industrial production and exports

Annual percentage changes; three-month moving averages



[1] Malaysia, the Philippines, Singapore, Taiwan (China) and Thailand. [2] Colombia, Peru and Venezuela.

Sources: IMF, *International Financial Statistics*; national data. Graph III.3

The global economic slowdown also depressed commodity prices, with the average dollar price of emerging market countries' non-oil primary commodity exports falling by about 9% in 2001. Demand for metals suffered most, reducing export receipts in Chile, Russia, South Africa and Zambia, while the supply of agricultural commodities continued to increase despite lower prices. The price declines were especially hard for exporters in Africa, where non-oil commodities, in particular coffee and cotton, often account for a major share of export revenue. At the same time, lower oil import prices helped some African countries, while in others favourable weather conditions supported agricultural output. In addition, Africa mostly trades with Europe, where demand was more sustained. Accordingly, growth in Africa improved last year to 3¾%, almost 1 percentage point higher than in 2000.

Commodity prices declined …

… but growth in Africa rose

The fall in oil prices (almost 15%) and a small drop in world oil demand reduced export receipts of the oil-exporting emerging market countries. As a result, these countries' current account surplus fell from $100 billion in 2000 to $56 billion last year. In Saudi Arabia, the largest oil exporter, GDP growth declined from 4½% in 2000 to 2%.

Some of these contractionary forces began to reverse course in late 2001. Exports of high-tech products and, to a lesser extent, components picked up towards the end of the year in Korea, Malaysia, the Philippines and Thailand (Graph III.4). However, more recent data as well as declining semiconductor and chip prices suggest that the rebound in Asian exports in the first half of 2002 may be more moderate than during previous recoveries.

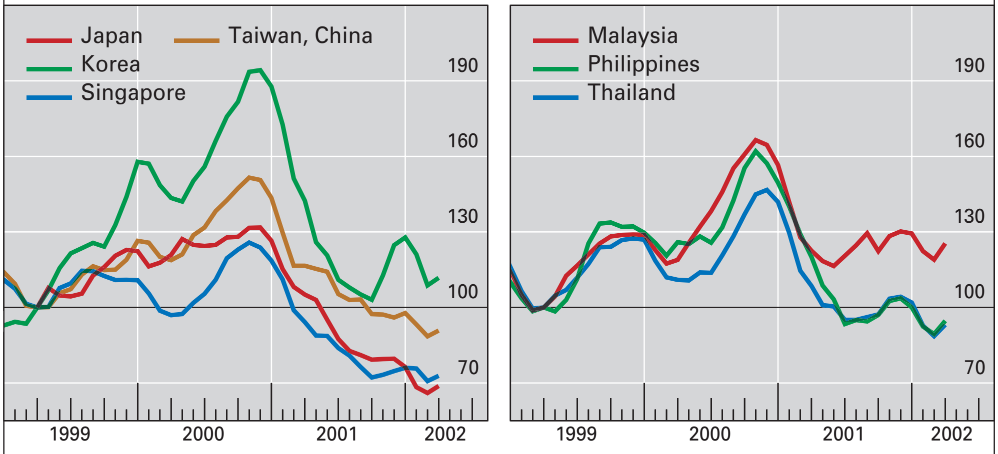
Signs of a moderate recovery have emerged …

The outlook for Latin American economies is less clear, largely because of external imbalances and the uncertain political situation in a number of countries. Higher non-oil commodity prices should support growth among Latin American as well as African commodity exporters. At the time of writing, however, there is considerable uncertainty about the prospects for both oil production and prices in the light of evolving political as well as economic circumstances.

… but outlook for Latin America is more uncertain

High-tech exports of Asian economies to the United States[1]

March 1999 = 100; three-month moving averages



[1] High-tech exports defined as the sum of the trade classifications SITC 75, 76 and 77.

Source: National data.

Graph III.4

Domestic factors

The slowdown in world trade was the driving force shaping developments in the more open economies discussed above. But overall output growth and changes in external balances were also influenced by the nature and size of domestic adjustments to the external shocks, as well as by some idiosyncratic factors.

Expansionary policies and import compression in Asia

Several Asian countries affected by the drop in external demand – Korea, Malaysia and Thailand – as well as the more closed economies of China and India adopted expansionary domestic policies, which stimulated household consumption, residential construction or public investment. Fiscal stimulus and weaker household saving led to a reduction in total saving in these countries. Other Asian economies – Singapore, Taiwan and, to a lesser extent, Hong Kong – adjusted to the weakening in export demand mainly through lower levels of import-intensive investment and inventories. This adjustment pattern sharply reduced the negative impact of slowing exports on the current account. Nevertheless, the positive saving/investment balance (evident since the slump in capital spending following the Asian crisis in 1997–98) and associated current account surpluses did decline in Asia last year.

Different adjustment patterns across other regions

In non-Asian emerging market economies, the pattern of adjustment to external shocks was different. Some of the oil-exporting countries (Mexico and Saudi Arabia) reduced public expenditure in response to lower export earnings. Others – for instance Russia and Venezuela – chose to reduce aggregate saving by using some of their accumulated oil surpluses to boost domestic demand. Response patterns and adjustments also differed across Latin America. Investment dropped sharply in Argentina, Mexico and Peru, but remained relatively stable or increased slightly in Brazil, Chile and Colombia. As saving in these three countries declined, their current account deficits widened.

Political and social tensions in Indonesia

Output developments in some large economies were further affected by specific domestic factors. Real GDP in Indonesia grew by little more than 3%, well below pre-crisis rates. Apart from lower commodity and oil prices, political uncertainties and social tensions in several provinces hampered expansion. Output growth of just over 3% forecast for 2002 may not be sufficient to prevent unemployment from rising. In addition, progress in bank and corporate restructuring continues to be hindered by complex legal and judicial problems.

Stronger reform momentum in Russia

Russia's economy expanded more slowly than in 2000, but faster than had been expected. The main sources of the recent slowdown appear to have been weaker external demand and the effects of past real appreciation. Domestic demand remained buoyant, however, with private consumption and investment responding favourably to the continued momentum of reform. The fiscal performance was again strong and the current account surplus also remained large (11% of GDP).

Brazil affected by energy crisis and spillover from Argentina

In Brazil, an energy crisis that required rationing of electricity, weaker terms of trade and tighter anti-inflationary policies all combined to reduce GDP growth to 1½% in 2001. The current account deficit widened slightly (to 4½% of GDP), but the trade balance posted the first surplus since 1994 and

FDI inflows reached $19 billion. Brazil nevertheless remains exposed to a volatile international environment given its large (albeit downward-trending) external financing requirement.

Weak domestic demand in Poland

Domestic developments also led to slower growth in Poland, where real GDP increased by just 1% in 2001. The principal source of weakness was investment, which fell by about 10%, partly reflecting high real interest rates and a persistently strong zloty. Private consumption was affected by rising unemployment, and ongoing fiscal consolidation depressed public consumption. Growth remained slow in the first quarter of 2002.

