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In this issue

Executive Board selection process

Fischer, Koch-Weser, Sakakibara are nominated for position of next IMF Managing Director

The IMF Executive Board has received three nominations for the post of the next Managing Director to succeed Michel Camdessus, who resigned effective mid-February (see page 67).

On February 22, the Board received the nominations of Stanley Fischer, the current Acting Managing Director of the IMF, and Eisuke Sakakibara, former Vice Minister of Finance of Japan. On February 29, it received the nomination of Caio Koch-Weser, State Secretary for International Finance of Germany. Fischer was nominated by José Pedro de Morais, Jr., Executive Director for a number of African member countries; Sakakibara was nominated by Yukio Yoshimura, Executive Director for Japan; and. Koch-Weser was nominated, on behalf of the member states of the European Union, by Joao Santos, an Advisor in the Board constituency that includes Portugal, which currently holds the presidency of the European Union. A supporting statement was made by Bernd Esdar, Executive Director for Germany. The IMF's Executive Directors are in consultation with their respective authorities on the nominations received. Also, statements by the nominating Directors have been posted on the IMF's website (www.imf.org).

Stanley Fischer has served as First Deputy Managing Director of the IMF since September 1994. Born in Zambia, he was educated at the London School of Economics and the Massachusetts Institute of Technology (MIT). He was then successively an assistant professor of economics at the University of Chicago and a professor of economics at MIT. He has also held visiting professorships at the Hebrew University, Jerusalem, and the Hoover Institution, Stanford University. He is the author *(Please turn to the following page)*

Interview with Claudio Loser

Caribbean countries face both challenges and opportunities as they pursue integration

The Caribbean was the focus of a recent high-level seminar, held in Barbados on February 8, in which the IMF and several other international organizations participated, along with national and regional officials. The IMF's Western Hemisphere Department has also stepped up its activities in that region, as part of a "Caribbean initiative." The editors of the IMF Survey *met with Claudio Loser, Director of the Western Hemisphere Department, to discuss important issues in these countries from both a national and an international perspective.*

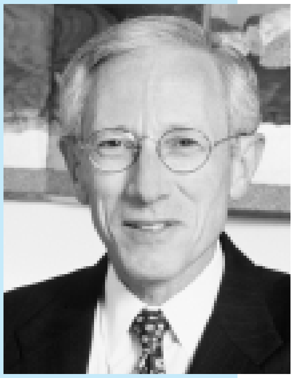
What was the focus of the high-level Barbados seminar and its chief message?

LOSER: This seminar was organized and cosponsored by the IMF and the Caribbean Development Bank. Participants included prime ministers, regional finance ministers, and central bank governors, as well as representatives from the regional and multilateral organizations, the University of the West Indies, and the private sector. Many IMF representatives also attended, including IMF Deputy Managing Director Shigemitsu *(Continued on page 68)*

Loser: "In view of its size, the Caribbean cannot be self-sufficient; its economies have to be very closely associated with the rest of the world."

(Continued from front page) of numerous books and articles in the field of economics.

Eisuke Sakakibara is currently a professor at Keio University and a special advisor to the Japanese Ministry of Finance. He holds degrees from the universities of Tokyo and Michigan and served in a number of positions in the Ministry of Finance before being appointed Vice Minister of Finance for International Affairs in 1997. He was also an economist at the IMF from 1971 to 1975 and a visiting associate professor of economics at Harvard University during 1980–81. Sakakibara is the author of a number of publications on the Japanese economy and other economic topics.



Stanley Fischer

Picture not available

Eisuke Sakakibara

Caio Koch-Weser

Caio Koch-Weser has been State Secretary for International Finance at the German Finance Ministry since May 1999. Prior to that, he served for 25 years with the World Bank in a number of positions, including those of personal assistant to then Bank President Robert S. McNamara, Deputy Treasurer, Director for West Africa, Division Chief for China, and Vice President for the Middle East and North Africa, before being appointed Managing Director for Operations in 1996.

Under the terms of Article XII of the IMF's Articles of Agreement, the Executive Board has the responsibility of selecting the Managing Director, who should be neither a governor of the IMF nor an Executive Director. Once selected, the Managing Director serves as both chairman of the Board—where he exercises no vote except a deciding vote in the case of an equal division—and chief of the operating staff of the IMF.

The Board's aim is to reach agreement on the selection of the next Managing Director by consensus through discussion and through a process in which flexibility takes precedence over formalism. To this end, the Board held an informal straw poll by secret ballot on March 2. In the poll, Caio Koch-Weser received the largest share of voting power; Stanley Fischer received the second largest; and Eisuke Sakakibara, the third largest. Executive Directors will continue to consult with each other and their national authorities on the next steps. Although the poll can be only indicative, it enables the Board, and in particular its Dean—Abbas Mirakhor, Executive Director for the Board constituency that includes the Islamic Republic of Iran—to gauge the support for different candidates and judge the emergence of a consensus. ■

Sir Joseph Gold is memorialized as authority on international law

Sir Joseph Gold, a leading authority on international monetary law, who for many years was General Counsel of the IMF, died at his home in Maryland on February 22 at the age of 87.

Acting Managing Director Stanley Fischer paid tribute to Sir Joseph in a statement to the IMF Executive Board, as "this extraordinary man who was so important in the life of the Fund for so long....Sir Joseph occupies a distinguished place in Fund history. His many contributions will remain as a lasting memory."

A U.K. national, Sir Joseph was one of the central pillars of the IMF staff from its earliest days, serving in different capacities for 53 years and making a lasting contribution to developing the law of the IMF and to the better understanding of the IMF through his writings. He joined the staff as a Counselor in October 1946, just three months after the IMF's doors were opened, and served in a number of senior positions before being appointed General Counsel in 1960.

Following his retirement in 1979, Sir Joseph worked for the IMF until last year as a Senior Consultant, a position from which he continued to write extensively on the legal framework of the IMF and the international monetary system. He was knighted by Queen Elizabeth II in 1980.

While on the staff, Sir Joseph was the principal draftsman of the First Amendment of the IMF's Articles of Agreement, which created the SDR, and of the Second Amendment, which revised the Articles after the termination of the par value system. He represented the IMF in various international forums, including a number concerned with the reform of the international monetary system.

Sir Joseph was a prolific writer on a wide range of legal issues pertaining to the IMF and the international monetary system. He was a legal lecturer at many universities, including the University of Michigan and Columbia School of Law. Sir Joseph was a founding member of the editorial committee of the *The Modern Law Review*, a member of the Advisory Board of the *George Washington University Journal of International Law and Economics*, and a member of the Advisory Board of Law and Policy in International Business at Georgetown University.

IMF Executive Board receives nominations for Managing Director, conducts straw pole

In two press releases, the IMF Executive Board announced that it had received, on February 22 and February 29, formal nominations for the post of the next Managing Director of the IMF. In addition, in a press release issued on March 2, the Executive Board announced that it had held an informal straw pole. The full text of Press Release Nos. 00/10, 00/12, and 00/15 is available on the IMF's website (www.imf.org).

Stanley Fischer, IMF First Deputy Managing Director, and currently Acting Managing Director, was nominated for the post by José Pedro de Morais, Jr., the Executive Director representing Angola, Botswana, Burundi, Eritrea, Ethiopia, The Gambia, Kenya, Lesotho, Liberia, Malawi, Mozambique, Namibia, Nigeria, Sierra Leone, South Africa, Swaziland, Tanzania, Uganda, Zambia, and Zimbabwe.

Eisuke Sakakibara, former Vice Minister of Finance in the Ministry of Finance of Japan, was nominated by Mr. Yukio Yoshimura, Executive Director for Japan.

