IMF SURVEY

International Monetary Fund
VOLUME 28
NUMBER 2

January 25, 1999

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Assessment of Programs

IMF Releases Internal Review of Its Response To Crisis in Three Affected Asian Countries

The IMF has released its first internal review of its policy approach to the crisis that erupted in Asia's financial markets in 1997. Covering the period through October 1998, the review focuses primarily on events in Indonesia, Korea, and Thailand—the three countries most severely affected by the crisis. *IMF-Supported Programs in Indonesia, Korea, and Thailand: A Preliminary Assessment*, by the IMF's Policy Development and Review Department, looks at the causes of the crisis, the IMF's response in terms of policy advice and financial support for the three countries, and the reaction to the programs. The released report also includes the Chairman's December 1998 summing-up of the IMF Executive Board's discussion of the review. It was the subject of press conferences on January 19, conducted by Jack Boorman, Director of the Policy Development and Review Department (see page 20).

Jack Boorman at press conference on IMF-supported programs in Asia.

The review notes that the Asian crisis differs from previous crises in a number of key respects and may indicate fault lines in an increasingly integrated global economic and financial system. Unlike so many other cases in which IMF assistance is requested, the Asian crisis did not result mainly from the monetization of fiscal imbalances. It was rooted, instead, in financial sector fragilities, stemming in part from weaknesses in governance in the corporate, financial, and government sectors. These weaknesses, given the increasing rapidity with which international capital movements can change course, made these economies increasingly vulnerable to changes in market sentiment, a deteriorating external situation, and contagion.

The IMF's support to all three countries was organized under the Emergency Financing Mechanism. This mechanism, with a dramatically shortened period of negotiation, review, and IMF Executive Board approval, permitted the programs to be put in place very quickly in response *(Please turn to the following page)*

Camdessus Welcomes Constructive Discussions with Brazil

In a statement issued on January 18, IMF Managing Director Michel Camdessus responded to comments to the press by Pedro Malan, minister of finance of Brazil. Following is the text of News Brief No. 99/3.

I confirm, as far as the IMF is concerned, Minister Malan's statement. I am personally very satisfied with the conversations that IMF staff and management have had over the last weekend with Minister Malan and the Brazilian team. The discussions were comprehensive and constructive and provided useful clarification of the policy stance of the Brazilian authorities.

I welcome in particular the confirmation that monetary policy will be aimed at preserving low inflation, the paramount objective of the *real* plan. I also welcome the reaffirmation of fiscal consolidation as the foremost priority of the Brazilian government together with the structural and privatization measures that are part of the agreed program with the IMF.

The dialogue between the IMF and the Brazilian authorities will be pursued actively over the coming days, and an IMF mission will visit Brasilia promptly to proceed with the program review envisaged by end-February and establish a new macroeconomic and monetary framework.

Excerpts from the statement issued by Pedro Malan, finance minister of Brazil, on January 18, appear on page 18.

IMF Quota Increase Enters Into Effect

Press Release 99/4, issued January 22, is available on the IMF's website (www.imf.org) and will be included in the February 8 issue of the *IMF Survey*.

Statement by Brazilian Finance Minister

Following are excerpts of a statement issued on January 18 by Brazilian finance minister Pedro Malan.

The central bank issued this morning a communiqué announcing that the exchange rate will now be determined by market forces. Monetary policy will aim at preserving low inflation achieved under the *real* plan and, in the short term, will respond promptly to significant movements of the exchange rate. Central bank interventions in the foreign exchange markets will be occasional, limited, and designed to counter disorderly market conditions.

In the new exchange rate regime, fiscal and monetary policies will have to play an even more crucial role in ensuring price stability and conditions for sustained growth.

Fiscal consolidation is our first and foremost priority, to which the Brazilian government remains fully committed. No efforts will be spared to reduce the fiscal deficit at all levels of government and produce the fiscal results announced for 1999–2001 in the Fiscal Stability Program. Additional measures will be adopted, as appropriate, to deal with the fiscal impact of the exchange rate devaluation. The federal government is enforcing the agreements concluded with the Brazilian States and has already activated the guarantees contained in those agreements as appropriate. ■

IMF Releases Internal Review

(Continued from front page) to immediate and overwhelming market pressures. At the same time, it necessitated exceptionally quick analysis and negotiation, and decision making, at times, had to be based on unusually incomplete information.

Initial Attempts to Restore Confidence

The design of the policy responses in the context of IMF-supported programs was dictated by the distinctive features of the crisis, the report notes. The strategy chosen, given the nature and scale of the crisis, combined macroeconomic and structural policy measures, along with an unprecedented commitment of financial resources to break a self-reinforcing cycle of capital outflows, exchange rate depreciation, and financial sector weakness.

Another key element of the IMF-supported programs was the decision to permit exchange rates to continue to float—part of the initial response of the authorities in all three countries to the pressures that had emerged—rather than readjusting the pegs to rates deemed defensible and consistent with medium-term fundamentals. The decision to float exchange rates opened the door to continued market depreciation. A more orderly arrangement might well have been possible as well as desirable at an earlier stage, but in the heat of the crisis, no practical alternative was seen to floating, especially in Korea and Thailand, where the initial efforts of the authorities to defend their exchange rates resulted in the exhaustion of reserves and removed much of their room for maneuver.

The programs and their initial implementation did not restore confidence rapidly enough—particularly in Indonesia, but also in Korea and Thailand. In the climate of economic and political uncertainty, investors were not reassured, and a vicious circle of capital outflows, depreciation, and weakened corporate and financial sectors resulted. While the inflationary consequences of the depreciations in Korea and Thailand were reasonably well contained, inflation rose sharply in Indonesia. Growth plummeted in all three countries, and external current accounts underwent abrupt swings. According to the IMF report, the magnitude of the sharp economic downturns was largely forced on the affected economies by the substantial current account adjustment dictated by capital outflows for which it was impossible to compensate through even larger official financing.

Restoring confidence quickly was intrinsically difficult, given the state of the affected countries' reserves, the volatility of market sentiment, and the array of structural problems that had to be addressed. Several factors contributed to weak confidence, including political uncertainties, irresolution in implementing policies, the revelation of information that further shook market confidence, the coverage of government guarantees of bank deposits, and uncertainties surrounding the financing packages.

It is clear in hindsight, the IMF review says, that the programs were not adequately financed to be carried out in an environment where the crucial effort to restore confidence failed. Two obvious alternatives would be more official financing or greater private sector bail-in. More official financing would have been problematic, however, given limited resources and moral hazard considerations. Earlier concerted involvement of the private sector could have been pursued, but if done too aggressively, could have had adverse consequences for emerging markets more generally if the private sector concluded that the rules of the game had changed.

The main lesson, the study suggests, is that such avenues should be explored in preparation for the next crisis—that is, instruments and mechanisms need to be found to elicit the maintenance of private sector exposure to a country facing a potential loss of market access without inducing adverse contagion. Even more important is prevention: inhibiting the buildup of financial vulnerabilities that made the crisis likely and complicated its resolution.

Policy Responses

Monetary Policy. The basic objective of monetary policy in the Asian crisis programs was to avoid an inflation-depreciation spiral. Given concern that excessive monetary tightening could severely depress economic activity, however, the policy followed in the programs was intended as a middle course, leaning against the wind in the foreign exchange market, rather than as an all-out pursuit of an exchange rate target.

During 1997, the authorities in all three program countries were somewhat reluctant to tighten monetary policies, both before and after the decision was made to float exchange rates. This initial vacillation, the IMF review notes, made the task of stabilizing more difficult later on. By early 1988, significant tightening had occurred in Korea and Thailand, with the effect of stabilizing and then strengthening the exchange rate. The tightening was not extreme—in either intensity or duration—when compared with previous crises elsewhere and, according to the IMF study, is unlikely to have been a major factor behind the output decline. In Indonesia, monetary developments went seriously off track, as the authorities lost control of money and credit in an environment of political turbulence and financial system collapse. The situation stabilized only in the latter part of 1998.