Financial market linkages and capital flows

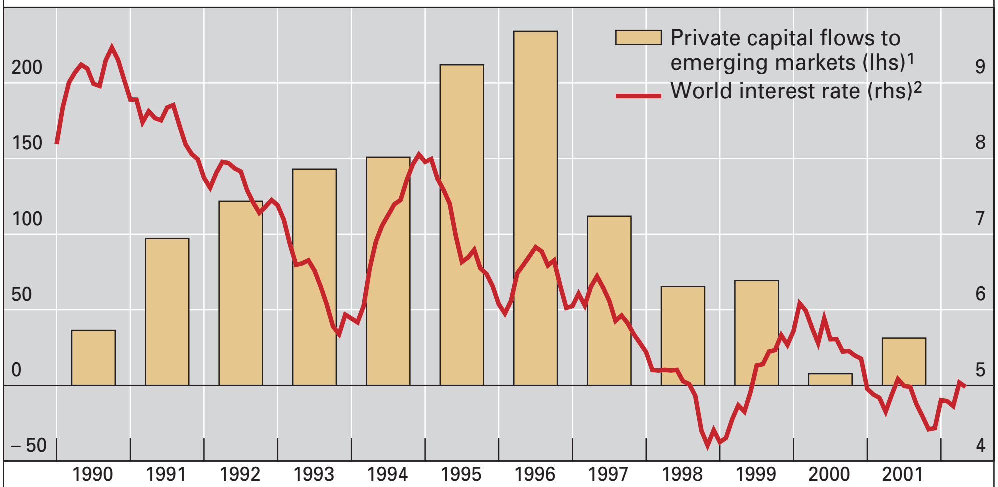
Relatively resilient capital flows

Changes in international interest rates have traditionally had a major influence on the volume of capital flows, with emerging markets typically receiving a higher volume of private capital inflows in years when interest rates are easing (Graph III.5). Last year, however, the decline in industrial country interest rates took place in an environment of global slowdown and increased investor risk aversion. In these circumstances, and given potentially disruptive crises in Argentina and Turkey, it might have been expected that capital flows to emerging market economies would drop sharply. In the event, lower interest rates did lead to a small increase in flows to emerging markets, and even some of the traditionally more volatile components of capital flows were relatively stable (Graph III.6).

Greater FDI flows targeted at large economies

FDI flows accounted for the bulk of the increase in private capital flows in 2001. Historically, FDI has been targeted at supplying both final and intermediate goods to industrial countries, and has thus tended to contract during industrial country slowdowns and expand during upturns. Since the mid-1990s, however, the growth in FDI flows has primarily reflected investors' interest in securing access to large markets for final goods, and has been related to privatisations and mergers and acquisitions. As a result, FDI flows

Capital flows and interest rate

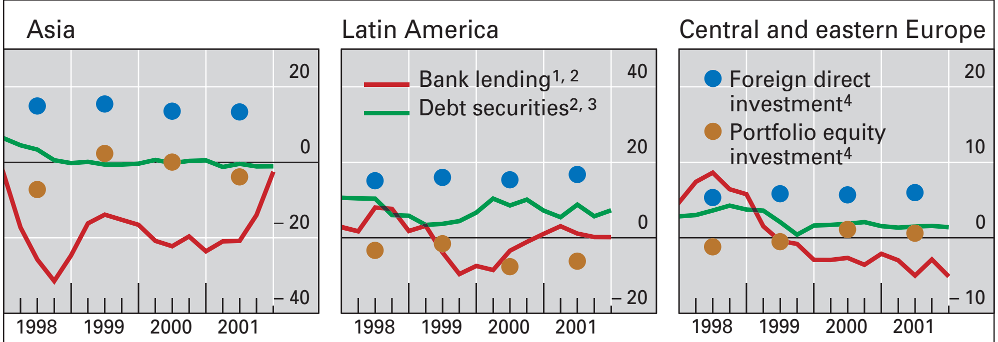


[1] In billions of US dollars. [2] Weighted average of 10-year government bond rates in the United States, the euro area and Japan; in percentages.

Sources: *The World Economy*, vol 25, no 2, February 2002; IMF; national data. Graph III.5

Capital flows

In billions of US dollars



[1] Exchange rate adjusted change in net claims of BIS reporting banks. [2] Four-quarter moving average. [3] Net issuance of international debt securities. [4] Net flows at a quarterly rate.

Sources: IMF, *World Economic Outlook*; BIS. Graph III.6

have been directed to fewer countries. This was also true last year, when revenues from the sale of a major Mexican bank and the takeover of a leading mining company in South Africa actually exceeded the rise in aggregate FDI flows to emerging markets. In addition, FDI flows to China boomed last year in response to its accession to the WTO.

Cross-border lending turned positive in some countries

Cross-border claims of BIS reporting banks vis-à-vis emerging market economies declined in 2001. However, in several Asian economies cross-border bank lending turned positive late last year for the first time since mid-1997 (see Chapter VI). Foreign banks and their domestic subsidiaries also continued to lend and to invest significant sums in central European countries and Russia. In contrast, international banks cut back sharply their claims on Argentina.

Portfolio equity flows reflected economic prospects

Portfolio equity inflows to Asia declined in 2001. They also fell, to a lesser extent, in Latin America, but remained stable in central and eastern Europe. The decline in the demand for and supply of equities in Asia during much of 2001 reflected uncertain economic prospects and the collapse of technology equity prices, which decreased the wealth held by investors in high-risk assets. Moreover, since the correlation between changes in the Nasdaq index and most emerging market equity prices had increased in recent years (Table III.3), the benefits of portfolio diversification towards emerging market

Correlations between changes in the Nasdaq index and equity prices[1]

	Hong Kong SAR	Korea	Malaysia	Singapore	Taiwan, China	Thailand
1995–1996	0.32	0.28	0.07	0.11	0.07	0.20
1999–2002 Q1	0.61	0.47	0.29	0.44	0.34	0.31
	Argentina	Brazil	Chile	Mexico	Poland	South Africa
1995–1996	0.16	0.14	0.09	0.27	0.16	0.09
1999–2002 Q1	0.25	0.50	0.30	0.61	0.44	0.52

[1] In national currencies; calculated using weekly observations.

Source: Bloomberg. Table III.3

paper were reduced. Since March 2002, however, equity prices in several emerging markets have decoupled from the Nasdaq index.

Emerging market equity issuance increased in the first quarter of 2002, and market indices rose faster than those in the United States (Graph III.7). Equity flows in the first few months of 2002 were largely directed towards Asia, Brazil, Mexico and South Africa, while other Latin American economies and Poland experienced outflows. These developments seem to reflect greater confidence in an improving global outlook, in particular in Asia. With few exceptions, the rally was broad-based rather than focused on the high-tech sector, and included the banking sector for the first time in several years. There was also a strong rally in equity markets in central and eastern Europe. Still, many emerging equity markets remain substantially below their peaks reached in 2000, and not all markets have benefited from the recent run-up in equity prices.

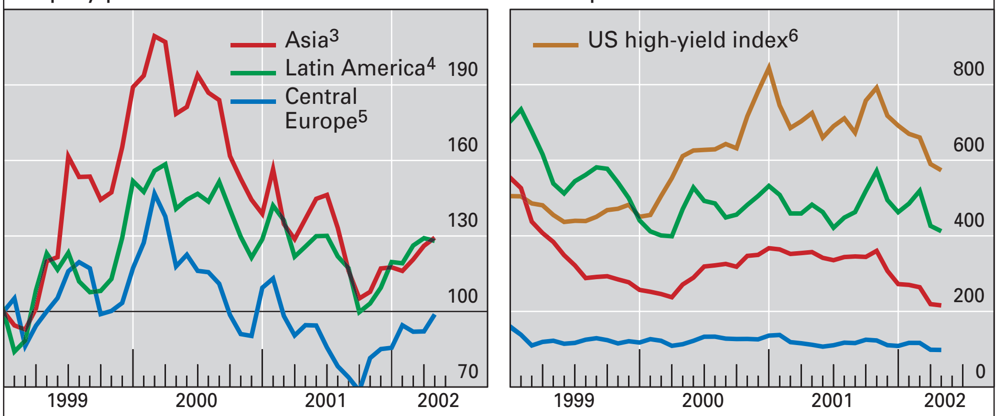
Stable bond flows as investors favour better risks

Net issuance of debt securities by emerging markets was fairly stable in 2001 (see Chapter VI). One reason was that the decline in industrial country interest rates and a slight reduction in investment grade spreads resulted in a sizeable lowering of interest rates for investment grade borrowers. This encouraged both established borrowers (China, Hungary, Malaysia, Mexico and Poland) and smaller issuers (Colombia, Croatia, Latvia and Uruguay) to come to the market. Spreads on the secondary market tightened during 2001, except for Argentina.