Caio Koch-Weser, Germany's State Secretary for International Finance, was nominated on behalf of the European Union member states by Joao Santos, an Advisor in the Executive Board constituency that includes Portugal, which currently holds the presidency of the European Union. Bernd Esdar, Executive Director for Germany, made a statement in support of the nomination of Koch-Weser.

Statements by the Executive Directors are posted on the IMF's website. ■

Pacific island countries receive help in strengthening financial sectors

The authorities of eight Pacific island countries—Federated States of Micronesia, Fiji , Republic of the Marshall Islands, Papua New Guinea, Samoa, Solomon Islands, Tonga, and Vanuatu—have agreed to the final text of a declaration on cooperation, intended to foster confidence in their financial sectors and in that of the region as a whole. The declaration was jointly drafted by staff from the Pacific Financial Technical Assistance Centre (PFTAC) and the Reserve Bank of Fiji, together with supervisory agencies that participate in the Pacific Islands Prudential Regulation and Supervision Initiative (PIPRSI), according to a press release issued by the PFTAC on March 1.

A joint project of the United Nations Development Program and the IMF, the PFTAC is playing a key role in advancing regional cooperation and coordination in financial sector regulation and supervision in the Pacific (see *IMF Survey*, January 10, page 15). The PIPRSI was formed because the Pacific island countries, despite improvements in their regulatory systems and supervision over the last decade, remain vulnerable to financial sector volatility and illegal financial operations. They therefore decided to reinforce their commitment to financial sector soundness and stability. Specifically, the countries will take steps to bring their domestic regulatory environment and supervision in line with international best practice. They will also commit to establishing more formal and extensive arrangements for closer cooperation and coordination among the members of the initiative.

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FINANCE & DEVELOPMENT

PUBLISHED BY THE INTERNATIONAL MONETARY FUND

The March issue of *Finance & Development*, which will be available shortly, focuses on the remarkably successful reform and recovery in Latin America and the Caribbean in the wake of the economic crises of the past few years. The articles, including several by finance ministers or central bank governors from the region, discuss the progress made in these countries and the global implications of their experiences.

An article by IMF Historian James Boughton offers a preliminary assessment of Michel Camdessus's 13 years as Managing Director of the IMF, highlighting his personal qualities and his contributions in the international sphere. Among the articles in this issue are

Latin America and the Caribbean: The Long Road to Financial Stability
Claudio M. Loser and Martine Guerguil

Argentina's Structural Reforms of the 1990s
Pedro Pou

Monetary Policy During the Transition to a Floating Exchange Rate: Brazil's Recent Experience
Arminio Fraga

Chile in the 1990s: Embracing Development Opportunities
Eduardo Aninat

Mexico: Recent Developments, Structural Reforms, and Future Challenges
José Angel Gurría

The Dollarization Debate
Andrew Berg and Eduardo Borensztein

Is the U.S. Current Account Deficit Sustainable?
Catherine L. Mann

Finance & Development is published four times a year by the International Monetary Fund, in English, Arabic, Chinese, French, and Spanish. Subscriptions are free of charge. To receive *Finance & Development*, please write to IMF Publication Services, Box FD 99, Washington, DC 20431, U.S.A.

Loser discusses achievements of Caribbean countries

(Continued from front page) Sugisaki, who delivered a luncheon address [see below].

The seminar dealt with key issues in the region, in the context of the Caribbean initiative, and was intended to bring into focus the IMF's interest in all the areas of activity affecting the Caribbean.

You mentioned the Caribbean initiative. What exactly is this and what is the IMF's role in it?

LOSER: The Caribbean initiative was put in place in response to a number of concerns voiced by the authorities of our Caribbean constituency. There was a perception on their part that the IMF was not paying sufficient attention to the region, which is made up of small, vulnerable states, and they felt they had been left behind in the process of globalization. Our response has been, particularly since last year, to push for a closer relationship with them. We began in the Western Hemisphere Department by restructuring our work on the Caribbean. We established two divisions that regroup most of the countries in the region. This restructuring gives us a better regional focus and helps us develop regional studies and to provide more specialized services to the region.

The initiative also involves closer cooperation and an enhanced policy dialogue with the authorities. In particular, we can offer the countries a better understanding of the key issues involved in the new international financial architecture that the IMF is helping to establish. One very important element of our relationship with the Caribbean economies is technical assistance, and we are seeking ways to increase its volume and effectiveness. As part of this effort, we are working on the development of a Caribbean Technical Assistance Center, in conjunction with the United Nations Development Program. We are hoping to bring in the World Bank, the Inter-American Development Bank, and other agencies on this project. A similar model has already demonstrated its potential in the Pacific [see *IMF Survey*, January 10, page 15].

Sugisaki outlines new initiatives in IMF-Caribbean cooperation

Following are edited extracts from an address given by IMF Deputy Managing Director Shigemitsu Sugisaki at the High-Level Seminar on the Caribbean in Barbados, February 8. The full text is available on the IMF's website (www.imf.org).

Caribbean nations have achieved some important economic successes over the last two decades, in often unpromising circumstances. For the most part, the region has enjoyed economic and political stability, its social indicators are good, and on average incomes are high relative to other developing countries in the Western Hemisphere. But growth has been relatively modest. And crucially, it has not been strong enough to bring about significant reductions in what remain distressingly high rates of unemployment and poverty.

This mixed picture makes it more important now than ever for the Caribbean to tackle head on the policy challenges that confront it. Sound policies are especially important in the Caribbean, because economies here are more vulnerable to external shocks than most. Many countries have made progress in diversifying their economies over recent years. But in many cases the structure of exports remains concentrated on just a few products. Many countries also rely on preferential access to markets for these exports. This is likely to be eroded and eventually lost as trade liberalization continues. The Caribbean is also seeing inflows of external assistance decline steadily.

In the face of these vulnerabilities, what are the key challenges policymakers face on the threshold of the new millennium? Let me briefly mention three: bolstering domestic financial systems, strengthening fiscal policies, and boosting competitiveness.

Many countries in the Caribbean are already addressing these challenges with courage and conviction. Reform efforts will succeed only when governments and electorates alike are committed to them and recognize their long-term benefits. Our role at the IMF is to provide support and assistance where we can and where we are wanted.

Our deliberations here this week will help the IMF in its efforts to develop a research agenda that is more relevant to the needs and circumstances of Caribbean nations. We already have work under way on several relevant topics like bank supervision and regulation, fiscal reforms, labor market and competitiveness, interest rate and exchange rate policy, and external debt management and vulnerability.

Another initiative is the creation of the Caribbean Regional Technical Assistance Center. This will bring together several regional and international institutions to improve the range and quality of technical assistance available to Caribbean nations. It will concentrate on budget management; tax reform; tax and customs administration; bank supervision; and monetary, fiscal, balance of payments, and national accounts statistics. This collective approach will allow the pooling of resources, permit greater collaboration between institutions, and provide for more effective follow-up between the users and providers of assistance.

I hope that these efforts make clear the IMF's determination to improve the service that we offer to our members in the region. Ultimately, the destiny of any nation lies in its own hands. But, together with our colleagues in other international institutions, we hope and believe that we can play our part in helping the Caribbean fulfill its economic potential.

What are the major policy challenges that the Caribbean region faces today and what are the prospects for meeting these challenges in the medium and long term?