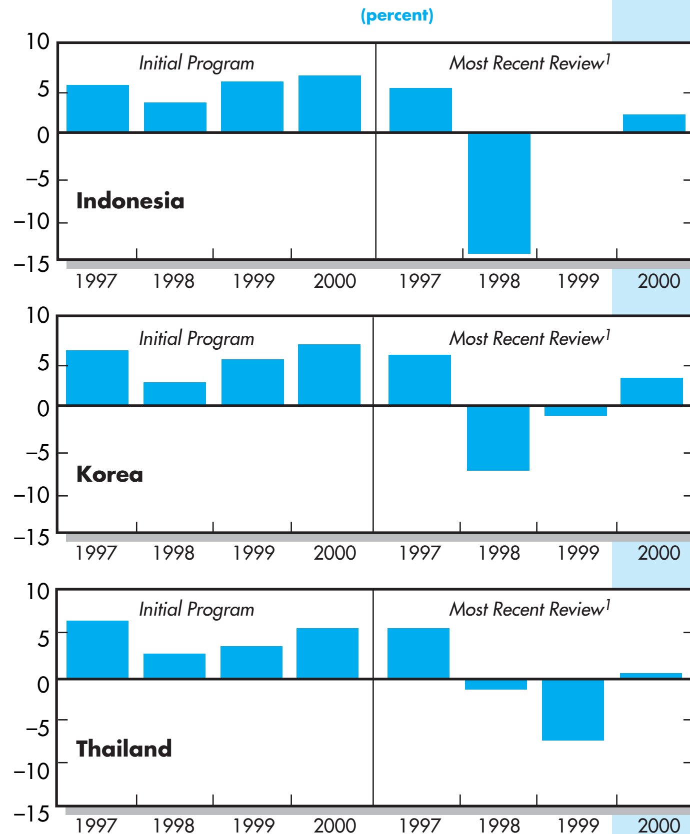
Fiscal Policy. The original programs in all three countries included some element of fiscal tightening to support the external adjustment and make room for part of the prospective costs of bank restructuring, thus bolstering confidence.

Fiscal plans were revised substantially during the course of the programs in response to changing economic conditions as it became clear that these countries were sliding into deep recessions. In the early program reviews, additional measures were introduced to offset part of the deterioration of the fiscal balance resulting from changing conditions. Later, the balance of priorities shifted toward supporting output and increasing the support available under social safety nets. From an early stage, fiscal deficits were allowed to expand to accommodate at least part of the automatic effect of declining activity and income and the exchange rate depreciations, providing support for economic activity from early 1998 on. In recent reviews, fiscal programs have been eased further to augment the automatic stabilizers. In some cases, however, it has proved difficult for the authorities to adjust government programs rapidly enough to provide the stimulus allowed under the programs.

Structural Reform. It was understood from the start that structural reforms needed to be a central pillar of the programs, in light of major weaknesses that underlay the crisis. The World Bank and the Asian Development Bank played essential roles in developing the structural components of the programs. In the financial and corporate sectors, there were two main strands to structural measures: dealing with the consequences of the crisis and establishing a prudential framework to help prevent a recurrence. Given the need for immediate action and the large number and variety of issues that had to be dealt with, the strategy for financial and corporate sector restructuring evolved with events and with deepening understanding of the nature and extent of the problems. Some key

Indonesia, Korea, and Thailand: Real GDP Growth

(percent)



[1]"Most Recent Review" refers to the latest available staff report showing full medium-term projections. (For Indonesia, August 1998; for Korea, November 1998; for Thailand, August 1998.)

Data: IMF staff reports

lessons that emerge, according to the IMF study, are a need to elaborate the IMF's policies in the areas of financial crisis management as well as financial and corporate restructuring; the need to treat corporate restructuring as an integral part of financial sector restructuring; and the need to give early priority to addressing deficiencies in the institutional and legal framework for financial and corporate sector restructuring.

In addition to financial and corporate restructuring, structural reforms in a range of other areas, including governance, competition policy, and trade, were intended to establish a basis for sustainable growth. Social sector policies were regarded as an integral part of the program: concerns about the impact of the crisis on the poorest and most vulnerable segments of society were expressed from the outset and became more pressing as the domestic recession deepened.

Criticisms that the programs were overloaded with structural measures at a time of great economic weakness

and that some might better have been delayed cannot, the study acknowledges, be entirely dismissed. And, indeed, as the programs evolved, the focus on the key financial and corporate issues sharpened. At the same time, the urgency of the crisis and complementarities among different reforms called for many steps to be taken simultaneously. Lasting recovery, the study asserts, hinged on comprehensive structural change. Nevertheless, such concerns may point to a need for further consideration of the appropriate pace and sequencing of reforms.

Preliminary Conclusions

Given that events are still unfolding and programs are still in the process of revision, any conclusions must necessarily be tentative, the report cautions.

Of the three crisis countries, Korea and Thailand have been rather successful in implementing the programs as agreed, whereas in Indonesia, partly because of the severity of the underlying political crisis, the program has repeatedly veered off course and required substantial modification. While this period has been very difficult for all three countries, developments have been much more favorable in the two that have been able to stick with their programs. In Korea and Thailand, the challenge is to persevere with their adjustment and get through the difficult phase where measures have begun to bite but their credibility has not yet been established, into the phase where they can start to reap the benefits. Indonesia faces a more difficult task, due to the need to repair repeated policy slippages and arrest a slide into an increasingly difficult social situation. Its recent progress in this direction, the study notes, has, however, been encouraging.

At this time, there remain risks to all the programs, with regard to both developments within the countries themselves and the external environment. The recession has continued to deepen in these countries, and the success of reforms in tackling structural weaknesses and reestablishing growth on a sustainable basis is still not assured. Global economic developments, including the weakness of the Japanese economy, turbulence in other regions, and the sharp decline in commodity prices also pose risks to the stabilization process and could delay economic recovery. The IMF study concludes, however, that financial market conditions are stabilizing and there are now signs that the recessions in these countries are bottoming out, with some resumption of growth expected in the course of 1999. ■

The text of *IMF-Supported Programs in Indonesia, Korea, and Thailand: A Preliminary Assessment*, by Timothy Lane, Atish R. Ghosh, Javier Hamann, Steven Phillips, Marianne Schulze-Ghattas, and Tsidi Tsikata, is available on the IMF's website (www.imf.org).

Press Conference

IMF Finds Design of Policy Recommendations "Broadly Appropriate" in Asian Crisis Review

On January 19, in a videoconference with Asian journalists in Singapore and at a press conference in Washington, Jack Boorman, Director of the IMF's Policy Development and Review Department, summarized the findings of the IMF's first evaluation of the IMF-supported programs in Indonesia, Korea, and Thailand. The following are edited excerpts of his opening remarks and some of the questions asked in the sessions. The full text of both press conferences is available on the IMF's website (www.imf.org).

BOORMAN: In essence, this study says that the IMF's policy recommendations, which Indonesia, Korea, and Thailand have followed to varying degrees, were broadly appropriate in the circumstances, given what was known at the time the programs were formulated and as they have been revised. The paper draws a few basic conclusions:

• Higher interest rates were needed at the outset of these programs to prevent the currencies from going into a worse downward spiral than in fact occurred.

• Tighter budgets appeared to be justified at the outset based on the IMF's—and others'—initial assessment of the prospective depth of the recession. But a loosening in those fiscal policies was seen to be needed as the crisis unfolded. There is surely a question, however, as to whether this loosening of policy should have been implemented somewhat sooner.

• The emphasis on structural policies—financial sector reform, corporate restructuring, and the other key elements—was appropriate.

This crisis differed from so many other cases involving the IMF in that it did not arise from profligate government spending and monetary financing of that spending. The crisis mainly reflected financial fragility in a world where volatile financial markets can move with devastating speed. If emerging problems—as was evident in Thailand, for example—are not dealt with in a timely manner, the room for maneuver shrinks dramatically. Once the period for timely action has passed, the challenge for the countries concerned—and indeed for the IMF and the international community—has to be to find policies that quickly halt the crisis and then promote lasting economic growth.