In the aftermath of 11 September, spreads rose sharply (by over 200 basis points on average), but subsequently dropped to a level not seen since early 2000 (Graph III.7). Spreads in Latin America were particularly volatile, reflecting an initial spillover from the crisis in Argentina, but since October 2001 there have been clear signs of a decoupling. New international bond

Equity prices and bond spreads

Equity prices[1] | Bond spreads[2]



[1] In US dollar terms, end-1998 = 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] 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; national data. Graph III.7

issuance by major emerging market borrowers increased in the first quarter of 2002.

Highly indebted economies remain more vulnerable

Although overall capital flows to emerging market economies have displayed a measure of resilience over the past year, many countries with high debt/GDP ratios, high debt servicing requirements or a large proportion of short-term debt relative to foreign reserves (Table III.4) have been and will remain highly sensitive to changes in financial market sentiment. For instance, net outflows contributed to the crises in Argentina and Turkey. In contrast, Mexico continued to attract significant amounts of new investment last year due to its growing economic integration with the United States. Similarly, investors increasingly perceive the EU candidate countries in central and eastern Europe as "convergence markets". Because of their adoption of policy frameworks that are increasingly defined by the European Union, these countries are considered less risky destinations for investment.

Capital flows not expected to rebound in 2002

The incipient recovery in the industrial countries is not expected to lead to a quick rebound in capital flows to emerging markets in 2002. Banks are likely to remain cautious given the increasing level of bad loans on their balance sheets. Other potential investors may be concerned about the evolving crisis in Argentina and possible spillover effects on other Latin American countries. FDI flows are expected to remain resilient although increasingly concentrated on countries with relatively large markets. New FDI commitments to China rose strongly in the first quarter of 2002, and the recovery in Asian exports and GDP, if sustained, is expected to boost capital flows to several other East Asian countries. Scheduled privatisations of utilities, infrastructure and telecommunications companies in central and eastern Europe may also attract large capital inflows. At the same time, Latin America's share of FDI is expected to decline as privatisations are projected to play a less significant role in 2002.

Debt indicators in 2000

	Public sector debt			Total debt service[1]	Public debt service[2]	Short-term external debt as a % of foreign reserves
	Total	External	Domestic			
	as a % of GDP			as a % of exports[3]		
India	60	9	51	13	11	9
Indonesia	99	59	40	25	10	80
Philippines	81	48	33	14	9	46
Argentina	52	34	18	71	43	116
Brazil	39	4	35	91	35	95
Hungary	55	8	47	24	11	38
Russia	67	52	15	10	4	64
Turkey	62	21	41	36	17	130

[1] Interest and principal payments on public and private long-term external debt (one year or longer). [2] Interest and principal payments on public sector long-term external debt. [3] Exports of goods and services.

Sources: World Bank; Institute of International Finance (IIF); national data; BIS statistics. Table III.4

Policy responses to the slowdown

The role of monetary and exchange rate policies

Monetary and fiscal policies in an unusually large number of emerging market economies were eased last year to offset the impact of the global slowdown. Policy rates in several countries were cut to their lowest levels since the Asian crisis (Table III.5). Some countries with flexible exchange rate regimes also allowed their exchange rates to weaken, thus providing an additional policy channel to dampen the negative shock. In contrast, other countries had to raise interest rates to guard against increased external vulnerability.

Easier monetary and fiscal policies ...

The easing of monetary policies was facilitated by two factors. First, the large cuts in industrial country interest rates enabled the emerging market economies to lower domestic rates without triggering capital outflows or pressure on the currency. Second, the general decline in domestic inflation (Table III.6) allowed the central banks to deliver sharper rate cuts than would otherwise have been possible. Yet some countries were confronted with rising price pressures, restricting their flexibility to counter the slowdown. Other restraining factors were the fear of contagion from the crisis in Argentina, increased political uncertainty in some Latin American countries, and vulnerability arising from a history of high inflation and imprudent fiscal policies in many countries.

... facilitated by industrial country rate cuts and low inflation

Strong bias towards easing in Asia

Monetary policy responses to the slowdown were faster in Asia than in other regions, helped by strong external positions and flexible exchange rate regimes. Indeed, with the exception of Indonesia, all countries with flexible exchange rates lowered interest rates last year, with the rate cuts being particularly sharp in the Philippines and Taiwan (Table III.5). India and Korea also lowered policy rates during the year and supplemented these cuts with quantitative easing; the former lowered the reserve requirement on banks and

Lower interest rates in most Asian countries with flexible exchange rates ...

Policy rates

	China	Hong Kong SAR	India	Indonesia	Korea	Malaysia
Change since Dec 2000[1]	–27	–475	–150	208	–125	–50
Level in April 2002[2]	1.98	3.25	6.50	16.61	4.00	5.00
	Philippines	Singapore[3]	Taiwan, China	Thailand	Czech Republic	Hungary
Change since Dec 2000[1]	–650	–200	–250	50	–150	–250
Level in April 2002[2]	7.00	0.81	2.13	2.00	3.75	8.50
	Poland	Russia[3]	South Africa	Brazil	Chile	Mexico[3]
Change since Dec 2000[1]	–950	–186	–50	227	–282	–1,200
Level in April 2002[2]	9.50	15.85	11.50	18.11	4.75	6.01

[1] Change in basis points. [2] In percentages, end of period. [3] Three-month interest rate.

Source: Bloomberg. Table III.5

Consumer prices

	1990–97	1998	1999	2000	2001	2002 Q1
	annual percentage changes					
Asia[1]	9.1	7.6	2.3	1.9	3.1	1.7
China	10.7	–0.9	–1.4	0.3	0.7	–0.5
Hong Kong SAR	8.5	2.9	–4.0	–3.7	–1.5	–2.8
India[2]	9.1	6.9	3.5	5.3	5.2	1.2
Indonesia	8.3	58.4	20.5	3.7	11.5	14.5
Korea	6.1	7.5	0.8	2.3	4.3	2.4
Malaysia	3.6	5.3	2.7	1.5	1.4	1.5
Philippines	9.9	9.7	6.7	4.3	6.1	3.6
Singapore	2.5	–0.3	0.5	1.5	1.1	–0.9
Thailand	5.2	8.1	0.3	1.5	1.7	0.5
Latin America[1]	157.5	9.7	9.1	6.6	6.6	7.3
Argentina	77.4	0.9	–1.2	–0.9	–1.1	4.2
Brazil	500.4	3.8	4.9	6.0	8.0	9.5
Chile	13.5	5.1	3.4	3.8	3.6	2.4
Mexico	21.0	15.9	16.6	7.9	6.2	4.3
Central Europe[1]	20.7[3]	11.8	6.5	8.7	5.9	4.0
Czech Republic	9.1[3]	10.7	2.1	3.9	4.7	3.8
Hungary	22.2[3]	14.1	10.0	9.8	9.2	6.3
Poland	24.7[3]	11.7	7.3	10.1	5.5	3.5
Russia	112.9[3]	27.7	85.7	20.8	21.5	17.8
South Africa	10.8	6.9	5.2	5.3	5.7	4.3

[1] Weighted average of the countries shown, based on 1995 GDP and PPP exchange rates. [2] Wholesale prices. [3] Average over the period 1993–97.