LOSER: Let me start on a positive note: if we compare the recent performance of the Caribbean countries with that of Latin America, we see that they have shown much stronger growth—close to 5 percent during the period 1996–99—lower inflation, overall lower public sector deficits, and higher levels of investment. This is in spite of the fact that the region is mostly made up of small countries that are more vulnerable to external shocks and that have in fact suffered from a number of them in recent years. The Caribbean economies also display lower poverty levels and have a much more equitable distribution of income than the Latin American economies. However, they do tend to have a lower level of savings, so they depend much more on foreign savings, and they have higher external current account deficits.

That said, what are the major challenges facing the Caribbean? First, even though these countries have a relatively high per capita income, compared to, say, countries in Africa or in South Asia, they are small and have vulnerabilities that other countries do not have. Second, for many years they were heavily dependent on foreign assistance or on the preferential treatment of certain exports, like bananas and sugar. However, these preferential arrangements are being phased out over time by the European Union and others, and the Caribbean countries now need to diversify their exports. Foreign assistance is also drying up, with a reduction in the level of aid to the Caribbean. Since these economies cannot depend on foreign resources to the same degree as in the past, they have to develop their own resource base and strengthen their own savings, in order to grow on a sustained basis. This is the major challenge. We believe that the new technical assistance center and the Caribbean initiative can help catalyze these restructuring efforts.

Another important policy challenge facing the countries of the Caribbean is their integration into the globalized economy. What policy actions need to be taken, for instance, with respect to domestic financial systems, exchange rate policy, and capital account liberalization?

LOSER: First of all, the Caribbean economies are very strategically located: they are close to the United States, easily accessible, with low transportation costs. Further, their population is on average highly educated. Also, these countries are already well integrated into the world economy through their links to their main traditional trading partners, which gives them strength for new sources of growth.

With a few exceptions, these countries have traditionally pursued very prudent monetary and fiscal policies, which has been reflected in their good macroeconomic performance in recent years. There are several types of exchange rate regimes in operation among the Caribbean countries, including a fully functional currency union. But despite the different regimes, the policies behind them are nearly uniformly strong, and in that sense, they are well managed.

The Eastern Caribbean currency union encompasses eight members, six of which are independent countries and members of the Fund. operating under the authority of the Eastern Caribbean Central Bank (ECCB). In practice, the ECCB functions like a quasi-currency board, and member countries have to follow prudent fiscal policies. The same cautious policies are true of other countries, like Trinidad and Barbados. Jamaica, too, has been strengthening fiscal discipline.

The region's financial systems have features that make them well placed to benefit from globalization, including a number of foreign-owned banks with close links to major banks abroad. There are also many local banks, which raises the issue of the quality of bank supervision. However, the various central banks have been taking important steps to strengthen financial supervision and prudential regulations. In fact, it is interesting to notice that during the episodes of financial turbulence of 1998 and 1999, no Caribbean country suffered any serious problems because of financial contagion.

Is all this sufficient to gain the confidence of the international capital markets?

LOSER: The Caribbean economies have to maintain supportive macro policies; but they also must advance with structural reforms—for instance, making their labor markets more flexible. Fiscal policy needs to be less dependent on import duties, and many of the countries are moving to broaden their tax base. Barbados, for example, has introduced a value-added tax that has worked very well, and others may follow that example. There are other issues in the area of taxation, including the level of property taxes and the possible introduction of user fees for services such as health and education.

The Caribbean countries are generally open in terms of capital flows, with only few, limited restrictions. One

The region's financial systems have features that make them well placed to benefit from globalization. — Loser

interesting possibility for these countries would be to unify their capital markets. This would raise some operational issues, because of the countries' differences in terms of size and output; but there is still significant scope for higher integration of capital markets in the Caribbean. In fact, the Caribbean economies are already much more integrated than other regions at the political and social levels. There are many contacts among them and a larger sense of community than you would find, for instance, in Latin America.

Many of the Caribbean countries are heavily dependent on tourism, which itself is vulnerable to economic fluctuations in the major markets. What is being done or what more can be done to diversify these economies ?

Loser: We have to understand that tourism is already a source of diversification. These countries started as monoproducers, producing a single or only a few agricultural commodities. Tourism has been an agent of diversification and modernization, although it is, admittedly, a cyclical industry. But in view of their small size, it would be impossible to fully insulate the Caribbean economies from developments in their large partners like the United States, Canada, and the European Union. There are a number of areas into which they can diversify further, however. An example is the high-tech data processing industry, as for instance in Jamaica, where this sector has been growing strongly, helped in part by the relatively high skill level of the population. Another area of development has been offshore financial sector activity, which can be a valuable source of growth as long as it operates within the principles of transparency and adequate supervision.

In view of their small size, it would be impossible to fully insulate the Caribbean economies from developments in their large partners.
— Loser

The costs of globalization include an increased vulnerability to fallouts from financial crises elsewhere and to the overall fluctuations of the world economy. How can the countries of the Caribbean build up defenses against, say, a slowdown in the U.S. economy, or a financial crisis in a major center?

Loser: These countries depend a lot on what happens in North America, of course; but if you come to think of it, there are less reliable places to depend on than North America. They also have important links with Europe in the areas of trade, services, and tourism. Links with Latin America are weaker, for two main reasons: first, the absence of common roots, which led each region to develop very different trade links; and second, the fact that up until relatively recently, Latin America was fairly unstable from an economic point of view. Then, in the Caribbean, Latin America is arguably seen as a less reliable source of foreign exchange than Europe or North America. The larger Caribbean countries are working on establishing closer links with Latin America, but there is a fair way to go before Latin America would be considered a major source of their foreign exchange earnings.

What role do the regional organizations, like CARICOM and OECS (Organization of Eastern Caribbean States) play? How effective are they? Can they be helpful in narrowing the wide differences in growth and performance among countries in the region? How helpful would narrowing differences and banding together be?

Loser: In terms of regional organizations, the OECS is the institution through which the eight members of the ECCB have institutionalized their economic and political cooperation. As noted, for this group of countries, the ECCB is a major source of discipline and policy harmonization. The CARICOM is also very important. Its member countries are involved in a major process of trade integration and tariff rationalization. These efforts are helpful as long as they foster trade and higher integration with the rest of the world. A key issue here is that the Caribbean is not a large region. The region's GDP—excluding the Dominican Republic and Haiti—is $27 billion, compared to about $1.9 trillion for the whole of Latin America and the Caribbean. So we are not talking about large numbers. Still, integration efforts, including through the provision of common services in areas like agriculture and transportation, help in creating new opportunities. But in view of its size, the Caribbean cannot be—and its people know this—self-sufficient; its economies have to be very closely associated with the rest of the world. And to make the best of this situation, they need to continue with strong macroeconomic policies that will help them absorb the impact of external shocks, while maintaining as open a trade and financial system as possible. ■

Photo Credits: Denio Zara, Padraic Hughes and Pedro Márquez for the IMF, pages 65, 66, 68, 69, and 71–75; Apichart Weerawong for Reuters, page 66.

Selected IMF rates

Week beginning	SDR interest rate	Rate of remuneration	Rate of charge
February 21	4.14	4.14	4.71
February 28	4.18	4.18	4.75

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 (as of May 1, 1999, the U.S. dollar was weighted 41.3 percent; euro (Germany), 19 percent; euro (France), 10.3 percent; Japanese yen, 17 percent; and U.K. pound, 12.4 percent). The rate of remuneration is the rate of return on members' remunerated reserve tranche positions. The rate of charge, a proportion (currently 113.7 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

Policymakers face major challenges in tracking and limiting spread of financial contagion

Over the past decade, the global economy has been rocked by major financial conflagrations that started out as local brush fires. Many of these fires proved uncontainable, spreading rapidly and destructively across boundaries and flaring up on continents half a world away, fueling fears of systemic failure and global meltdown. Policymakers at both the national and international level have been searching for ways to prevent the outbreak and spread of financial crisis or, at least, to limit its duration and reduce the severity of its effects. A recent conference cosponsored by the World Bank, the Asian Development Bank (ASDB), and the IMF, entitled "International Financial Contagion: How It Spreads and How It Can Be Stopped," addressed these issues.