Stemming a crisis of confidence that is manifested in the collapse in the value of a currency, with the attendant risk of hyperinflation, leaves a government little choice but to take tough monetary policy actions. All

three countries increased interest rates somewhat to make holding the domestic currency more attractive, but in the view of the report, they did not act soon enough or boldly enough to head off a full-blown crisis. All the countries are now, however, seeing the benefit of tightened monetary policy, as the restoration of currency stability allows interest rates to decline. In Korea and Thailand, those interest rates have now declined to precrisis levels. The report concludes that if we were making these decisions again, we would, if anything, call for prompter and more aggressive action along similar lines.

On the fiscal side, a degree of budget tightening was envisaged at the outset of each program, in part to pay for some of the substantial and inevitable costs of reforming the financial sector. This tightening was planned at a time when the IMF, like most other observers, envisioned a comparatively mild slowdown in growth.

The tightening was put into reverse once it became apparent that the recessions these countries faced were going to be deeper than expected and that expansive budget policies would be needed to help cushion the economies as the recessions developed. The message here is twofold. First, there was good reason from the standpoint of halting the slide in confidence to guard against fiscal slippage initially; and second, the extent of the actual tightening of budgets should not be overstated. But the budget targets in the programs were predicated on a view of macroeconomic prospects that turned out, in hindsight, to be mistaken, and the easing of policy could have come more promptly as circumstances changed.

The paper also discusses why original projections were overoptimistic, and here the message is a bit tricky and nuanced. Yes, there were optimistic projections, but they were predicated on the programs' working as planned. This, in turn, depended on forceful implementation and a quick return of investor confidence. These projections did not materialize for several reasons, including a lack of clarity in certain policies, hesitancy on the part of governments in carrying out their own policies, and, importantly, the reaction of financial markets.

The paper gives a lot of attention to structural policies, making the point that a major focus was needed in this area to address the root causes of the problem—notably, the vulnerabilities in the financial and corporate sectors. Structural policies take time to yield results, and it is, in my view, premature to conclude that they have been overambitious or too diffuse. In reviewing the programs, we remain convinced that comprehensive financial and corporate structural reforms were needed at the very center of the programs in these three countries. In addition, social safety nets were strengthened, and indeed in some cases created, to alleviate the human cost of the crisis. The paper highlights the collaboration between the IMF, the World Bank, and the Asian Development Bank in this important area.

Last, let me say a few words on the other document, the summing-up by the Chairman of the Executive Board. This is an attempt to pull together the views expressed by the 24 Executive Directors who represent the IMF's 182 member countries. On the main themes, the Board agreed with the staff's view of the exceptional nature of this crisis and the comprehensive focus of programs, embracing both macroeconomic and structural policies, as well as unprecedentedly large external financing.

Jack Boorman (left) and Shailendra J. Anjaria, Director, IMF External Relations Department, respond to questions at the press conference.

The purpose of this exercise has been to draw on the experience that we and the countries have had to date, to look hard and honestly at the crisis, and to provide outside observers with our own analysis and views. Lessons are emerging, a number of which are being explored in discussions of international financial architecture. Certainly, things can be done to forestall crises, such as increasing the transparency of financial information and improving financial supervision and regulation in all countries. We are also examining ways of promoting greater private sector involvement in forestalling and resolving financial crises and looking at issues regarding the adequacy of official financing.

Question: *The IMF seems to have admitted that it contributed to the bank runs that occurred in Indonesia after the closure of 16 banks in November 1997. How central was this episode to the breakdown of Indonesia's program and the subsequent economic dislocation?*

Boorman: This is one of the most difficult questions of the entire exercise. Let me take it in two parts. First, on the impact of the bank closures on the markets, I'd

encourage you to chart the pattern of the Indonesian rupiah from the middle of 1998 and time the major episodes of weakening with the closure of the 16 banks, the rumors of President Suharto's illness, the announcement of Mr. Habibie as the candidate for vice president, and so forth. The connection between the rupiah's decline and the closure of the 16 banks is relatively modest in the context of the overall decline in the rupiah.

Second, on the closures themselves, this goes to the fundamental issue—why close those banks at that time? It was no secret that there were severe weaknesses in the Indonesian banking system. There was the feeling—on both sides—that a signal had to be given that the authorities were going to come to grips with this problem by closing weak banks. The question on our mind is not so much whether those banks should have been closed, but whether the issue of deposit guarantees was properly dealt with and whether a sufficient number of banks were, in fact, closed.

The handling of the deposit guarantees is an issue that all of us who were involved in the decision agonized about greatly. The initial decision in November 1997 to limit their coverage was influenced by awareness that guarantees or perceived guarantees prior to the crisis lay behind what was at best casual, if not irresponsible, behavior on the part of certain creditors and debtors. In addition to the fact that the guarantees were limited, there were also problems in the way the guarantee was promulgated and explained. It is my impression that the existence of the guarantee was not terribly well publicized. It was not clear the extent to which people had confidence in it; even people who would have been covered by the guarantee were withdrawing their deposits.

Question: *Incredibly high interest rates hurt the whole Korean economy and may be one reason why the recession was deeper than expected. Also, some argue that rescheduling was more important in stabilizing Korea's currency than higher interest rates.*

Boorman: Perhaps the most extensive chapter in the study is devoted to monetary policy, precisely because of the questions you raise. The extent to which, and the time over which, interest rates need to be raised to counter weakening of the currency is as much an art as it is a science. This is what central bankers get paid for—to have this feel of the markets and to understand and be able to work with them to use interest rates to instill confidence. The study examines the experience and use of interest rates by other countries. You'll notice that an overnight rate of 30 percent is by no means exceptionally high in the context of a currency crisis.

As to whether interest rates and monetary policy were used properly, you have to ask two other questions: how tight did monetary conditions become and what contribution did they make to the weakening of the economy? On the first question, the evidence is particularly interesting that monetary conditions did not tighten dramatically—or for very long—either in Korea, in particular, or in Thailand.

On the second question, the report shows you cannot attribute much of the recession to tight monetary conditions. It was a result of many other things, including, in particular, certain dynamically unstable factors like the unhedged foreign currency exposure of corporations, their short-term exposure, and so forth, that weakened the corporate position dramatically.

But there are difficult issues in knowing how to manage monetary policy and interest rate policy in the context of a crisis, one that also stems from a weak financial sector. Good research needs to be done, but the experience here shows that monetary policy did work.

On the rescheduling, the rollover of short-term exposures and the restructuring of those obligations were tremendously important in relieving pressure on the foreign exchange market. But the extent to which one factor or the other contributed to the stabilization of the currency is difficult to tell. In the episodes after the January restructuring when the won came under additional pressure and the authorities used interest rates, the pattern of response suggests the importance of interest rate policy.

Question: *What specific steps should have been taken to avoid the crisis? And how do you plan to improve your growth forecasts?*

Boorman: On the first, it's not simply a matter of specific steps; it is how business is conducted and policy is formulated to prevent crisis. A number of things were done in each of these countries that warranted correction years ago. These countries opened themselves to great vulnerability by accepting short-term capital flows in a way that ultimately proved destabilizing.

The way in which Korea and Thailand opened the capital markets was the issue. Korea permitted its banks to borrow and fund themselves externally with very short-term credits and then onlend those credits on a medium- and long-term basis to Korean corporations. A maturity mismatch resulted. At the same time, foreign investors couldn't get into Korea with long-term money. The bond markets weren't developed, and there were lots of restrictions on the purchase of equity in Korea. The structure made the country tremendously vulnerable to open markets because of the bias toward short-term exposure.

On how to improve growth forecasts, part of the problem relates to the question of assumptions. Do you assume policies are going to be implemented and confidence restored? If so, you're going to have one scenario, but this scenario is at risk if markets do not react as expected. One thing you can do is to build in contingencies more explicitly than is frequently done. For

the program with Mexico, we very explicitly built in different scenarios for oil price developments. The other element is to look in as detailed and careful a fashion as you can at what happens in the neighborhood if things go wrong. Our World Economic Outlook exercise does this to a certain extent, but there are further aspects. For example, an unwinding of the Thai baht can change the competitive position of Malaysia, Indonesia, and similarly situated countries; how can you build that into your growth forecast in a more explicit way than has been done to date?