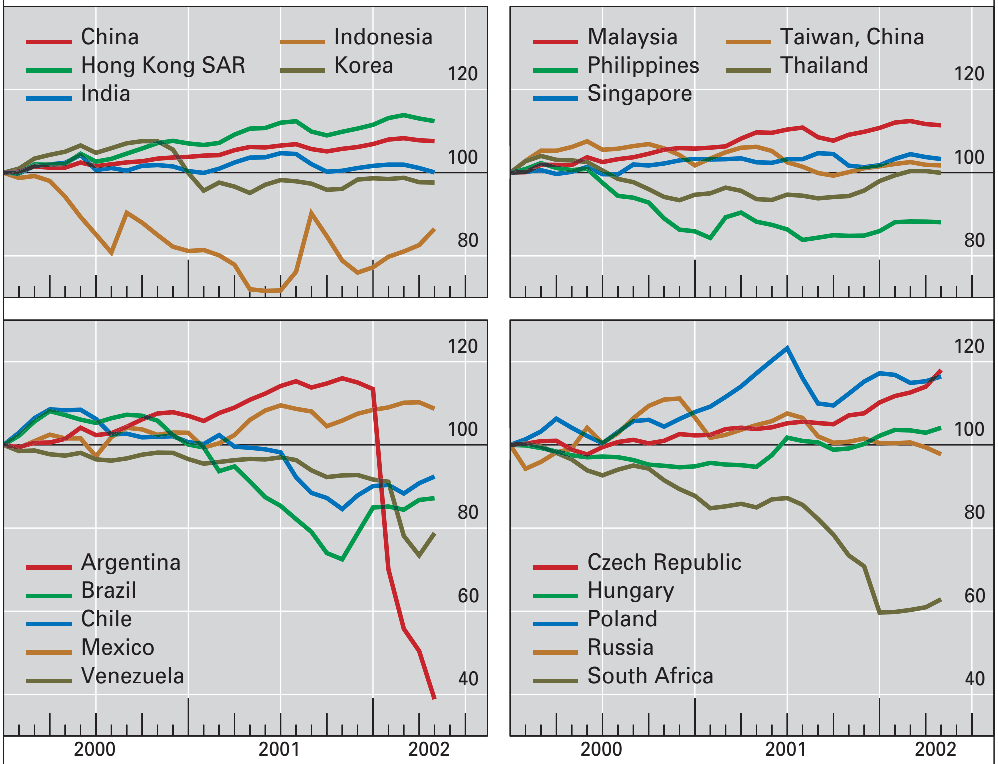
Sources: IMF; national data. Table III.6

the latter raised the aggregate credit ceiling following 11 September. By contrast, Indonesia had to tighten monetary policy to stem rising inflation and growing exchange rate pressure. The sharp cuts in Asian interest rates helped support demand during the slowdown and should improve the prospects for recovery. Nevertheless, if the recovery gains strength, monetary policy may have to be tightened. Thus, Korea raised interest rates in the second quarter of 2002 following the recovery of both domestic and external demand.

... but changes in effective exchange rates varied

Although the exchange rates of most countries fell against the rising dollar, the potential gains in competitiveness were moderated or neutralised by other factors. For instance, a rapid rate of depreciation of the yen and the Korean won against the dollar (by about 20% between mid-2000 and early 2002) put upward pressure on the effective exchange rates of most other Asian currencies (Graph III.8). The subsequent strengthening of both currencies against the dollar has helped to relieve that pressure somewhat. Moreover, in countries with relatively high rates of inflation (Indonesia and the Philippines), nominal depreciations did not translate fully into gains in international competitiveness. Finally, in some countries (for example India) the preference for keeping the exchange rate relatively stable against the dollar resulted in only small movements in the effective exchange rate.

Nominal effective exchange rates[1]



[1] An increase indicates an appreciation; end-1999 = 100.

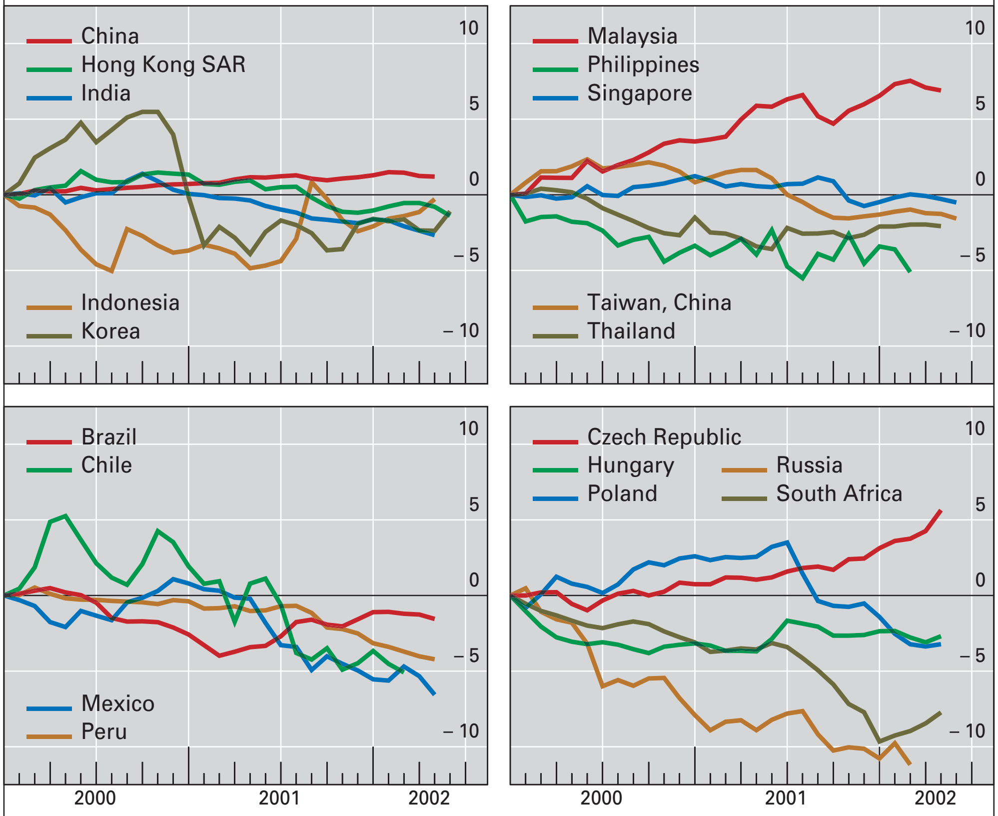
Sources: IMF, *International Financial Statistics*; BIS calculations. Graph III.8

Despite these offsetting factors, the competitive gains from the exchange rate depreciation were large in some countries. The real effective rate of the Korean won fell by 5% between August 2000 and March 2002, with a large part of the decline occurring during the period of very weak external demand. In Taiwan, the real exchange rate fell by 7% in the 12 months to August 2001. Singapore also allowed the exchange rate to dampen external shocks. Using the nominal effective exchange rate as an operational target, the authorities eased their policy stance from an appreciation bias to a neutral stance in July 2001, and subsequently widened the exchange rate band to accommodate depreciation after 11 September.

Varying policy responses in countries with fixed exchange rate regimes

In countries with exchange rates linked to the dollar, the stance of monetary policies varied even though US rate cuts generally created room for monetary easing. The domestic interest rate was already low in China and was not cut until early 2002. In Malaysia, the policy rate was kept unchanged to attract capital inflows. After it was lowered in September, key short-term interest rates did not move much in response. In both countries, capital controls were able to insulate domestic rates from the global interest rate cycle. In contrast, Hong Kong closely followed reductions in US rates. While the currency link continued to serve as a credible anchor in all three cases, the strength of the dollar against most other currencies caused their real effective exchange rates to appreciate, particularly from the autumn of 2001. This may explain why these countries relied on fiscal policy to stimulate domestic demand.