Theories of contagion

In a session chaired by Guillermo Perry of the World Bank, participants considered some of the conceptual and empirical issues related to contagion. In their analysis, Garry Schinasi of the IMF and Todd Smith of the University of Alberta noted that theoretical contagion models rely on market imperfections to explain why adverse shocks in one asset market might be associated with asset sales in unrelated markets. However, basic portfolio theory can explain contagion, without recourse to market imperfections. Portfolio diversification and leverage, Schinasi said, may be sufficient to explain why investors would find it optimal to sell many higher-risk assets in response to a shock to one asset.


Garry Schinasi

Also questioning the presence of contagion, which they defined as "a significant increase in cross-market linkages after a shock," Kristin Forbes and Roberto Rigobon, both of the Massachusetts Institute of Technology Sloan School of Management, noted that recent empirical work has found little evidence of this phenomenon during crises. They concluded that many countries are highly interdependent, regardless of the current economic climate, and the strong cross-country linkages that exist after a crisis are not significantly different from those during more stable periods.


Kristin Forbes

Building on the issues raised by Forbes and Rigobon, Matt Pritsker of the Board of Governors of the U.S. Federal Reserve System argued that the channels through which a shock in one country or market spreads to other countries or markets are not well understood. But this does not imply that markets are irrational. Rather, more channels for propagation need to be theoretically modeled and empirically tested. In his paper, he considered several channels—including a common lender and the interaction of financial institutions and markets—and found that none of them require irrationality for shocks to be transmitted. Nevertheless, excessive price movements in one market or country may arise as a result of contagion from elsewhere, due to market imperfections involving information asymmetries.

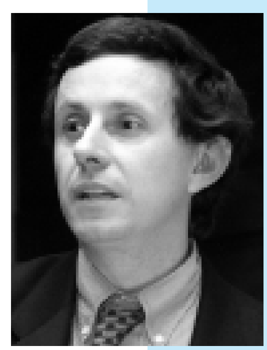

Matt Pritsker

Roberto Chang of the Federal Reserve Bank of Atlanta and Giovanni Majnoni of the World Bank attempted to identify and evaluate the public policy implications of financial contagion. On the domestic level, Chang said, they emphasized the need for policies aimed at reducing financial fragility—for example, reducing unnecessary short-term debt commitments. At the international level, the authors stressed the need for improving financial standards.


Roberto Chang

Measuring contagion

In a session chaired by Yung Chul Park of Korea University, theoretical issues were explored further. Looking at the experience of 20 countries with three crises—debt (1982), Tequila (late 1994–95), and Asian "flu" (1997)—José De Gregorio of the Universidad de Chile (and Minister of the Economy for Chile in the new administration taking office on March 11) and Rodrigo O. Valdés of the Central Bank of Chile asked what the "propagation" channels of crises across countries are and whether there are useful policy instruments that


José De Gregorio

countries can use to shield themselves from contagion. They concluded that although crises may be triggered by common shocks, transmission of their effects across countries depends on regional trade, but also on the countries' macroeconomic characteristics—current account deficit, level of the exchange rate, and credit conditions. The increased financial integration in the world suggests that contagion is more frequent and pervasive now than during previous episodes of financial turbulence, but although the causes of the crises may have changed, the channels through which contagion spreads have not.

Considering the policy actions that countries might take to narrow the transmission channels in times of crisis, De Gregorio said they found no evidence that capital controls are effective. In contrast, exchange rate flexibility and a maturity structure heavily weighted toward long-term debt did have a limiting effect.


Graciela Kaminsky

The literature on contagion, according to Graciela Kaminsky of George Washington University and Carmen Reinhart of the University of Maryland, has focused on attempts to document its presence and to discriminate among the possible transmission channels of financial disturbances. However, the global or regional consequences of a disturbance may depend on where the shock originates. Analyzing the daily behavior of financial indicators for 35 countries, Kaminsky and Reinhart reached a preliminary conclusion that the global or regional consequences of a disturbance depend importantly on whether the shock originates in the periphery or in the center. In the case of the Asian crisis, for example, Japanese banks' exposure to Thailand played a prominent role in the spread of the crisis. If the shock never reaches the center, however, it is unlikely to become systemic, Kaminsky said. In the case of Brazil, for example, financial market participants at the center countries were largely positioned for a devaluation of the real by early 1999; as a result, this crisis was "more of a ripple in global capital markets than a tidal wave."


Barry Eichengreen

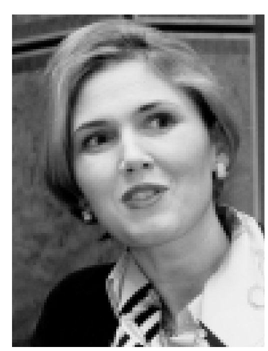
Barry Eichengreen and Galina Hale, both of the University of California, Berkeley, and Ashoka Mody of the World Bank looked at how negative shifts in market sentiment are felt in the bond market and the country characteristics associated with the damage. They found a role for changes in fundamentals and market sentiment following three crises of the 1990s (Mexico, Asia, and Russia). However, Eichengreen said, although there is ample evidence of changes in market sentiment, the dominant effect is within the region in which the crisis originates and on prices rather than quantities or maturities. Only in East Asia following the 1997 crisis did changes in market sentiment have a large impact on bond issues. The observed decline in bond flotations following the outbreak of the Mexican crisis can be fully ascribed to deteriorating fundamentals, according to the authors, as can, "to a surprising extent," the increase in spreads in Asia. The authors do not, therefore, deny a role for the "flight to quality" as a channel for contagion, Eichengreen said, but suggest, rather, that its impact may be more limited than often assumed.

Role of investors

The role investors play in spreading contagion was explored in the session chaired by Jung Soo Lee of the Asian Development Bank. The Asian crisis has highlighted the importance of strong domestic financial systems, according to Linda Goldberg, presenting the paper she wrote with Gerard Dages and Daniel Kinney, all of the Federal Reserve Bank of New York. There is less agreement, however, on the role of foreign banks in contributing to strengthened financial systems. Both Argentina and Mexico had opened up their financial systems to direct foreign participation through the ownership of local financial institutions, she said. The experiences of both countries suggest that foreign ownership of domestic financial institutions contributes positively to the overall level and stability of domestic credit.


Linda Goldberg

International banks are a major source of financing for emerging economies, but they are also among the most volatile, according to Caroline Van Rijckeghem of the IMF and Beatrice Weder of the University of Basel. Banking centers may add to financial contagion, Weder said, when two countries that depend on a common bank lender are vulnerable to spillovers through this linkage. Spillovers through such "common bank lenders" were important in transmitting the Thai currency crisis, and possibly the Mexican and Russian currency crises as well. In the Russian crisis, however, the withdrawal of funds seems to have been more generalized.


Beatrice Weder

It is often argued that foreign

outflows lead to price overreaction and contagion, but many financial economists contend that international investors do not create or exacerbate crises; their trading behavior simply reflects their assessment of underlying fundamentals. To test this contention, Kenneth A. Froot of Harvard University, Paul G.J. O'Connell of FDO Partners, LLC, and Mark S. Seasholes of Harvard University explored the behavior of daily international portfolio flows into and out of 44 countries from 1994 through 1998—encompassing almost 4 million trades by large institutional investors. Among their findings, O'Connell said, was that international investors engage in positive feedback or "trend chasing"—that is, an increase in today's returns leads to an increase in future flows. In addition, O'Connell said, inflows have a positive forecasting power for future emerging market returns. Interestingly, their data revealed that international investors did not abandon emerging markets during the Asian crisis, despite the steep decline that took place in emerging market equity prices.