Question: *Is there more the IMF can do to inform the markets?*

Boorman: The IMF is publishing many more documents, including letters of intent on individual country programs and Public Information Notices, which summarize Board discussions on country developments.

In a world of open markets, programs for emerging market economies with access to capital markets will only work if the capital markets and private investors become convinced that the situation is going to be corrected. How do you convince markets? Well, you can't simply hold up the flag and say the country has an IMF program; therefore, trust us. It requires lots of information so that the markets can assess the programs, policies, and the commitment of the authorities. Also, policymakers need to explain the actions they are taking, as well as why they are taking these actions and what they think the initial results are going to be. They have to admit that the initial results are not always pleasant, while keeping the public focused on the objectives.

Question: *What are the principal mistakes that the IMF made in Asia?*

Boorman: Let me give you a few examples of the kinds of lessons we are learning. I've already alluded to a couple of them. With the wisdom of hindsight, we would have been more insistent on earlier and more aggressive tightening of monetary policy and raising of interest rates. In each of these countries we saw a performance on monetary policy and on interest rates that left the markets confused, after the exchange rates were floated, as to the extent to which the countries were going to defend rates and about what the conduct of monetary policy was going to be.

Another lesson is not to be too optimistic about the initial reaction of markets and of the public to the programs. In many cases, we and the authorities seem to go through a two-try approach. In Mexico, the measures the authorities committed themselves to initially had to be strengthened before markets became convinced the authorities were really coming to grips with their problems. In Thailand, only when the new government came in and Finance Minister Tarrin went public, aggressively talking about the design of the program and the things that needed to be done, did people become convinced that the authorities were going to be able to deal with the situation. In Korea, only after the elections—when Kim Dae Jung, the President-elect, came out forcefully and said these are the right policies, we're going to implement them fully—combined with the restructuring of the commercial bank debt did the course of events turn around.

Other issues include the involvement of the private sector—perhaps the thorniest of the architecture issues. In preventing crises, how can you induce the private sector to behave in a manner that is less likely to create vulnerabilities of the kind that we've seen in these countries? That relates to supervision and regulation in the host country, as well as in creditor countries.

Another lesson is not to be too optimistic about the initial reaction of markets.

It also raises possibilities that are already being experimented with, such as the lines of credit that Argentina and Mexico have with private banks, from which they can draw in the event of difficulties. That's a way for the private sector to provide support to the country in a moment of crisis rather than to be seen as running for the exits and creating further pressure on the country.

There is also the question of how to involve the private sector once a crisis has begun. There are no simple mechanisms; no institution in the world has the authority to force continued private sector participation. We have had a lot of experience over the last couple of years in Korea, Ukraine, and Russia. But a lot of questions remain, including the critical issue of how you reschedule or restructure in a world of securitized debt, where a large portion of the debt is held in bonds. We and the international community are looking at those issues to try to bring about a better situation. ■

Selected IMF Rates

Week Beginning	SDR Interest Rate	Rate of Remuneration	Rate of Charge
January 11	3.54	3.45	3.79
January 18	3.48	3.48	3.72

The SDR interest rate and the rate of remuneration are equal to a weighted average of interest rates on specified short-term domestic obligations in the money markets of the five countries whose currencies constitute the SDR valuation basket (the U.S. dollar, weighted 39 percent; deutsche mark, 21 percent; Japanese yen, 18 percent; French franc, 11 percent; and U.K. pound, 11 percent). The rate of remuneration is the rate of return on members' remunerated reserve tranche positions. The rate of charge, a proportion (currently 107 percent) of the SDR interest rate, is the cost of using the IMF's financial resources. All three rates are computed each Friday for the following week. The basic rates of remuneration and charge are further adjusted to reflect burden-sharing arrangements. For the latest rates, call (202) 623-7171 or check the IMF website (www.imf.org/external/np/tre/sdr/sdr.htm).

Data: IMF Treasurer's Department

New York Meetings

Asian Crisis Impact, Global Economic Prospects Are Among Issues Discussed by AEA Panels

The impact of the Asian crisis on the global economy, the roots of financial crises, and the prospects for an economic downturn in the United States were among the topics addressed at the annual meeting of the American Economic Association (Allied Social Science Associations), held in New York January 3–5.

Mussa: Emerging markets should adopt better policies.

Asian Crisis

At a roundtable on the lessons from the financial crisis in east Asia, senior officials from the IMF and the World Bank, together with other observers, provided their views. Michael Mussa, Director of the IMF's Research Department, noted that the crisis was likely to drive world output 5 percent below its potential path by the end of 2000 and explained that there were four main issues:

• Emerging markets should adopt better macroeconomic policies, coupled with strengthened supervision and management of financial systems, to minimize vulnerability to financial crises. These should be combined with sound policies to minimize the risks created by large inflows of private capital.

• Better policy responses were needed to lessen the damage from crises, and countries should continue to resist excessive exchange market pressure.

• At the systemic level, it was not enough to leave matters to the working of the market, since the market had no quick, clean solution to the problems of countries facing the potential for systemic default. The financial assistance of the international community, including the IMF, was needed, although it could not successfully resolve all crises.

Stiglitz: There is a need to mitigate the consequences of crises.

• The conditions that are a requirement of IMF lending help countries adopt appropriate policies and avoid future crises. In this respect, the new IMF Supplementary Reserve Facility would play an important role.

Later, in answer to questions, Mussa said that at the national level there were a variety of mechanisms that could protect countries from the consequences of crises. At the international level, however, there were too few such mechanisms.

What went wrong in Asia? Joseph Stiglitz, Chief Economist at the World Bank, asked. Ex ante, he said, the markets did not foresee any problems. The positive elements outweighed the negative. While there had been some problems in Thailand, these were minor. In Asia as a whole the miracle had worked and growth had benefited the great majority of the people. Also, according to the economic models, many countries that did not have financial crises appeared more vulnerable than those that did. Even in retrospect it was not obvious where the roots of the crises lay. The real problem was in the scale of borrowing by the private sector.

Moreover, Stiglitz said, there is a need to mitigate the consequences of crises. Most developing countries do not have the social safety nets of the more advanced countries, particularly in the informal sectors, such as agriculture. More attention should be paid to countries' exposure to risk and the measures that need to be taken to protect them from the consequences of such risk. In the final analysis, he concluded, no country has perfect policies and the architecture of the international system should be robust enough to cope with vicissitudes.

Another perspective was provided by Rudiger Dornbusch of the Massachusetts Institute of Technology. He noted that whereas the "old-style" crisis had primarily affected the current account, the Asian crisis had to do with balance sheets, with changes in the exchange rate increasing debt burdens and the problems being compounded by bad banking systems. Owing to globalization, he said, when a crisis broke out in one country, it quickly spread to others and a small problem developed into a huge one. He argued that the solution was not for the IMF to provide more money, but early debt restructuring. In a country such as Brazil, he observed, IMF lending had checked the crisis and given time; it was now appropriate for the country to adopt a currency board. An offshore lender of last resort, he felt, was needed to take over the responsibilities of the IMF.

Edmund Phelps of Columbia University, New York, saw the solution to a "crisis of corporatism" in Asia as more capitalism. A long period of disequilibrium and overoptimistic expectations lay at the root of the collapse of some Asian economies. At the global level, he

Fischer Speech Addresses Subject of International Lender of Last Resort

IMF First Deputy Managing Director Stanley Fischer addressed a joint luncheon of the American Economic Association and the American Finance Association on January 3 on the need for a lender of last resort. A summary of his address was published in the last issue of the *IMF Survey*, dated January 11, pages 6–7. The full text is available on the IMF website: www.imf.org.

said, a new independent institution was needed to disseminate timely information to the markets, a role that an official body such as the IMF could not undertake since it might risk precipitating a new crisis.

International Financial System

In another panel, Stiglitz, Dornbusch, and other participants discussed issues of global financial markets and public policy.

In his comments, Stiglitz noted the considerable fragility in current arrangements and went on to outline some of the principles for the new international financial system. It was necessary, he said, to address the roots of current problems. One should recognize that it was hard to build sound financial institutions, even in industrial countries. Important objectives, in his view, should be to increase the stability of capital flows and to develop sound banking systems. He warned against the tendency to anthropomorphize the market and see it as a single entity. In fact, he said, there are several different markets, both within and outside a country.