Monetary conditions indices[1]



[1] Calculated as a weighted average of movements in the short-term interest rate and the nominal effective exchange rate since December 1999. An increase indicates a tightening of monetary conditions.

Sources: IMF, *International Financial Statistics*; BIS calculations. Graph III.9

Graph III.9 shows indices of monetary conditions based on the combined impact of changes in short-term interest rates and nominal effective exchange rates. As the graph indicates, monetary conditions mostly eased during 2001. However, they tightened in Brazil, the Czech Republic, Indonesia and Malaysia, and remained more or less unchanged in China, Hungary and Thailand.

Less room for manoeuvre in Latin America

High external financing needs, increased inflationary pressures in some countries, declining investor confidence and growing political uncertainty limited the scope for monetary easing in Latin America. Indeed, many countries had to tighten monetary policy to support their currencies.

Tighter monetary policy in Brazil and Venezuela ...

With inflation running above target and the currency under pressure related to the crisis in Argentina, Brazil tightened monetary policy during much of 2001. The subsequent easing, particularly from November 2001, was limited by remaining inflationary pressures. Nevertheless, the sizeable currency depreciation (about 23% in real effective terms between end-2000 and October 2001) supported export growth. Venezuela tightened monetary policy to defend its currency before allowing the exchange rate to float in early 2002. Inflation remained high, however, so that the subsequent large nominal depreciation did not improve competitiveness.

Chile and Mexico were able to use monetary policy to stimulate demand. In Chile, low inflation and sound external and fiscal balances allowed the central bank to lower interest rates, except during a period in the second half of 2001 when the peso came briefly under pressure. In Mexico, the rebalancing of portfolios by foreign investors in favour of Mexican assets, an associated sharp appreciation of the exchange rate and a decline in inflation contributed to a decline in interest rates. However, with wage growth accelerating at the beginning of 2002, Mexico subsequently adopted a more cautious monetary policy stance. At the time of writing, notwithstanding the depreciation in April 2002, the real effective exchange rate of the peso remains 20% above the level preceding the 1994 crisis. This is likely to limit the tradable sector's ability to benefit from the global recovery now under way. In fact, the peso's appreciation has already led to the closure of some export-oriented firms, the relocation of several companies overseas, and the replacement of domestic products by cheaper imports in some of the intermediate goods sectors.

... but lower rates in Chile and Mexico

Limited easing elsewhere

In central and eastern Europe, the slowdown in external demand coincided with large capital inflows and a steady exchange rate appreciation. This prompted central banks to cut interest rates and to intervene occasionally in foreign exchange markets. However, fiscal pressures and inflation risks put a floor on rate cuts in Poland and Hungary. In the Czech Republic, the strengthening of the exchange rate, along with a combination of strong productivity gains and only moderate wage growth, allowed the central bank to reduce interest rates to very low levels.

Appreciating exchange rates in central Europe

In South Africa, policy challenges were heightened during the fourth quarter of 2001 when an exceptionally sharp depreciation of the exchange rate raised inflation expectations. Since inflation has continuously exceeded the end-2002 target, the central bank has recently rolled back much of the easing implemented during 2001. Although the rand has since recovered, last year's sharp depreciation has improved the country's external competitiveness and exports have contributed significantly to overall growth.

Policy challenges in South Africa

Effectiveness of monetary policy in stimulating growth

How far has monetary policy been able to stimulate demand in emerging market economies? One way to assess this effect is to look at the impact of the policy rate cuts on long-term interest rates. A more proactive response of central banks to economic shocks may also affect consumer and business sentiment, but this effect is harder to measure.

Monetary easing has generated positive effects

Long-term bond rates in emerging market economies declined last year, particularly over the second half, when monetary policy was substantially eased (Table III.7). Indeed, long-term rates have fallen to their lowest levels since the Asian crisis. As in industrial countries (see Chapter II), lower interest rates have supported a revival of the housing sector in several emerging market countries. They may also have helped corporate restructuring. Nevertheless, it is not clear whether the sharp drop in long-term rates was

Long-term rates fell in most countries ...

Long-term interest rates[1]

	End-1998	End-1999	End-2000	June 2001	End-2001
Hong Kong SAR	6.36	7.74	6.46	6.37	6.22
India	12.22	11.24	10.94	9.45	7.92
Korea	8.30	9.85	8.12	7.24	6.79
Malaysia	6.81	6.36	5.49	4.20	3.76
Philippines	18.36	15.61	18.20	15.39	15.75
Singapore	4.48	4.56	4.09	3.64	3.97
Taiwan, China	5.12	6.03	5.13	3.84	3.81
Thailand	7.26	6.40	5.09	6.34	3.40
Chile	7.19	7.19	6.21	5.87	5.63
Mexico	7.50	6.68	6.70	6.05	6.00
Czech Republic	13.94	10.19	8.09	7.16	7.06
Hungary	12.88	9.82	8.80	8.20	7.71
Poland	...	10.41	13.19	13.18	9.56
South Africa	15.85	13.67	12.72	10.88	11.53

[1] Ten-year or nearest long-term rate; in percentages.

Sources: Bloomberg; national data. Table III.7

entirely due to monetary easing. In India, for instance, a large part of the decline in long-term bond rates reflected a "flight to quality" by banks and financial institutions, which sharply increased investment in government securities and drove bond prices higher.

... but corporate credit growth remained depressed

In most countries, however, lower interest rates have not led to higher credit growth. In fact, real credit growth was negative in several Asian countries, even though monetary easing was most pronounced in this region (Graph III.10). The slow progress of bank restructuring and a large overhang of non-performing loans may have limited the supply of new credit. However, much of the weakness in credit growth also seems to reflect the lack of creditworthy borrowers as well as conscious decisions by firms to reduce their indebtedness.

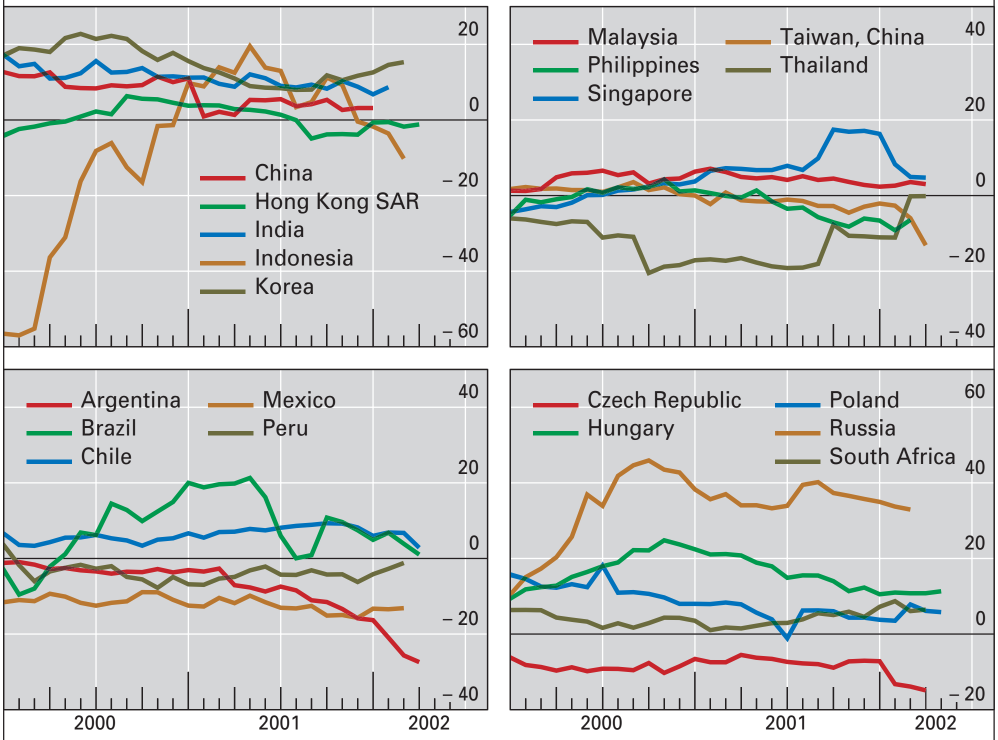
Banks increased consumer credit ...