Paul G.J. O'Connell

Analyzing the behavior of another important group of investors, Graciela Kaminsky, Richard Lyons of the University of California, Berkeley, and Sergio Schmukler of the World Bank examined the role of mutual funds in spreading crises. They found that mutual fund managers take account of the features of a country's economy and financial markets when deciding whether to adjust their exposure in that country. Economic fragility was not the only factor triggering withdrawals from emerging market economies—the decision also hinges on liquidity.

Case studies

The experience with contagion of individual countries, groups of countries, emerging market economies, and transition economies was considered during two sessions devoted to case studies, chaired by Michael Mussa, Director of the IMF's Research Department, and Gerard Caprio, Director of Financial Strategy and Policy, World Bank.


Ratna Sahay

• R. Gaston Gelos and Ratna Sahay, both of the IMF, looked at financial spillover patterns since 1993 in the transition economies of Central and Eastern Europe, Russia, and the Baltics and concluded that with increased financial market integration, the financial markets of the more advanced transition economies were behaving more and more like their Asian and Latin American counterparts.


Francesco Giavazzi

• Carlo A. Favero and Francesco Giavazzi, both of Bocconi University, Milan, found evidence of contagion in the 1992 exchange rate mechanism crisis (ERM) following the June 1992 referendum in which Danish voters rejected the Maastricht treaty.

• The analysis of Ilan Goldfajn of Pontificia Universidade Catolica, Rio de Janeiro, and Taimur Baig of the IMF indicates that in the aftermath of the 1998 Russian crisis, Brazil's residents led the flight of capital from their country and were subsequently followed by foreign investors, resulting in the collapse of the Brazilian real. The authors did not find support for the hypothesis that the contagion was triggered by some investors reducing their exposure to Brazil to balance their portfolio affected by losses from the Russian crisis.


Ilan Goldfajn


Alejandro M. Werner

• Analyzing the contagion of Mexico's national markets from the crises of the past three years, Santiago Bazdresch and Alejandro M. Werner, both of the Bank of Mexico, said that the quick policy action taken by the Mexican government in the face of the adverse external environment was sufficient to restore market confidence and was responsible for Mexico's healthy economic performance in 1998.

• Yung Chul Park and Chi-Young Song of Kookmin University noted that Korea's initially strong fundamentals before the Asian crisis and its rapid post-crisis recovery suggested that herding behavior of foreign investors panicking from the financial crises in Taiwan Province of China and Hong Kong SAR sparked the exodus of institutional investors from Korea that precipitated the crisis.


Chi-Young Song

• Tilak Abeysinghe of the National University of Singapore investigated how the recessionary impulses generated by the Asian crisis were transmitted across the borders of the eight crisis-affected countries of East and Southeast Asia. Although transmission plays an important role in the medium run, the immediate economic contractions are largely a result of direct shocks attributable to pure contagion, he noted. The postcrisis period, therefore, is likely to see intense competition among the crisis-hit economies for export markets and foreign direct investment.

Michael D. Bordo

- Michael D. Bordo and Antu P. Murshid, both of Rutgers University, examined financial crises over the past 120 years for evidence of transmission channels of contagion. They concluded that the emphasis on contagion effects in the recent literature is "clearly overblown."

Yung Chul Park

Roundtable on international financial reform

In a discussion chaired by Stefan Ingves, Director of the IMF's Monetary and Exchange Affairs Department, panel members considered ways countries could shore up their defenses against the fallout from financial crises in other countries, as well as strengthen their domestic financial systems and macroeconomic policy actions to protect against crisis in their own economies. Rudiger Dornbusch of the Massachusetts Institute of Technology said ministers of finance needed to understand that, in the "new world out there," everything is correlated. If something big happens, it happens everywhere, especially in the immediate neighborhood. Any government that operates a "sleaze house" is going to get hit hard. The only way to avoid the worst effects of contagion, he said, is to "clean up your house." Countries that do not want to take any risks should get out of the domestic banking industry altogether, sell the banks to foreign countries, or offer offshore guarantees. The best way to avoid currency crises, Dornbusch said, is for a country to divest itself of its national currency altogether by establishing a currency board. An economy without a central bank and a domestic banking system, Dornbusch said, may not be able to avoid contagion altogether, but at least the effects would be less harmful.

Rudiger Dornbusch

Morris Goldstein

Morris Goldstein of the Institute for International Economics offered a shopping list of actions countries and the international community could take. IMF lending rates for countries seeking financial assistance should be "risk-based." Countries should get rid of unsustainable exchange rates, provide evidence of sound macroeconomic policy, and adopt prudent standards and regulations. When a country in distress comes to the IMF for assistance, the IMF should impose normal access limits if the crisis is not systemic. Any restructuring or debt workout must involve the private sector, and no category of debt (like bonds) should be excluded from the new contracts. If the crisis is systemic, Goldstein said the IMF should apply a rough rule of thumb: if the crisis is the fault of the country, then the country has to fix it (that is, enter into a program with the IMF). In the case of a temporary crisis that threatens the international system, Goldstein recommended the establishment of a new facility (to replace the IMF's current Contingent Credit Lines), funded with SDRs, available only to developing countries, and activated by a majority vote of the IMF's shareholders.

The advice countries are given is often very difficult to implement, according to Yung Chul Park. For instance, the dictum to avoid balance sheet problems is hard to carry out because the problems—like maturity mismatches and exchange rate pressures—don't surface until the crisis hits. Emerging markets are enjoined to conform to Western monetary and fiscal standards, Park said, but foreign investors do not seem to care so long as the potential returns are promising. If emerging markets become too concerned about shoring up against crisis—say, by tightening policy whenever a current account deficit threatens—they may not be able to invest more than they are saving.

Philip Turner

Prudent oversight, of both the domestic and the international financial system, can help make an economy more resistant to contagious financial shocks, according to Philip Turner of the Bank for International Settlements. However, regulators and supervisors face several dilemmas in framing their policies and determining their actions in practice. Setting universal standards is probably impossible because degrees of sophistication in the banking system and depth and variety in the financial markets vary widely among countries. As a result, supervision will, in practice, remain a responsibility of the individual country, Turner said. ■

The papers presented at the conference on international financial contagion are available on the World Bank's website at www.worldbank.org/research/interest/confs/past/pstconfs.htm.

Emerging markets face a cautiously upbeat future; sound policy and improved information are key

The prognosis for emerging markets recovering from the financial crises of the past few years is guardedly hopeful. At the same time, developments in industrial country financial markets, especially the United States, bear close watching; the private sector can and should play an active role in crisis prevention and resolution; and improved information flows to the market from reliable and impartial sources, like the IMF, are of vital importance. These were some of the themes pursued in a recent IMF Institute seminar, featuring former IMF staff members who now head economic analysis units for leading investment banks and funds. The panel included Bijan B. Aghevli, formerly Deputy Director in the IMF's Asia and Pacific Department and currently Director of Asia Economic and Policy Research for Chase-Manhattan Bank; Mohamed A. El-Erian, formerly Deputy Director of the IMF's Middle East Department and currently Managing Director, Pacific Investment Management Company; and Mahmood Pradhan, formerly Senior Economist in the Asia and Pacific Department and currently Chief Emerging Markets Economist with Tudor Proprietary Trading.