There were two extreme views of the IMF, Dornbusch said. On the one hand was the view that the IMF should be transformed into a world central bank or an international lender of last resort, while, on the other, it was argued that the IMF had failed and should be abolished. Neither of these extreme positions was likely to happen, he said. Asking what went wrong in Asia, he maintained that both the content of programs and the level of assistance had been unsatisfactory. He had no problems with the normal IMF prescriptions of higher interest rates and fiscal stability in a crisis. He considered, though, that the IMF should have focused more aggressively on developing an effective debt strategy to tackle the crisis.

David M. Jones of Aubrey G. Lanston and Co., Inc. made the point that if countries were able to correct problems in their domestic economies, then everything would work out satisfactorily on the international front. He said that world markets had been close to a "meltdown" in mid-August 1998 after the Russian crisis. The effects of the global crisis had been limited by the quick actions of Alan Greenspan, the Chairman of the U.S. Federal Reserve Board, who had stepped in to stabilize markets in the wake of the near-collapse of the Long-Term Capital Management (LTCM) hedge fund. Transparency, he observed, is key for central banking success, and Greenspan and the Federal Reserve had been noticeably more transparent in their recent actions.

China and the Asian Crisis

In a panel on the issue of whether China might catch "the Asian flu," Jeffrey Sachs of the Harvard Institute for International Development commended China on maintaining a satisfactory growth rate at a time when the economies of other Asian countries were either stagnant or contracting. At the root of the Asian crisis, he said, lay several factors, including domestic mismanagement and "crony capitalism," compounded by a dramatic reversal of international capital flows. He did not agree with the moral hazard argument that money kept flowing into Asian countries in the expectation of a bailout. In fact, money flowed in because investors did not expect Asia to collapse; rather, they expected to make a lot of money. What really went wrong, Sachs considered, was the working of international financial markets, which created a self-fulfilling panic.

The question of the future stability of the Chinese currency, the renminbi, was considered by Gene Chang of the University of Toledo. He said that many of the conditions for a currency crisis that had affected other Asian countries did not yet exist in China. The renminbi was not convertible in the capital account, foreign financial capital could not flow freely across the border, and China could isolate its markets from outside shocks. But he saw a likelihood that the costs of continuing to peg the renminbi would increase as international and domestic conditions changed in the future. A fiscal expansion could lead to a deterioration of the Chinese current account balance, he said. Or, if the Hong Kong dollar were to depreciate, this could lead to concerns over the stability of the Hong Kong SAR economy that could lead in turn to a depreciation of the renminbi.

Dornbusch: The IMF should have developed an effective debt strategy.

The experience of Korea held a number of lessons for China, in the view of Elliot Parker of the University of Nevada. These were delaying financial liberalization could be costly, effective bankruptcy legislation was necessary for economic growth, the national regulatory authorities should backstop liberalization, and greater transparency was always desirable.

Tigers and Tequilas

The similarities and differences between the Asian crisis and the Mexican crisis of 1994 were addressed by Guillermo Calvo and Carmen Reinhart of the University of Maryland in a session moderated by IMF First Deputy Managing Director Stanley Fischer.

Calvo observed that there were a number of differences between the two crises. For example, a low level of savings was one cause of the problem in Mexico, but not in the Asian countries. The impact of the Russian crisis on the markets was remarkable, he said, in that Russia rarely traded with emerging markets and its economy constituted no more than 1 percent of world GDP, yet its default affected all emerging markets. He identified a tendency for clusters of market special-

Sachs: Investors did not expect a collapse in Asia.

ists to be formed, who in their turn unduly affected Wall Street investors.

Reinhart concluded from a study of 20 developed and emerging markets that contagion was more a regional than a global phenomenon. She also observed that the susceptibility to crises was "nonlinear." In other words, a single country falling victim to contagion was not a predictor of crisis in other countries, but when several countries fall victim the likelihood of crises elsewhere increases sharply. In the same way, often clusters of banks were formed with a common exposure. When a crisis broke out, these banks pulled out not only from those emerging markets that encountered problems but from other markets too.

Calvo: The market impact of the Russian crisis was remarkable.

In commenting on these two presentations, Maurice Obstfeld of the University of California at Berkeley agreed that there was a puzzling question why the aftermath of the Russian crisis was so severe.

John Williamson, Chief Economist in the World Bank's South Asia Regional Office, said that contagion had been spread in Asia through countries' exposure to the international market. It was clear, he said, that there was a need to regulate capital markets. Until this was done, countries should keep up their defenses.

Reinhart: Contagion is a regional phenomenon.

Current Expansion

In an analysis of U.S. domestic economic prospects, a panel addressed the question of how different the current economic expansion in the United States is from earlier expansionary episodes.

Mark Watson of Princeton University observed that the behavior of GDP in the current expansion appeared less volatile than during previous expansions. The current long-term bond rates indicated that output would continue to increase, as would the federal funds rate.

Williamson: Capital markets should be regulated.

The current figures for inflation and unemployment were astonishing in the view of James Stock of Harvard University. Earlier, the natural rate of unemployment (NAIRU) had been estimated at 6.7 percent. Unemployment had now fallen below the low end of the NAIRU confidence interval. Philip Klein of Pennsylvania State University noted that in 1995 industrial strikes in the United States reached a 15-year low, a sign of declining union power that had resulted in more flexible labor markets.

Alan Blinder of Princeton University, a former member of the Board of Governors of the U.S. Federal Reserve System, agreed that the current expansion was different from previous ones. It was unusual that GDP growth had expanded while inflation had not, he said, adding that "if in 1997 we had forecast the actual outcomes in 1999, we would all have been laughed at and then fired." He explained that the greater transparency of monetary policy at the Federal Reserve had helped to stabilize market volatility.

In answer to the question of how long the expansion would last, Victor Zarnowitz of the Foundation for Business and Economic Research said that normally a boom would be followed by a bust. But the bust is usually limited. For this reason, he did not forecast a severe recession even if the current expansion were to end. In any event, he concluded, one could have a strong expansion after a severe recession. ■

Ian S. McDonald
Editor-in-Chief, *IMF Survey*

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Available on the Web

Public Information Notices (PINs)

PINs are IMF Executive Board assessments of members' economic prospects and policies issued—with the consent of the member—following Article IV consultations, with background on the members' economies.

Letters of Intent and Memoranda of Economic and Financial Policies

Prepared by a member country, these documents describe the policies that the country intends to implement in the context of its request for financial support from the IMF.

Policy Framework Papers

Prepared by the member country in collaboration with the staffs of the IMF and the World Bank, these documents, which are updated annually, describe the authorities' economic objectives and macroeconomic and structural policies for three-year adjustment programs supported by Enhanced Structural Adjustment Facility resources.

Recent releases include:

Argentina:	Policy Memorandum, January 11
Armenia:	Letters of Intent, December 8 and December 18, 1998
	Policy Framework Paper: 1998–2001
Benin:	Letter of Intent and Memorandum of Economic and Financial Policies, December 21, 1998
Ghana:	PIN No. 2, January 12
Malawi:	Policy Framework Paper, 1998/99–2000/01
Niger:	Policy Framework Paper, 1998–2001
Tajikistan:	Policy Framework Paper, 1998–2001

Full texts are available on the IMF's website (www.imf.org).

Camdessus Address to Finance Ministers

Signs That Crisis Is Abating Are Based on Positive Actions of Asian Countries

Following is a summary of a paper prepared for presentation by IMF Managing Director Michel Camdessus and delivered by Hubert Neiss, Director of the IMF's Asia and Pacific Department, at the Asia-Europe Finance Ministers Meeting in Frankfurt, Germany, January 16.

In the past few months, the evidence has been mounting that the worst of Asia's crisis may be past. The cautious optimism at present stems from the actions that are being taken in Asia itself—in several well-known cases with IMF support—and from the measures taken by governments around the world to sustain economic activity and diminish the risk of global recession.