With business demand for credit being low, easier monetary conditions have led banks to diversify into consumer credit. Mortgage and consumer credit grew by 70% in China in 2001, albeit from a low level. Korean banks have been particularly aggressive in promoting lending to households through easier terms on mortgages. This has allowed household debt to rise very rapidly to historically high levels. In India, competition for consumer loans has reportedly led banks to extend mortgage credit at below prime lending rates. In Hong Kong, higher mortgage lending partly offset lower corporate lending.

... and were encouraged to lend more

The authorities in many Asian countries have provided special incentives to encourage banks to lend. The Hong Kong Monetary Authority temporarily waived the loan-to-value requirement for the refinancing of home mortgages. The Bank of Korea offered a liquidity adjustment facility to banks facing temporary liquidity problems arising from restructuring. In the Philippines, the central bank lowered interest rates on overnight deposits to encourage banks to reduce their excess liquidity and expand business lending. In

Real credit growth[1]



[1] Annual percentage changes; domestic credit to the private sector deflated by consumer prices.

Sources: IMF, *International Financial Statistics*; BIS calculations. Graph III.10

Thailand, the central bank relaxed loan provisioning and classification requirements.

Large credit contraction in Latin America

In Latin America, the recent credit contraction can be attributed to both cyclical and structural factors. In Argentina, the banks' capacity to lend in 2001 was severely affected by the financial crisis, while in Peru a rapid decline in deposits had a similar effect. The sharp deceleration in credit growth in Brazil in 2001 was widely attributed to increased financial market uncertainty in the wake of the Argentine crisis and the associated reluctance of both borrowers and lenders to expose themselves to higher default risks. In Mexico, the credit contraction has reflected financial disintermediation and increased reliance by firms on cross-border sources of finance. Except for Mexico, the reduction in international equity and bank flows to Latin America has exacerbated the slowdown in domestic credit growth.

The role of fiscal policy

Faced with the economic slowdown, many emerging economies implemented fiscal stimulus measures in 2001. In others, however, the revenue impact of slower growth or higher debt servicing costs forced governments to cut spending.

Fiscal deficits remained large in Asia ...

Fiscal policy in most Asian countries was either accommodating or expansionary last year. Budgetary stimulus was a major driver of domestic demand in Hong Kong, Singapore and Thailand. In other countries, tax reforms or the accumulation of surpluses in pension funds concealed

Fiscal balances and public debt								
	Overall balance			Primary balance			Public debt	
	1999	2000	2001	1999	2000	2001	1996	2001
	As a percentage of GDP							
Asia[1]	–1.0	–1.3	–2.9	–1.5	–0.5	–0.3	28.6	51.8
China	–2.1	–2.8	–2.7	…	…	…	7.3	16.3
Hong Kong SAR	0.8	–0.6	–5.0	.	.	.	.	.
India	–5.4	–5.7	–5.7	–0.7	–0.9	–1.1	49.4	58.1
Korea	–2.7	1.1	1.5	–1.5	2.6	2.7	8.8	20.8
Singapore	10.3	11.4	–0.3	.	.	.	.	.
Taiwan, China	1.0	–0.6	–0.7	–0.5	–2.5	–2.6	22.7	31.7
Indonesia	–1.6	–3.2	–3.7	2.2	2.5	1.7	27.3	106.9[2]
Malaysia	–3.2	–5.8	–5.5	–0.5	–3.1	–2.6	35.3	43.8
Philippines	–3.8	–4.1	–4.0	–0.2	0.2	0.8	61.3	79.1
Thailand	–3.3	–2.2	–2.4	–9.4	–1.8	–1.1	16.3	57.5
Latin America[1]	–3.4	–2.5	–3.0	0.0	0.6	0.1	29.3	35.3
Argentina	–2.9	–2.7	–3.3	0.0	1.1	0.5	35.2	52.6
Brazil	–6.9	–3.2	–3.7	2.3	1.9	1.9	33.3	53.3
Chile	–1.5	0.1	–0.3	–1.1	0.6	0.2	16.7	15.6
Colombia	–6.0	–6.1	–6.0	–2.5	–2.2	–1.9	14.4	43.4
Mexico	–1.1	–1.1	–0.7	2.5	2.6	2.6	26.6	20.4
Peru	–3.1	–2.7	–2.8	–1.0	–0.5	–0.6	45.2	35.9[2]
Venezuela	–2.6	–1.7	–4.0	0.1	0.8	–1.1	33.8	25.7
Central Europe[1]	–2.6	–2.9	–3.9	–1.2	0.5	–0.9	43.2	36.1
Czech Republic	–2.9	–3.5	–4.5	–1.8	–2.3	–3.3	10.3	16.1[2]
Hungary	–3.0	–2.8	–2.8	–3.0	3.3	2.1	71.5	53.2
Poland	–2.0	–2.2	–4.5	1.0	0.4	–1.6	47.8	39.0[2]
Russia	–1.2	2.5	3.0	1.9	4.7	5.3	48.1	64.0[2]
South Africa	–2.3	–1.5	–1.9	2.9	3.5	2.8	45.2	42.8

Note: Comparison across countries should take into account that different definitions of the public sector are used; for Hong Kong SAR and Indonesia, fiscal years; for India, federal government only.

[1] Simple averages. [2] 2000.

Sources: IMF; IIF; national data; BIS estimates. Table III.8

stimulatory expenditure measures or a very accommodating policy stance. In China, an improvement in revenue performance limited the budgetary impact of increased public infrastructure spending and higher wages for government employees. With a deficit of over 5% of GDP, fiscal policy in Malaysia remained highly accommodating. Moreover, the impact of expenditure measures was either masked by the effects of tax reform or will only affect the budget outcome for 2002. Korea's fiscal surplus rose last year, but this mainly reflected growing surpluses in the social security funds; abstracting from this effect, the fiscal stimulus to domestic demand was sizeable.

... but only limited scope for fiscal stimulus in India

The scope for fiscal stimulus was much more limited in India, where a central government budget deficit of over 5½% of GDP overshot the target by a wide margin. With budget deficits of state governments also remaining large, worries about fiscal risks and their adverse implications for real interest rates have resurfaced. Relatively large structural fiscal imbalances have also limited the scope for fiscal expansion in Indonesia and the Philippines.

Temporary fiscal stimulus can have a significant impact on demand, particularly when combined with a looser monetary policy. However, tax and expenditure policies that imply changes to the medium-term course of fiscal policy can reduce policy effectiveness by raising both domestic interest rates and country risk premia. The activation of countercyclical fiscal policies in some Asian countries has been constrained by such concerns. Public debt/GDP ratios in several countries have increased to high levels (Table III.8). Allowing for the actual and potential fiscal costs of bank restructuring, debt levels in some Asian countries would, in fact, be much higher than those reported. With nominal interest rates (and thus debt service) declining last year, the actual degree of fiscal deterioration was contained. But in the event of tighter monetary policy, debt service costs would increase further.

Effectiveness of fiscal stimulus

In Latin America, several countries relying on external finance had to cut government spending to counter revenue shortfalls and higher debt servicing costs. In some countries, a tax structure highly reliant on commodity taxes accentuated the revenue shortfalls and the need to cut spending. In others, investor concerns about fiscal discipline prevented governments from allowing the automatic stabilisers to operate. For instance, Mexico responded to the sharply lower oil revenues and tax shortfalls by cutting spending to keep the fiscal deficit within 1% of GDP. Similarly, Brazil took steps to achieve more than the targeted primary surplus for the consolidated public sector (3.7% of GDP instead of 3.3% at the end of 2001) and to contain the overall deficit within 4% of GDP. Only Chile, with its low public debt ratio and the goal of maintaining a structural surplus, could ease fiscal policy last year.