Recovery in Asia and prospects for Japan

Describing the situation in Asia as "smooth sailing now, but still rough seas to navigate," Bijan Aghevli said the Asian crisis countries had turned the corner earlier than forecasters had predicted. Although the economies were recovering at different rates, all were doing well. Three factors lay behind this strong resurgence, Aghevli said: stimulative policies, a turnaround in market sentiment, and the synergistic relationship among the countries.

Stimulative policies. All the countries included in his survey (China, Hong Kong SAR, Indonesia, Malaysia, the Philippines, Korea, and Thailand) went into the crisis with a strong fiscal position, low levels of domestic debt, and low inflation. Thus, the heavy deficits they incurred during the crisis were manageable, while weak domestic demand and a regionwide fall in commodity prices kept inflation down. Fiscal policy has supported the recovery, but at the cost of rapidly deteriorating fiscal positions, Aghevli said. The authorities' tightening of monetary policy—as a first and necessary line of defense against assaults on the domestic currency—has since been relaxed. With exchange rates stabilizing, interest rates have now fallen sharply to precrisis levels, although they remain relatively high. Coupled with considerable excess capacity and little or no inflation, these interest rates could cause problems. At the same time, real exchange rates remain substantially depreciated relative to precrisis levels, giving rise to concerns about competitiveness. On the brighter side, all crisis countries have rebuilt their reserves to comfortable levels sufficient to cover short-term debt.

Participants in the IMF Institute seminar (from left): Mahmood Pradhan, Bijan B. Aghevli, IMF Institute Director Mohsin Khan, and Mohamed A. El-Erian.

Market sentiment. The crisis-propelled deterioration in market sentiment prompted a shift from consumption to saving, which played a large part in restoring confidence. By 1998, Aghevli said, equity prices in Asian markets had risen beyond precrisis levels, while bond spreads, although higher than before the crisis, have narrowed.

Synergy. The simultaneous recovery in all countries created strong synergies among them, leading to even stronger growth in the market for Asian exports, a trend that Aghevli said is expected to continue into 2000.

Growth may slow in the medium term, however, Aghevli warned, since the recovery is cyclical rather than structural, and output levels are still well below potential. Countries that implement strong structural reform, he said, will probably grow faster than those that lag behind.

Although it is not clear that Japan has reached the turning point, Aghevli said he was bullish (or, at least "less bearish") on the country's prospects. As with the other recovering Asian economies, Japan has implemented supportive fiscal and monetary policy, although market sentiment remains lukewarm. Nevertheless, the recovery in the region and the strong performance in Europe and the United States suggest that the same synergistic forces propelling the rest of the region will help pull up the Japanese economy—a case, Aghevli said, of "the tail wagging the dog." A potential concern, however, is the risk of a sharp appreciation of the yen, whose movements, Aghevli said, are difficult to predict, since they do not always reflect fundamentals. In his opinion, however, the Bank of Japan will intervene to keep the yen from rising too much.

A secure future for emerging markets?

A year ago, Mohamed El-Erian said, emerging markets were in turmoil; investors were still reeling from the Asian and Russian financial crises; and the IMF was on the receiving end of bad press from all quarters. A year later, growth is picking up in most emerging market countries; investors are flocking back; and the IMF is winning praise for its handling both of individual country problems and of the risk to the international financial system.

Do these developments, El-Erian asked, signal the emergence of these economies as "islands of stability" in a turbulent international environment, or simply the upswing in a cyclical process that could downshift into another round of turmoil and disruptions?

For many emerging market economies, El-Erian said, 1999 was a year when three "key stars" were in alignment: better country fundamentals as several countries strengthened their domestic policies; a supportive external environment, as U.S. growth remained buoyant and picked up in Europe; and favorable market technicals (that is, not only were cross-border flows returning to the emerging markets, but the deep devaluations that had driven these flows out in the first place had also shaken out much of the over-indebtedness and over-leveraged investments built up in the mid-1990s).

Despite these favorable developments, emerging markets face a "choppy" outlook, El-Erian said, as generally supportive internal factors compete with more difficult external ones. Because the recent policy strengthening has been rooted in structural improvements and institutional gains, domestic policy fundamentals are expected to continue to improve, El-Erian said. But private investors are keeping "three issues on the radar screen": the risk of policy complacency; the difficulties emerging markets typically face in "managing success"; and uncertainties about the sustained implementation of better policies in some systemically important countries (such as Argentina, Russia, and Turkey). Market technicals are expected to remain generally supportive, El-Erian said, as the impact of low valuation is replaced by a broadening of the investor base, and crossover funds gradually flow back into the markets.

The external environment could be more problematic, however. For one thing, the risks of a slowdown in world growth could be increasing. Also, perceived dislocations in major industrial country financial markets could lead to an increase in average investor risk aversion and a reduction in the relative attractiveness of emerging market assets.

For countries with IMF-supported programs, El-Erian said, this murky outlook accentuates the importance of sound economic policies and appropriate contingency plans that lessen the economy's vulnerability to negative contagion from disturbances in external financial markets. The need to provide markets with timely and comprehensive information is also very important, and the IMF can play a vital role in this regard, El-Erian noted.

The IMF could also provide an important service to the market, El-Erian said, by acting as an international clearinghouse for information on how the market is positioned. Information helps to smooth out the market and prevent the abrupt reversals resulting from "betting on boxing matches staged in the dark." The IMF could also play a useful role as an objective advisor in helping countries, rather than investors, exploit market imperfections.

Involving the private sector

Agreeing with his fellow panelists that the overall prospects for emerging markets are generally good, Mahmood Pradhan voiced similar concerns. A global economic slowdown could dampen the market's newly restored enthusiasm for emerging market assets, even in countries, like those in Asia, with strong economic fundamentals, he cautioned. For countries in Latin America, which are currently facing a steep external financing requirement, a worsening in the global environment could have a seriously damaging impact.

Turning to recent developments in financial markets, Pradhan said that for hedge funds and leverage institutions, the price of holding positions is back to precrisis levels. There is now less of a risk of a systemic crisis, he said, but the potential remains for leverage positions to get out of hand again if market volatility begins to rise.

Both the official and the private sector have been grappling with the knotty problem of damage control and reconstruction after a financial crisis. Pradhan said that private sector involvement was essential in this effort, because the official sector lacked the resources to cover all the shortfalls, while the private creditor community could handle defaults relatively easily. What was lacking in current debt reconstruction strategies, Pradhan said, was the ability of the private sector to do its own credit risk assessment. This lack could be filled by an open exchange of information between the IMF and private creditors. The terms of IMF-supported programs for a country seeking financial assistance should be made public, including the proportion of adjustment the country needs to make, how much of the financing gap the official sector is willing to provide, and the conditions that need to be met before this financing is disbursed. The more complete such information is and the more widely disseminated, the better equipped the public sector is to make its own risk assessment and to decide how fully it wishes to participate. The price of not participating is a bigger "haircut" all around, Pradhan said, so the IMF should remain firm and resist any attempts by small groups of creditors to negotiate better terms, since this could set a dangerous precedent for future debt workouts. ■

Korea's crisis resolution strategy aims to restore confidence and promote sustained recovery

Within a two-year span, Korea's economy plunged into a severe recession and now is recording a dramatic turnabout. What triggered the crisis? What prompted the recovery? And what remains to be done to ensure that Korea's economy sustains strong growth within a stable macroeconomic environment?

Most observers in late 1997 were shocked to see Korea—the world's eleventh largest economy with an impressive record of macroeconomic performance—swept into the financial market turmoil then raging in Southeast Asia. In retrospect, however, the country's remarkable growth had masked a number of structural weaknesses, in particular a weak financial sector and an overleveraged corporate sector. These weaknesses contributed to a sharp buildup of short-term external debt (estimated in excess of $100 billion by mid-1997) that left the economy vulnerable to external shocks and adverse shifts in investor sentiment.