Background to the Crisis

The crises in east Asia were the result of interaction among flawed national financial systems, deficient corporate and public governance, and shortcomings in the global system. As global financial markets developed, especially in the early 1990s, capital was attracted to east Asia, in large part because of its exceptional reputation for growth and macroeconomic management. But the crises exposed serious structural weaknesses in these recipient countries that had been concealed by the magnitude of the flows, inadequate risk assessment by foreign creditors, and some weaknesses in supervisory practices in some creditor countries.

Another key factor was that the pace of de facto liberalization of short-term capital flows exceeded that of longer-term flows, which encouraged domestic banks and corporations to accumulate large amounts of short-term external borrowing. As a result, the countries became highly vulnerable to sudden shifts in investor sentiment, an important factor in the striking speed and virulence with which the crisis spread through the region and threatened to extend worldwide.

Basic Strategy of IMF-Supported Programs

Since the countries faced an immediate liquidity crisis coupled with profound structural problems, the programs had to be comprehensive, embracing both structural and macroeconomic policies.

- Structural reform, particularly in the financial and corporate sectors, assumed a central role.
- Macroeconomic policies were used initially to stabilize the economy and later to support economic recovery. Monetary policy aimed to prevent a spiral of depreciation and inflation; once a measure of stability had returned to exchange markets, interest rates were allowed to decline. Fiscal policy sought to complement monetary policy and to make room in the budget for the costs of bank restructuring.
- Large official financing packages were seen as an essential complement to the policy programs to help break the cycle of capital outflows, exchange rate depreciation, and financial sector weakness.

The social dimensions of the programs were recognized from the start, but as the recession deepened, it became evident that the social consequences would be much greater than expected. In response, stronger measures were taken—for instance, to raise income transfers and to broaden the coverage of social safety nets. For the longer term, the challenge is to establish cost-effective, sustainable social programs that do not create harmful labor market disincentives or discourage job creation. The programs have featured close collaboration with the World Bank and the Asian Development Bank.

Performance and Prospects

Across Asia, the concern is to ensure that a new momentum is established for growth. The precise macroeconomic policies that are appropriate differ somewhat from country to country, but in almost every case there is need for decisive structural reform.

The programs with Indonesia, Korea, and Thailand were reviewed by the IMF's Executive Board in December 1998. A review of the Philippines' program was also completed earlier in the fourth quarter. Each program was on track and each country made purchases on schedule. Korea, the first country to have used the new Supplemental Reserve Facility, was able to make its first major repurchase [repayment] within a year of the onset of the crisis—important evidence that the programs are working.

The Board was impressed by the progress in stabilizing key financial variables, but was concerned at the depth of recession that the countries were experiencing. The slowdown was much sharper than assumed in formulating the programs, in part owing to the unanticipated deterioration in the external environment. Its magnitude prompted substantial revisions in economic policies. Now, with these policies beginning to take effect, the prospects are favorable for a return of growth during the course of 1999. Though the timing of the upturn is difficult to forecast precisely, it appears that growth has already started, at least in Korea. If confirmed, this will make the length of the recession comparable to that of Mexico after its crisis three years earlier.

The "other side of the coin" associated with the downturn and capital outflows was the large adjustment in current account balances, far exceeding original program projections. These adjustments—largely due to a sharp

compression of imports—have permitted external reserves to rise sharply, underpinning the currency appreciation experienced by each of the crisis countries that has been so critical to restoring stability. Interest rates have declined, notably in Korea and Thailand, where they have returned to, or fallen below, precrisis levels.

Over the medium term, these economies clearly have the potential to resume a high growth path. Strong savings and improved productivity will play a key role in restoring sustainable growth. But deep structural problems remain, and the credibility of the programs requires that implementation of reforms should be accelerated further over the coming months.

The Asian countries in crisis have the potential to return to rapid growth paths.

Other Asian Countries

Recovery in the countries in crisis depends to a significant degree on the situation elsewhere in the region. Macroeconomic conditions across Asia differ appreciably, but most countries need to undertake significant reform to strengthen their economies for the long term.

Japan, as the world's second largest industrial economy, has a key role to play in both regional and global terms. A prerequisite to reigniting sustained economic growth is the resolution of the problems in the banking system. The October 1998 legislation represents a significant step in this direction, establishing a broad framework that now needs to be applied effectively and transparently. But macroeconomic policies also have a major role to play in stimulating domestic demand. Recent policy measures—the announcement of major fiscal stimulus supported by monetary measures to boost liquidity growth—are clearly moves in the right direction. The critical challenge is to ensure that the recent initiatives are implemented in a manner that quickly provides the necessary stimulus to the economy.

Developments in *China* and *Hong Kong SAR*—notably the successful maintenance of the exchange rate regimes and the subsequent lowering of interest rates—have helped to restore stability in Asian financial markets. Fiscal policy is also providing helpful support to demand in both cases. While China's growth is likely to slow this year and it faces many structural challenges, its economic performance continues to provide support for recovery elsewhere in the region.

India's situation is rather different from those in East Asia, since it has experienced only a mild slowdown, an upturn in inflation, and a deteriorating trade balance. In these circumstances, the priorities are to address weakness in the fiscal position and to rein in the rapid rate of monetary expansion.

In *Malaysia*, economic activity remains weak, and the outlook for sustained recovery is uncertain. Although policy is becoming more expansionary, we are concerned about the implications for medium-term growth prospects of the imposition of capital and exchange controls as well as the relaxation of some prudential standards and the introduction of directed lending.

Characteristics of a Revitalized Asia

The Asian countries in crisis have the potential to return to rapid growth paths, even if the rates of growth are slightly lower than in the precrisis years. Since it is quite possible that the volume of investment will be smaller than in the past, rising growth rates will depend on gains in efficiency, which in turn hinge on the determined implementation of structural reforms. There are two main avenues for policymakers' attention: to build on those features that were associated with east Asia's remarkable reputation in the past and to give new emphasis to policies for sustained high-quality growth.

By drawing on "traditional features," policymakers can create an Asia that

- is open and competitive and continues to eschew protectionist policies;
- consolidates its record of sound macroeconomic policies;
- still maintains high rates of domestic saving; and
- invests efficiently and promotes technical progress through vigorous structural reform.

By assigning priority to policies for higher-quality growth, the economic leadership can also contribute to an Asia

- with sound financial systems, based on standards and practices that are consistent with internally accepted principles;
- that promotes an independent, competitive private sector with strong corporate governance;
- with high standards of public sector governance and transparency that maintains an arm's-length relationship between the government and corporate sectors;
- that opens its capital markets through an orderly strategy accompanied by the strengthening of domestic financial systems; and
- that enhances social welfare and environmental protection.

Conclusion

Recent developments in Asia give further encouragement to the view that, eventually, the countries in crisis can return to high growth rates that can be reflected across the region. At present, it is possible to identify risks and constraints, particularly with regard to the external environment and the return of new capital inflows to the region, that make the precise pace and timing of the recovery a little uncertain. But our view—one that now seems to be shared by many outside the IMF—is that recovery will be under way by the end of 1999. ■

Following are excerpts of recent IMF press releases. Full texts are available on the IMF's website (http://www.imf.org) under "news" or on request from the IMF's Public Affairs Division (fax: (202) 623-6278).

Benin: ESAF

The IMF has approved the second annual loan for Benin under the Enhanced Structural Adjustment Facility (ESAF), in an amount equivalent to SDR 9.1 million (about $13 million) in support of the government's economic and financial program for 1998–99. The loan is available in three installments, the first of which will be available on January 15, 1999.

To consolidate the progress made over the past few years, the government intends to rigorously implement economic and structural reforms and make up for recent delays. The medium-term strategy for 1998–2001 aims at further reducing financial imbalances, keeping the economy on the path of sustained growth and job creation, and diversifying the productive base. The principal objectives are to achieve an average real GDP growth of 5.5 percent a year, keep inflation below 3 percent, and reduce the external current account deficit to levels that can be covered without recourse to exceptional financing.

In order to achieve this medium-term strategy, the authorities' economic and financial program for 1998–99 is designed to promote access to basic public services by improving public resource management and to increase government saving so as to reduce the share of investment financed by external resources.