Tighter fiscal policy in Latin America ...

... except in Chile

Fiscal policy was expansionary in Poland, where the central government fiscal deficit widened to 4½% of GDP in 2001, reflecting a slowdown in revenue and faster than expected growth in expenditure. To contain the imbalance, the 2002 budget has adopted a cyclically neutral stance. In Hungary, the budget deficit remained unchanged, but there was a marked increase in off-budget spending. Fiscal stimulus also played an important role in promoting demand in the Czech Republic. In Russia, the fiscal surplus increased to 3% of GDP, reflecting a mixture of expenditure restraint and tax reforms, including lower corporate tax rates and a new unified natural resource tax.

Significant fiscal easing in Europe

Crises in Turkey and Argentina

Both Turkey and Argentina have been heavy international borrowers in recent years: their combined external debt amounted to $264 billion at the end of 2001 compared with $193 billion in 1996. Crises in these two countries thus had the potential for a wider impact on emerging market financing. Yet both crises were perceived internationally as largely domestic events, and their spillover effects on the broader market have so far been muted (see Chapter V). Nevertheless, the Argentine crisis could still affect future investment by international banks in emerging markets given the losses that foreign-owned banks have suffered.

Crises in Turkey and Argentina were largely home-made

Turkey

Despite high growth, problems accumulated during the 1990s

The Turkish economy during the 1990s experienced relatively robust but volatile growth, accompanied by large public sector deficits, high inflation and periodic current account crises. Given its openness, a dynamic private sector and a high household saving rate, the economy usually recovered quickly from these crises. Over time, however, a growing proportion of capital inflows went via the banking system to the public sector, and the proportion of public sector debt held by domestic banks increased.

Banking crisis triggered the currency crisis

As fiscal and current account deficits widened sharply in 2000 and as short-term external debt jumped to 130% of reserves, interest rates became highly volatile. The market value of banks' holdings of government debt also began to fluctuate widely. As the banks' capital base was too weak to absorb such swings, expectations that the government might be forced to rescue the banks increased pressure on the exchange rate, which fluctuated within a narrow band under a crawling peg regime. When in February 2001 political conflict over efforts to fight corruption in the banking sector led to a loss of investor confidence, the authorities were forced to float the lira. It initially depreciated by 45% against the dollar, and the pass-through into consumer prices was very rapid.

The stabilisation programme did not restore confidence

The announcement of a wide-ranging package of measures in April 2001 failed to restore confidence, despite evidence that the budgetary and monetary performance was on track. Persistently high domestic interest rates (up to 40% in real terms) were not only a symbol of the lack of confidence, but also the biggest obstacle to the sustainability of budget policy. The deteriorating global economic environment was an aggravating factor. Nevertheless, some positive trends also began to emerge: exports recovered and the current account swung into surplus; large state-owned banks were recapitalised and put up for sale; and 13 medium-sized banks were sold or closed.

Debt sustainability problems emerged after 11 September ...

... but tight policies helped improve market sentiment

Following the events of 11 September, the lira came under renewed pressure and interest rates climbed again. As nearly 80% of Turkey's domestic debt stock is indexed to short-term interest rates or to the exchange rate, and public debt repayments were projected to rise in 2002, there were major concerns about debt sustainability. Difficulties in accessing international capital markets were compounded by weak prospects for privatisation and FDI. The authorities, however, maintained a very tight fiscal stance and pressed forward with public sector reforms. These policy actions improved the chances of additional external financing from the IMF and strengthened market sentiment. By mid-April 2002, the lira had appreciated by 30% from a mid-October low and the interest rate on the domestic benchmark bond had fallen by more than 20 percentage points. Inflation pressures were still high, but were at least easing. Lower domestic interest rates and currency appreciation, in turn, began to improve the debt dynamics. Turkey was thus able to return to international debt markets in the first quarter of 2002, placing around $1½ billion of sovereign debt at falling spreads, ranging from 550 to 700 basis points.

Despite these positive trends, industrial output and domestic demand remained sluggish in the first quarter of 2002 and the financial difficulties of the corporate sector persisted. Uncertainties about the pace of private bank recapitalisation, which is critical for the resumption of bank lending to the private sector, and rapid real exchange rate appreciation created additional risks for the recovery.

However, the recovery remains elusive

In summary, the origins of the Turkish crisis were clearly domestic. The policy responses and the way the crisis has evolved to date reinforce some lessons of the recent Asian crisis – in particular, the importance of prompt decisions on banking sector restructuring, the need to push forcefully adjustment in the real sector (which in Turkey included large state-owned enterprises), and the importance of commitments to honour public sector debt obligations. At the same time, Turkey's experience illustrates how difficult it is to restore confidence and restart growth against the backdrop of a fragile banking sector, entrenched fiscal deficits and a weak global environment.

Argentina

External shocks and rigid wages hit competitiveness ...

Argentina entered 2001 with an economy already mired in a prolonged recession. Weak commodity prices in the late 1990s and real exchange rate appreciation, resulting from Brazil's devaluation in 1999 as well as from the steady appreciation of the US dollar, reduced profitability in the tradable goods sector and slowed investment. Since the nominal exchange rate was fixed, the real rate could adjust only if unit labour costs fell, a development impeded by a rather rigid labour market.

... and efforts to restart growth in early 2001 failed

In April 2001, the authorities sought to stimulate growth while at the same time limiting the fiscal deficit. New corporate investment was expected to come from steps taken to increase the liquidity of the banking system, a reduction in tariffs on capital goods and higher tariffs on consumer goods. On the fiscal side, a tax on financial transactions was introduced to raise additional revenue. However, these measures failed to stop the economic slide. The lack of clarity about policy implementation and conflicts among key policymakers sapped market confidence, pushing bond spreads above 1,000 basis points. Investors questioned in particular the extent of fiscal adjustment, given that the provinces were not obliged to cut spending. Moreover, the loosening of commercial bank reserve requirements (which allowed the banks to deposit a smaller fraction of reserves abroad and to use government bonds to satisfy the requirements), while designed to increase liquidity, in fact undermined the credibility of the currency board and reduced banks' ability to attract fresh funds from abroad.

As liquidity problems raised the spectre of crisis ...

Faced with a difficult liquidity situation themselves, the authorities swapped some $30 billion of maturing external debt for longer-term bonds in June 2001. The swap was very costly (some new bonds carried rates of nearly 16%) and thus substantially increased the future debt burden. In response, the authorities announced in late July a "zero deficit" plan, requiring all levels of the government to restrict spending for the rest of the year to the amount of revenue actually collected. But, as economic activity and tax revenues continued to shrink, households began to withdraw their bank deposits in July and August. Foreign reserves fell sharply, and markets began to anticipate more disorderly scenarios for resolving the crisis.

... and new measures again failed ...

The retrenchment in private capital flows to the emerging markets following the events of 11 September prompted the government to seek further relief by restructuring some $41 billion of public sector debt held by local banks, pension funds and provincial governments. But with a difficult external debt restructuring still lying ahead, the economy contracting and fiscal revenue falling rapidly, bond spreads soared past 3,000 basis points in late November. A worsening of deposit flight led the government to restrict both withdrawals and transfers abroad. In late December, the government also suspended external debt payment. In early January 2002, the government abandoned the currency board regime and announced first a dual exchange rate, and then a floating rate system. However, no effort was made to establish a domestic policy anchor to constrain both inflation and exchange rate movements. In practice, severe controls on bank transfers meant that the currency became virtually non-convertible. In addition, all dollar-denominated deposits and liabilities in the banking system were converted into pesos, but at different, non-market exchange rates.