Indeed, in the second half of 1997, there was a marked deterioration in Korea's external financing situation following a number of large bankruptcies earlier that year and a series of downgrades of Korea's credit rating. In particular, new financing dried up, and it became increasingly difficult to roll over the large stock of short-term debt. With external reserves almost depleted by November 1997, Korea was at the brink of default. In the ensuing financial crisis, the country faced massive capital outflows, a sharp depreciation of the won, a collapse of confidence, severe distress in the corporate and financial sectors, and a substantial decline in private demand.

To deal with the crisis, Korea agreed to a $21 billion Stand-By Arrangement with the IMF on December 4, 1997 (see *IMF Survey*, December 15, 1997, page 385). Policies adopted under this program successfully restored external stability, rebuilt reserves, and initiated reform of the financial and corporate sectors. Following a sharp recession in 1998, the economy is again growing rapidly and output is now above its precrisis level. The won has strengthened substantially after losing half its value soon after the crisis erupted, and the stock market has registered large gains propelled in part by purchases by foreign investors.

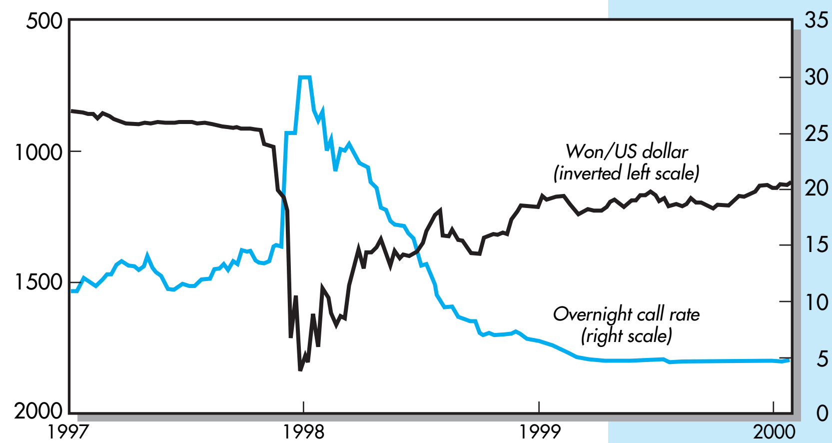
Crisis strategy

The objectives of Korea's crisis resolution strategy were, first and foremost, to restore confidence and stabilize financial markets, and second, to lay the foundation for the resumption of sustained recovery in the real economy. The program thus included a mix of macroeconomic policies and far-reaching structural reforms, as well as the largest financing package in IMF history. Combined with the IMF's resources, the total package amounted to $58 billion, including support from the World Bank and the Asian Development Bank, and a "second line of defense" pledge from bilateral donors. In addition, Korea reached agreement with foreign banks in late 1997 to extend the maturity of short-term claims on its banks to avoid a default on external obligations.

At the outset of the program, Korea's macroeconomic policies focused on a temporary interest rate hike aimed at stabilizing the won and avoiding a depreciation-inflation spiral. This step helped restore financial stability by early 1998 (see chart, this page), and once the won was stabilized, macroeconomic policies quickly eased to provide stimulus to the economy. The overnight call rate progressively declined, falling below its precrisis level by July 1998 and below 5 percent by March 1999. The authorities also adopted an expansionary fiscal stance early in the program to mitigate the impact of the inevitable recession.

The government recognized early on that the smooth implementation of adjustment policies would require broad social consensus. It fashioned a Tripartite Accord involving labor, business, and the government that ultimately paved the way for an array of important measures that exposed corporations more fully to market forces, created a more flexible labor market, and attracted foreign investment. The authorities also strengthened the social safety net by expanding the unemployment insurance system and providing direct support through public works programs, temporary livelihood protection, and other social programs.

Korea: interest and exchange rates

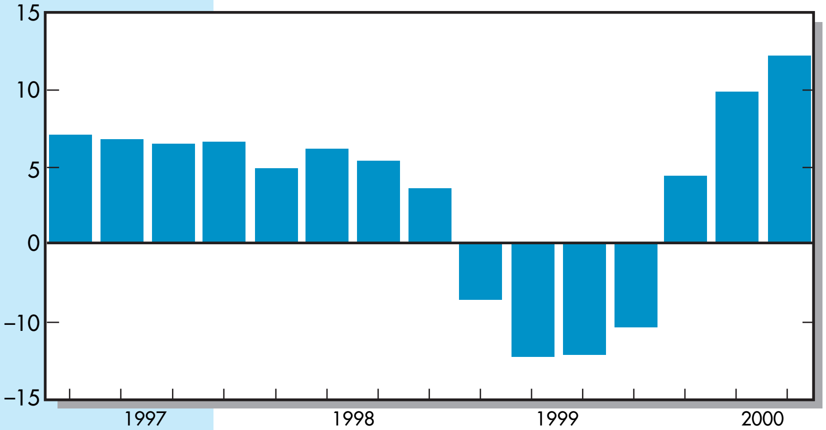


Data: Bank of Korea

Structural reforms

While a severe international liquidity squeeze triggered the crisis, structural weaknesses were at the heart of Korea's problems. If the confidence of foreign investors was to be regained, structural issues needed to be addressed. Korea realized that it would be critical to take measures from the outset that would boost investor confidence and enhance the credibility of the stabilization program. Its ambitious structural reform agenda focused on liberalizing the capital account, restructuring the financial and corporate sectors, enhancing labor market flexibility, and improving data reporting.

Korea: real GDP
(4-quarterly percent change)



Data: Bank of Korea

To liberalize the capital account, the authorities took steps to ease restrictions on portfolio investments and direct corporate borrowing abroad to attract much needed foreign capital and reduce the excessive amount of short-term debt. In addition, they also liberalized regulations on foreign takeovers of nonstrategic Korean companies and restrictions on foreign ownership of corporations to promote foreign direct investment and impose greater market discipline on corporations.

Korea's financial restructuring sought to restore stability to the financial system quickly through liquidity support, a time-bound blanket guarantee, and closures of nonviable institutions. The financial restructuring effort also aimed at resolving the problem of nonperforming loans, recapitalizing banks, and strengthening the institutional framework by bringing prudential regulations and supervision in line with international best practices.

The restructuring and recapitalization of weak banks have proceeded quickly. The Korean government moved swiftly to close 5 commercial banks and 14 merchant banks, nationalize 4 commercial banks, and acquire sizable stakes in 7 other banks. The authorities used public funds to facilitate the liquidation of failed institutions, the restructuring of weak but viable banks, the recapitalization of both commercial banks and specialized and development banks, and the purchase of impaired assets from financial

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institutions. Banks that benefited from public funds were required to provide a viable recovery plan and write down shareholder capital. To date, public outlays for recapitalization and purchases of nonperforming assets have amounted to about 15 percent of GDP.

Over the last two years, banks have made considerable progress in strengthening their capital base, but they are likely to need additional capital in the period ahead as accounting standards and loan classification criteria are strengthened. Tighter loan classification criteria, introduced at the end of 1999, are expected to give rise to further provisioning requirements, as loans are reclassified based on the ability to repay rather than the earlier delinquency criterion. In addition, ongoing corporate restructuring could identify additional nonperforming loans that banks would have to resolve.

Korea has also taken important steps to improve its supervisory oversight and to bring its prudential regulations in line with best international practice. It strengthened the operational independence and autonomy of the Financial Supervisory Commission (FSC) and unified functions of four separate supervisory agencies under the Financial Supervisory Service, the executive body of the FSC. Legislative action bolstered the independence of the Bank of Korea and allowed it to focus on maintaining price stability, while relinquishing direct supervision of the banking system.