Structural Reforms

To revitalize public administration and strengthen civil service management the government will implement civil service reform. To increase foreign and private domestic investment, the government is determined to broaden the divestiture program, including the restructuring and privatization of a number of public enterprises and the liberalization of the telecommunications utilities and cotton sectors. The government will provide an improved regulatory framework to promote sound and sustainable development of the private sector.

Addressing Social Needs

A priority of the government will be to cushion the impact of the adjustment policy on the most vulnerable groups of the population by improving access to essential services and continuing the implementation of its strategy for addressing social dimensions of development.

Benin joined the IMF on July 10, 1963. Its quota is SDR 45.3 million (about $64 million), and its outstanding use of IMF resources currently totals SDR 66 million (about $93 million).

Press Release No. 99/2, January 11

Benin: Main Economic Indicators

	1995	1996[1]	1997[1]	1998	1999	Program 2000	Program 2001
	(annual percent changes)						
GDP at constant prices	4.6	5.6	5.6	4.4	5.7	5.6	5.9
	(percent of GDP)						
Overall fiscal deficit (cash basis)[2]	–8.9	–6.0	–5.4	–5.7	–3.3	–3.2	–2.8
Debt service (after debt relief)[3]	29.9	20.7	18.4	18.9	18.1	18.5	16.2
Current account balance[4]	–6.4	–4.5	–5.2	–4.9	–4.4	–4.5	–4.5

[1]Estimates.
[2]Before all official grants.
[3]In percent of fiscal revenue.
[4]Including current official grants but excluding project grants.

Data: Beninese authorities and staff estimates and projections

Pakistan: ESAF, Extended Arrangement, CCFF

The Executive Board of the IMF approved on January 14, 1999 Pakistan's second annual program under the Enhanced Structural Adjustment Facility (ESAF), completed the second review under the Extended Arrangement, and approved a purchase under the Compensatory and Contingency Financing Facility (CCFF) in respect of a shortfall in export earnings during 1998.

Under these facilities, SDR 409.5 million (about $575 million) will be disbursed following the Executive Board meeting. Additional assistance of SDR 417.0 million under the ESAF and SDR 379.1 million under the Extended Arrangement will be made available during the remainder of the program period.

Program Objectives

To strengthen the balance of payments and lay the basis for sustainable high rates of growth, the government of Pakistan has adopted a program of macroeconomic policies and structural reforms that are supported by the IMF, the World Bank, and the Asian Development Bank. The macroeconomic objectives for 1998–2001 are

- recovery in real GDP annual growth from 3–4 percent to 5–6 percent over the medium term;
- reduction in annual inflation to about 6 percent in 2001/02;
- reduction of the external current account deficit from about 3 percent of GDP in 1998/99 to less than 1.5 percent of GDP in 2001/02;
- stabilization of the total public sector debt-to-GDP ratio; and
- improvement in social indicators.

Macroeconomic Policies and Structural Reforms

A key to achieving these objectives is fiscal consolidation. The budget deficit is targeted to decline from 5.5 percent of GDP in 1997/98 to 4.3 percent of GDP in 1998/99, and to 3.3 percent in 1999/2000. The monetary policy stance is being geared toward restoring confidence in domestic financial markets and ensuring a steady flow of credit to the private sector consistent with growth and balance of payments objectives.

Pakistan's structural reform agenda is largely focused on the budget and on restructuring and strengthening the financial position of public enterprises. The government is in the process of making substantial efforts to broaden the tax base, revamp tax administration, and implement the restructuring plans for the energy sector and other public enterprises. Simultaneously, the government intends to move forward with the privatization of financial institutions and trade liberalization and make further progress in developing market-based foreign exchange and payments systems.

External Financing

The financing of the agreed program will involve significant efforts by all of Pakistan's creditors. In this context, a meeting of the Paris Club is expected late in January to consider a request by Pakistan for a rescheduling of its medium- and long-term debt-service payments falling due to Paris Club official creditors during the program period. The Pakistani authorities intend to seek comparable treatment from all its other official, bilateral, commercial, and private creditors.

Press Release No. 99/3, January 15

Portuguese Banking Reforms

Integration into European Union Played Key Role in Reshaping of Banking Sector

A background study in the IMF's recently released staff country report on Portugal seeks to take the pulse of the country's banking sector upon its entry into the euro era. The author, Jörg Decressin, an Economist in the European I Department, speaks here about the dramatic transformation in Portuguese banking, the challenges that lie ahead, and the lessons that can be gleaned from its experience.

IMF SURVEY: *How would you characterize the health of Portugal's banking sector prior to the country's entry into the European Union in 1986?*

DECRESSIN: Portugal nationalized its banking system in March 1975, and the sector subsequently developed in an environment characterized by pervasive public intervention in the economy and large macroeconomic imbalances, including public sector borrowing that exceeded 20 percent of GDP in some years. To deal with the deficit, the government resorted to monetization, credit ceilings, and capital controls, which it hoped would enhance its ability to mobilize and channel resources.

The expansion in the monetary base helped distort banks' balance sheets: deposits grew much faster than credit to the private sector, and excess reserves were

Recent Publications

IMF Economic Reviews (free)

IMF Economic Reviews 1998: 3. Compilation of Public Information Notices (PINs) covering September–December 1998.

Staff Papers

Staff Papers, Vol. 45, No. 4 (December 1998) ($54.00 for four issues; $27.00, academic rate).

Working Papers ($7.00)

98/166: *Economic Determinants of Government Subsidies*, Benedict Clements and others. Provides an empirical analysis of the determinants of government subsidies using panel data for 40 countries during 1975–92.

98/167: *The Decline of Traditional Sectors in Israel: The Role of the Exchange Rate and the Minimum Wage*, Eric V. Clifton. Examines the role of exchange rate appreciation and the minimum wage in the relative decline of traditional sectors in Israel.

98/168: *Managing Capital Flows: Lessons from the Experience of Chile*, Bernard Laurens and Jaime Cardoso. Reviews Chile's experience in managing short-term capital flows and draws lessons for policymakers.

98/169: *Do IMF-Supported Programs Work? A Survey of the Cross-Country Empirical Evidence*, Nadeem Ul Haque and Mohsin S. Khan. Reviews cross-country studies and finds that IMF-supported programs have generally helped stabilize an economy.

98/170: *Monetary Policy in the Aftermath of Currency Crises: The Case of Asia*, Ilan Goldfajn and Taimur Baig. Evaluates monetary policy and its relationship with the exchange rate in five Asian crisis countries.

98/171: *Private Saving in Colombia*, Alejandro López-Mejía and Juan Ricardo Ortega. Studies the main determinants of the sharp decline in Colombia's private savings in the 1990s.

98/172: *International Capital Flows and National Creditworthiness: Do the Fundamental Things Apply as Time Goes By?* Paul Cashin and C. John McDermott. Examines whether Australia's pattern of international borrowing in its post-capital-controls period was optimal.

98/173: *Fixed-Income Markets in the United States, Europe, and Japan: Some Lessons for Emerging Markets*, Garry J. Schinasi and R. Todd Smith. Identifies factors contributing to the development and effectiveness of debt securities markets in the major advanced economies.

98/174: *The Wage Bargaining Structure in Norway and Sweden and Its Influence on Real Wage Developments*, by Alun Thomas. Investigates the determinants of wages in the tradables and services sectors in Norway and Sweden.

98/175: *Export Credit Agencies, Trade Finance, and South East Asia*, Malcolm Stephens. Examines what caused trade finance to decline in southeast Asian countries after 1997.

Policy Discussion Papers (formerly Papers on Policy Analysis and Assessment) ($7.00)

98/14: *Economic Transition and Social Protection—Issues and Agenda for Reform*, Sanjeev Gupta. Describes the factors constraining social protection policies in the Baltics, Russia, and other countries of the former Soviet Union.

IMF Staff Country Reports ($15.00)

98/115: Rwanda—Statistical Appendix
98/116: Republic of Uzbekistan—Recent Economic Developments
98/117: Venezuela—Recent Economic Developments
98/118: Sri Lanka—Recent Economic Developments
98/119: Thailand—Statistical Appendix
98/120: India—Recent Economic Developments
98/121: Fiji—Statistical Appendix

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channeled to the purchase of government paper, directly or indirectly through low-interest deposits at the central bank. Virtually all of Portugal's interest rates were fixed administratively, with subsidized rates accorded to certain projects. In real terms, interest rates were low or negative. On the eve of Portugal's entry into the European Union, many banks found themselves inadequately capitalized and recording losses.