... a crisis erupted with unprecedented ferocity

These policy changes have imposed large costs on Argentine banks and their customers, and have pushed the banking system and the whole economy ever deeper into crisis. The spread on Argentine bonds has hovered around 4,000 basis points since late December. When the peso was allowed to float freely, it plunged more than 70% against the dollar. Recent projections suggest that inflation could reach more than 50% in 2002 after three years of deflation. Real GDP shrank by 4½% in 2001 and current projections envisage a drop in output of 10–15% in 2002. The current account deficit narrowed last year due to severe import compression, but the fiscal deficit rose despite spending cuts. The budget for 2002 maintains the cuts in public sector wages and pensions as announced last year, increases spending only on emergency help for the poor, and foresees a deficit of about 1% of GDP.

What went wrong?

Seen against the backdrop of good economic performance and resilience to shocks during 1991–97, and a solid, predominantly foreign-owned banking system, the gravity of the Argentine situation has come as a surprise to many. The reasons for this outcome are clearly worth exploring. Several fundamental weaknesses of the Argentine economy have been well known for some time.

A highly indebted closed economy ...

First, the Argentine economy is both very closed and highly indebted. Merchandise exports accounted for just 10% of GDP in 2001, while the total external debt amounted to 55% of GDP. Moreover, public sector debt held domestically, much of it denominated in US dollars, amounted to an additional 26% of GDP. The combination of high external debt and low export earnings meant that external debt service requirements amounted to 83% of current account receipts in 2001. Total external debt was equal to about 400% of exports of goods and services, an exceptionally high level that indicated the substantial risk of an external financing crisis. Moreover, the ratio of short-term external debt to foreign reserves was very high, around 115%

at the end of 2000. While these debt indicators were never particularly favourable for Argentina, they had all risen substantially since the mid-1990s. For instance, total external debt increased by 15% of GDP between 1996 and 2001; total debt service as a percentage of exports of goods and services almost doubled; and central government debt rose from 35% of GDP in 1996 to 53%.

… and currency mismatches …

Second, the private and public sectors both had large domestic liabilities denominated in US dollars, but few dollar-earning assets to match. These currency mismatches were masked by convertibility arrangements, under which the peso and the dollar seemed equivalent. In reality, however, the Argentine economy was extremely vulnerable to any interruption in external financing and in particular to a devaluation of the exchange rate.

… made Argentina extremely reliant on external financing

Once external financing was cut off (private financing in the third quarter of 2001 and official financing in the fourth quarter), expectations of a large devaluation led to a quick reassessment of the government's debt service and fiscal position. This in turn raised fears about a possible government debt default. Such concerns also led to a deterioration of the perceived quality of corporate balance sheets, and thus to the emergence of new contingent claims on the budget. The quality of bank assets also worsened: the deepening of the recession affected the standing of claims on the private sector, and banks were also exposed via holdings of government paper. While the central bank attempted to contain the run on the banks (by providing liquidity to the deposit-losing banks and raising reserve requirements for the deposit-taking, mostly foreign-owned, banks), its actions were clearly circumscribed by the currency board arrangement.

Changes to bank contracts worsened the crisis …

Following the outbreak of the crisis, the announcement of certain measures by the authorities and their modification within days increased uncertainty. One announcement was the conversion of dollar-denominated loans into pesos at an exchange rate of one peso per dollar, and of dollar-denominated deposits into pesos at an exchange rate of 1.4 pesos per dollar. This compared with the market exchange rate of about two pesos per dollar at the time, and over three pesos per dollar by May 2002. These asymmetrical changes created problems for which the banks and their customers were wholly unprepared. Most private banks were viable under the old convertibility regime; depending on the credit standing of their customers, some of them might even have remained viable after the government debt default and the devaluation. But the proposed changes would generally have resulted in losses exceeding the equity positions of shareholders in these banks.

… while the deposit freeze weighed on economic activity …

Another highly damaging measure has been the freeze on deposits. Although implemented as a temporary measure to stop bank runs in previous banking crises in Argentina and elsewhere, this deposit freeze has been so comprehensive and protracted – some bank deposits may not be paid out before January 2005 – that it has virtually suspended the domestic payment system. Given that a large fraction of the Argentine economy, especially in the service sector, is informal and operates in cash, the freeze has weighed heavily on economic activity. While the impact of the freeze is difficult to isolate from other aspects of the banking crisis, it has undoubtedly compounded a general decline in confidence in the banking system and in overall economic policies. The longer-run effects may be further deposit outflows to banks abroad, higher costs of credit and banking services, and a reduced scope of financial intermediation.

... and new laws further eroded confidence

Considerable damage was also done by amendments to the bankruptcy law, which severely restricted creditor rights, and uncertainties about the application of the "economic subversion" law, under which bankers and businessmen were subject to court action for bad or negligent business decisions. Although the controversial provisions of both laws were amended in May 2002, the uncertainties they created had already severely dented the confidence of investors and businessmen in the application of basic legal rights.

Impact of the Argentine crisis on activities of international banks

The experience in Argentina could make foreign banks ...

Over the past decade, foreign bank participation has come to be seen as key to developing the banking systems in emerging market economies. Foreign-owned banks became major players in many emerging markets, including Argentina, where they accounted for well over one half of banking system assets and liabilities. Partly in consequence, but supported as well by a strong supervisory regime, the Argentine banking system was considered among the strongest in Latin America. However, the Argentine government debt default, the sharp devaluation of the peso and uncertainties concerning the status and character of deposit and loan contracts as well as creditor rights quickly pushed Argentina's banking system to the verge of collapse. This raises a number of issues regarding future activities of foreign-owned banks in emerging markets.

... more cautious about legal and judicial systems ...

Evidence of the decoupling of other markets in Latin America from Argentina, as well as the absence of any sign of "deposit contagion" in other emerging markets, seem to support the view that markets so far have perceived Argentina as a special case. Nevertheless, international banks may over time become more cautious about establishing new operations in those emerging market economies where political, legal and judicial systems are perceived as being unreliable. More generally, international banks may tighten their standards for lending to emerging market governments and public sector institutions through local subsidiaries.

... more likely to diversify their activities ...

Another longer-term outcome of the Argentine crisis could be that banks which derive a high proportion of profits from operations in one particular emerging market (or region) will seek to diversify their investments. Because the host country authorities might be reluctant or fiscally unable to bail out a large foreign bank subsidiary, they might well pressure the parent to invest new funds to recapitalise the subsidiary. Foreign banks might wish to avoid having a dominant position in any particular country since a refusal to recapitalise the bank would be seen as extremely damaging to the country concerned.

... and more reluctant to lend in foreign currency

In addition, foreign banks could become less inclined to conduct dollar-based business in some emerging market economies. Since the mid-1990s, foreign banks have been setting up subsidiaries in many emerging markets. In part, this was an effort to limit their cross-border exposures and to avoid currency mismatches associated with foreign currency lending from their home bases. However, the Argentine experience indicates that, when bank customers hold foreign currency deposits but have few other dollar-earning assets (such as export receipts), devaluations may hit the banks equally hard. Foreign-owned banks may therefore adopt more prudent pricing policies for foreign currency loans, or focus entirely on local currency business.

Other capital inflows could also be affected

A broader concern for the emerging market economies is that inflows of foreign direct investment could be affected because of the large losses facing the foreign companies that had invested heavily in Argentina. In addition, given the heavy losses suffered by continental European retail investors, who held an estimated $20 billion of Argentine government bonds, emerging market economies may find it more difficult to place their debt issues with retail investors in the future.