Corporate restructuring efforts initially concentrated on improving governance and competition policies. Subsequently, the focus shifted to financial and operational restructuring, with the goal of reducing debt levels and strengthening capital structure. Unlike past interventions, however, the government has limited its role to reforming the institutional framework to provide for a market-based restructuring. The government has also signaled that no conglomerate is "too big to fail." The Daewoo Group—the second largest *chaebol*—has been forced to enter into a workout program with its creditors.

The restructuring of the top five *chaebol* (Hyundai, Daewoo, Samsung, LG, and SK) is taking place within the framework of capital structure improvement plans reviewed by banks. With the exception of Daewoo, the top five *chaebol* have made significant progress in meeting their pledges under these plans. Equity issues, spin-offs, asset sales, and strategic alliances with foreign investors have accounted for most of the improvement. For the Daewoo Group, the workout plans for its affiliates will restructure control of these affiliates and lead to strategic sales and other operational changes. A creditor-led out-of-court debt workout process is overseeing restructurings of highly leveraged second-tier *chaebol* and other large corporations.

Korea has also taken major steps to strengthen market discipline and governance. It has clarified the responsibilities of corporate boards and enhanced their independence, strengthened minority shareholder rights, improved bankruptcy procedures by strengthening creditor rights and streamlining the bankruptcy process, implemented accounting and auditing standards (with effect for 1999 accounts) consistent with international best practice, bolstered the Fair Trade Act on competitive business practices, and greatly liberalized the foreign investment regime.

Korea: Key macroeconomic indicators

	1996	1997	1998	1999 Est.
Real GDP	6.8	5.0	–5.8	10.0
Private consumption[1]	7.1	3.5	–9.6	9.0
Gross fixed investment[1]	7.3	–2.2	–21.1	4.4
Stockbuilding[2]	0.6	–2.0	–5.6	4.0
Exports[1]	11.2	21.4	13.3	18.5
Imports[1]	14.2	3.2	–22.0	27.3
Inflation[1]	4.9	4.4	7.5	0.8
Unemployment (percent)	2.0	2.6	6.8	6.3
Budget balance[3]	0.0	–1.7	–4.3	–4.6
Current account balance[4]	–23.0	–8.2	40.2	25.2
Net capital inflows (+)[4 5]	23.9	–28.0	–14.3	9.1
Usable reserves[4]	29.4	9.1	48.5	74.0
Per capita GDP (in dollars)	11,423.0	10,361.0	6,905.0	8,962.0

[1]Percent change.
[2]Contribution to GDP growth.
[3]In percent of GDP, excluding privatization proceeds.
[4]In billions of dollars.
[5]Balance on capital and financial accounts.

Data: Bank of Korea, and IMF staff estimates

Economic recovery

The severe disruption in financial markets and loss of confidence that characterized the Korean crisis prompted that country's worst recession in over three decades, with real GDP falling by almost 6 percent in 1998. But the turnaround in economic activity following this severe contraction has been unexpectedly rapid (see chart, page 78). An easy macroeconomic policy stance has helped to spur recovery, and progress made in implementing structural reforms has helped restore market confidence and revive bank lending.

Real GDP is estimated to have grown by 10 percent in 1999 (see table, this page). Indeed, the Korean economic recovery has been faster and stronger than in other countries that suffered similar financial crises in recent years (see chart, page 80). A strong rebound in private consumption, investment in new technology, and strong exports have led the recovery. Inflation has remained subdued following a temporary spike in early 1998, and in line with the fast economic recovery, unemployment fell sharply to about 5 percent in January 2000 from close to 9 percent a year earlier. Given the rapidly changing cyclical position of the economy, it will be necessary to remain vigilant to demand pressures and inflation. In this regard, it is thus appropriate that Korea's 2000 budget aims at withdrawing the stimulus.

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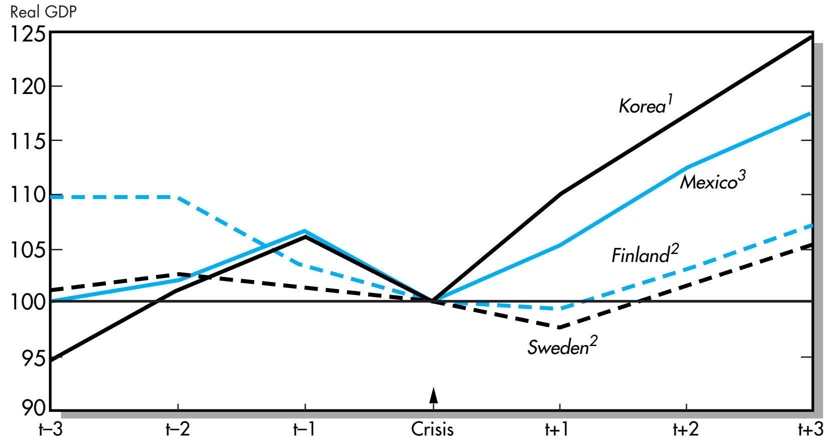
Korea's external position has also improved notably. Strong external demand and gains in competitiveness have spurred exports and resulted in sizable current account surpluses. Capital inflows increased markedly in 1999, reflecting joint ventures and asset sales related to corporate restructuring, and investors' favorable outlook on Korea's economic prospects. International reserves amounted to $80 billion by the end of February 2000—sufficient to provide cover for external short-term liabilities.

Korea: comparison of output recovery with other crisis countries

(crisis = 100)



[1]Estimate for 1999 and forecast for 2000–01; crisis year = 1998.
[2]Crisis year = 1992.
[3]Crisis year = 1995.

Data: IMF, *International Financial Statistics*, and IMF staff estimates and projections

Remaining agenda

Over the past two years, Korea has accomplished a great deal. Bold policies and a commitment to reform have made Korea a more open, competitive, and market-driven economy. But the country must complete the process it has begun. For balance sheet improvements to be sustained, banks will need to strengthen business practices, especially with regard to risk analysis and lending practices. Priority will also need to be given to privatizing nationalized banks and divesting government stakes in recently acquired banks. Further restructuring of the nonbank financial sector, particularly the investment trust industry, is also urgently needed. On the corporate front, the process of lowering the level of debt needs to be accelerated, and financial restructuring will need to be buttressed by deeper operational restructuring and improved disclosure. For companies, devoting more explicit attention to the bottom line will require increasing profitability through cost cutting, the sale of noncore assets, and strategic alliances.

Much of the credit for Korea's successful stabilization and recovery belongs to the Korean people, who sacrificed and worked hard, and to the Korean political leadership, who claimed "ownership" of the program from the outset and pushed forward relentlessly with tough reforms. The achievements to date have been remarkable, but the sharp turnaround should not deflect attention from the remaining agenda. The challenge ahead will be to avoid complacency and maintain the momentum of reforms. ■

Dhaneshwar Ghura
IMF, Asia and Pacific Department

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00/13: IMF Approves $39 Million Stand-By Credit for Estonia, March 1

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00/11: IMF, People's Bank of China Sign Memorandum of Understanding to Establish Joint Training Program, February 21

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Notes: PINS are IMF Executive Board assessments of members' economic prospects and policies. They are issued following Article IV consultations—with the consent of the member—with background on the members' economies; and following policy discussions in the Executive Board at the decision of the Board.
Letters of Intent and Memorandums of Economic and Financial Policies are prepared by a member country and describe the policies that the country intends to implement in the context of its request for financial support from the IMF.