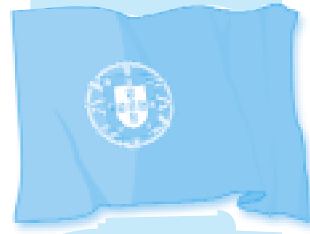
IMF Survey: *Portugal subsequently carried out extensive reforms of its banking system. What did this entail?*
Decressin: While early banking reforms had already been implemented under a stabilization program supported by an IMF financing arrangement in 1983–85, the reform process was invigorated subsequently, with the result that a system once tightly controlled by the state has, by now, been transformed into a fully liberalized and modern one.

The reform encompassed domestic deregulation, privatization, and the opening of Portugal's capital account. It was essential to first reduce the large macroeconomic imbalances that had prevailed during part of the 1980s. Once that was done, the reforms proceeded gradually and in stages. The liberalization of the legal and operational framework of the banking system as well as the reform of monetary policy instruments were initiated before state-owned banks were reprivatized and capital controls abolished. Legal and operational reforms allowed private banks to operate alongside public banks, granted the central bank more autonomy, and provided for a shift to universal banking (which allowed banks to participate in both commercial and investment activity). In addition, prudential regulations were strengthened considerably.

On the monetary side, the authorities deregulated interest rates, abolished credit ceilings, and introduced open market operations. They dismantled capital controls gradually, giving priority to transactions most directly linked to international trade and right of establishment and, finally, embarked on an ambitious privatization program.

IMF Survey: *Did Portugal's integration into the European Union and later preparations for the euro spur the reform process?*
Decressin: Portugal's integration into the European Union played a crucial role in reshaping the banking system. Key in this regard was the European Union's Second Banking Coordination Directive, which Portugal incorporated into domestic law in 1992. This directive provided for universal banking, gave credit institutions a single license to do business in EU countries, and defined the conditions under which a new bank could be opened or an existing bank could be closed by the central bank. In concert with other EU members, prudential regulations were strengthened through directives on the Bank for International Settlements solvency ratio, loan-loss provisioning, capital requirements for market risk, and large exposures.

These reforms also paved the way for integrating the banking sector within the European Union—a process that will be catalyzed by the euro. Within the Portuguese banking sector, rising competition and, as prospects for early EMU participation brightened, declining interest rates have caused intermediation margins to narrow. This, in turn, has triggered an ongoing consolidation in the banking system and prompted banks to forge extensive links with other markets, notably insurance, to preempt competitive pressures from nonbank financial institutions in the mobilization of resources and develop new sources of income.



IMF Survey: *How well positioned is Portugal to deal with increased competition in the euro area?*
Decressin: Portugal's largest banking groups, which accounted for 80 percent of banking system assets in 1997, are reasonably well positioned to withstand the intensified competition. Their recent performance generally compares well in terms of profitability with other major European banking groups, although a smaller fraction of their income stems from commissions and related business. The major European banks tend to be larger, with higher productivity. But lower personnel costs (and also a flexible wage system that ties salaries to bank performance) have to some extent compensated for the productivity differential.

A number of the smaller banks, however, may find themselves under considerable competitive pressure, which suggests the process of consolidation is not yet finished.

IMF Survey: *What challenges lie ahead?*
Decressin: The euro will catalyze the integration of financial markets and give further impetus to the ongoing restructuring in Europe's financial services industry. Intermediation activity is likely to rise, but competition will also intensify. This will pose essentially three challenges for the Portuguese banking system.

First, Portugal's banks will need to generate more revenue from fees and commissions while reducing overstaffing and rationalizing the branch network. Banks have already taken significant strides in this regard. They will also have to tackle the challenges raised by the Year 2000 problem.

Second, as the large banking groups expand into new areas of business to maintain profitability, supervision will have to adapt. The Portuguese authorities are working on a more structured and formal approach to information sharing and cooperation between the Bank of Portugal, the insurance supervisory authority, and the stock exchange supervisory commission.

Third, over the past few years, restructuring efforts have benefited from above-potential economic growth and a household credit boom. Such favorable conditions cannot prevail indefinitely. Our simple econometric model analyzed the banking system's sensitivity to the economic cycle

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and provides a rough idea about the potential decline in profitability as the current economic boom unwinds.

IMF Survey: *Is the domestic credit boom a source of concern?*

Decressin: Ultimately, only the next downturn will bear out the soundness of such lending, but Portugal's household indebtedness remains below that in other EU countries (for example, Germany, the Netherlands, and the United Kingdom) and the sharp decline in interest rates of recent years has alleviated its financial burden. Also, household credit, unlike credit to nonfinancial enterprises, is almost fully collateralized, and the mortgage credit has not fueled a real estate boom. Moreover, the growth in credit to nonfinancial enterprises, which typically is more sensitive to economic conditions, has remained moderate until recently. But the sharp acceleration in credit growth since 1997 cannot continue unabated without raising concerns about the thoroughness of banks' credit approval process. Given that under EMU the Bank of Portugal can no longer raise interest rates to dampen credit growth, the burden will fall fully on the supervision of lending practices.

IMF Survey: *What lessons might other countries usefully draw from Portugal's experience?*

Decressin: In contrast to a number of other countries, Portugal's financial liberalization has triggered comparatively modest and more balanced credit growth and no sustained increase in net external lending. Typically, credit booms after financial liberalizations are attributed to the increase in opportunities to take on more risk in the presence of mechanisms, such as limited liability, that distort bank managers' lending decisions.

Portugal's experience seems to confirm the common wisdom that to avoid excess, financial liberalization has to proceed gradually, be appropriately sequenced, and be supported by both a prudent macroeconomic stance and a strengthening of supervision. Portugal benefited from three things:

• *Prudent macroeconomic policy.* A tight monetary policy, which was called for when the escudo joined the exchange rate mechanism (ERM), and convergence toward the Maastricht criteria became the centerpiece of Portugal's economic policy. This policy circumscribed the scope for a domestic lending boom, particularly after credit ceilings were abolished.

• *Orderly sequence of reforms.* Fiscal consolidation preceded deregulation, since the whole banking system had been geared to providing low-cost financing to the public sector. Financial liberalization then proceeded gradually. Private banks were permitted to operate alongside public banks well before the financial system was deregulated, allowing expertise to grow in an environment where the scope for risk taking remained limited—some of these

Decressin: Portugal's financial liberalization has triggered comparatively modest and more balanced credit growth and no sustained increase in net external lending.

private banks that started operating in the 1980s grew to become the buyers of key state-owned banks a decade later. A preparatory framework for moving to indirect methods of monetary control was established before the abolition of credit ceilings. In addition, interest rates were deregulated before credit ceilings were lifted, allowing banks to charge risk-adjusted rates of return and rebuild profitability. In the final stage, the capital account was opened, the forces of competition were unleashed by privatization, and the scope for activity was widened by allowing universal banking.

When foreign borrowing was about to take off in the early 1990s, it was reined in by temporary controls on capital inflows—namely, through the introduction of a compulsory non-interest-bearing deposit with the central bank on financial loans from abroad and restrictions on forward transactions, as well as on the purchase of domestic securities by nonresidents. And when the scope of risk taking was widened significantly around 1992 with the opening of the capital account and the introduction of universal banking, the ERM turmoil provided Portuguese agents with a vivid example of the risks of international activity. This experience is thought to have contained risk taking thereafter.

• *Strengthened supervision.* Perhaps most important, deregulation was accompanied by a strengthened supervision by the Bank of Portugal. Several laws conferred on the Bank of Portugal both greater autonomy and increased powers of supervision and control. Prudential regulations were reinforced considerably in the context of the adoption of the EU's Second Banking Directive. In addition, Bank of Portugal staff characterize their approach to supervision as having become increasingly "risk-based" rather than "rules-based." ■

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