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Speeches in Asia

Camdessus outlines developments in reform of architecture, advances in Asian recovery

During the first week of a circuit through Asia and Europe, IMF Managing Director Michel Camdessus delivered addresses in Hong Kong SAR, Tokyo, and Seoul. Summaries of these addresses follow. The full texts, as well as the transcript of a press briefing given by Camdessus at the Japan Press Club on May 18, are available on the IMF's website (www.imf.org).

On the East Asian leg of his trip, IMF Managing Director Camdessus (right) met with Japanese Prime Minister Keizo Obuchi.

Despite progress, urgent tasks remain

In his remarks at the thirty-second International General Meeting of the Pacific Basin Economic Council in Hong Kong SAR, on May 17, Camdessus outlined developments in the international monetary reform effort, including capital account liberalization.

The emerging markets crisis that began a year and a half ago revealed deficiencies in the international financial system both on the debtor side—in the national policies and institutions of the emerging markets and developing countries—as well as on the creditor side, notably in the capacity of investors to undertake adequate risk assessment and of supervisory authorities to monitor their activities. A broad consensus has emerged for embarking on a major *(Please turn to the following page)*

Development economics conference

Participants discuss reform of financial system, evolving issues in development economics

Kenneth Arrow

The reform of the international financial architecture, the social agenda, and the economics of transition were the main issues discussed in this year's Annual Bank Conference on Development Economics (ABCDE), which was held April 28–30 at the World Bank. In addition, parallel workshops dealt with a wide range of issues, from health, social insurance, and decentralization to issues of an open economy, financial markets, trade, and foreign aid.

In his opening keynote address, Kenneth Arrow, Professor Emeritus at Stanford University, emphasized that economic activity is often a more complicated process than simple models have depicted. In view of this, he said, it is essential for policymakers to take the knowledge into account as an important factor of production. Both the degree of education and openness to new ideas are important factors in determining a society's learning capacity.

Economic architecture

In the first session, Dani Rodrik of Harvard University and Andrés Velasco of New York *(Continued on page 169)*

Camdessus addresses Asian recovery

(Continued from front page) and immediate cooperative effort simultaneously to contain the crisis—a task now well advanced—and to reform the "architecture" of the system. This reform must be based on a mature partnership between governments and market players. In normal times, this means establishing an arm's-length relationship between governments and markets—neither too close nor too distant. When crisis strikes or contagion looms, it will involve efforts to find voluntary, market-based methods of involving the private sector in working out solutions from which everyone will benefit.

The effort expected from the private sector should be accompanied by powerful intervention from the public side to help contain the crisis, reestablish confidence, and provide temporary financing.

Progress so far

Progress has been made in four domains.

Transparency. A lack of transparency may be found at the origin of the recurring crises in the emerging markets, and it has been a pernicious feature of the "crony capitalism" that has plagued most of the crisis countries and many more besides. It may seem like a very tall order to change the culture and attitudes of many decades, but, in fact, considerable progress is being achieved in defining new standards and establishing new practices.

International standards and codes of conduct. Consensus is crystallizing on the need to establish at the international level the discipline already prevailing in domestic markets. A tremendous effort is under way to establish standards and codes of good practice at the international level that build on and offer the potential to globalize the standards that exist within the most advanced nations. The IMF has been formulating standards or codes of good practice for governments with respect to data dissemination and transparency in fiscal policy and monetary and financial policies, of which many are already well advanced or being implemented. Standards established by other agencies on issues such as securities markets, accounting, bankruptcy law, and corporate governance are also at various stages of production. In the critical area of financial sector strengthening, the IMF and the World Bank are cooperating closely to help promote stronger financial systems, based on the internationally accepted Basle Core Principles. But there is scope for even deeper international cooperation, and the Financial Stability Forum that has just been established [by the Group of Seven industrial countries] to encourage dialogue among the many national and international agencies will make an invaluable contribution.

Public and private sector cooperation. Public and private forces must join hands in the effort to prevent and resolve crises, but the focus should be on prevention. Just as the public sector is being asked to adapt its culture, so too the private sector will have to increase its own transparency, to use internationally accepted standards, to promote an arm's-length relationship with government, and—as far as financial institutions are concerned—to evaluate and manage risks much more carefully while developing a more mature partnership with clients. This should lead to an active contribution in resolving a crisis when it does strike.

The effort expected from the private sector should be accompanied by powerful intervention from the public side to help contain the crisis, reestablish confidence, and provide countries with the temporary financing they may require during the adjustment and reform phase. An innovative and promising development is the IMF's recent approval of a new mechanism, the Contingency Credit Lines (CCL). The CCL are designed to help countries that have sound macroeconomic management and a strong financial system, are applying internationally recognized standards, and have established responsible relationships with their international creditors to withstand the pressure on their balance of payments that might arise from a sudden loss of confidence caused by the contagion from crises in other economies. Other initiatives are also being considered to help the orderly workouts of crises if they do occur.

Capital account liberalization. The breakneck pace of development of the international financial markets during the decade preceding the Asian crisis raised questions about the appropriate approach to the liberalization of the capital account.

- *Should capital account liberalization be pursued at all?* The emerging markets exposed themselves to volatility, often unintentionally, by allowing the rapid but poorly managed liberalization of short-term flows. It became too easy for banks and corporations to incur short-term debt without adequate prudential safeguards. So the question should really be: since de facto capital liberalization is under way, how can the process be best managed to increase economic stability and growth and how can a judicious approach be taken by both debtor and creditor nations? Debtor nations will need to satisfy two prerequisites: a sound, internally consistent macroeconomic framework; and a robust financial system with sound institutions and a good regulatory and supervisory framework. Because many countries cannot meet these conditions overnight, creditor nations and institutions need to pay attention to assessing and managing risk.
- *Should there be a formalized institutional approach to capital account liberalization?* At the IMF Annual Meetings in 1997, the IMF's Executive Board was invited to propose "an amendment to the IMF's Articles of Agreement that would make the liberalization of capital movements one of the purposes of the IMF and extend, as needed, the IMF's jurisdiction through the establishment of carefully defined and consistently applied obligations regarding the liberalization of such movements." Although it was understandable that the crisis made the international community think twice before proceeding, it is now time for momentum to be

reestablished. As confidence returns to world markets and financial flows are starting to grow again, new forms of innovation will undoubtedly take place. It is vital that these next stages of integrating global financial markets take place within the framework of "carefully defined and consistently applied obligations" rather than the world having to accept the risks of a return to the piecemeal approach of the past decades.

• *Is there an appropriate role for controls on capital movements during a transition period?* A consensus is emerging that capital controls do not deal effectively with fundamental economic imbalances, although they may be useful in certain circumstances. Controls work best when they are price-based and temporary; it would be illusory to attribute greater value to them. Countries that have found them successful have also simultaneously adopted stronger macroeconomic policies and/or measures to strengthen or restructure the banking sector. These, more than controls, were the key to the observed success.

Areas that need work

Urgent work is still needed in at least three areas.

• *Social issues*. The Asian crisis laid bare the surprisingly underdeveloped state of the formal social welfare systems of the countries affected. The IMF was well aware of the potential for deteriorating employment and social conditions, and the programs it supported were designed to use, to the maximum possible extent, the limited resources available to shelter the most vulnerable. Here, the World Bank took the lead role in helping authorities design the structural policies and social content of the programs.

Existing mechanisms are not enough, however. The Asian crisis has highlighted how important it is for a country to build up its social defenses at the same time it builds up its economic defenses—*before a crisis strikes*. Each country must have a social pillar in its policy framework. Equally, the stability of the international economic system requires that a strong social pillar be an integral part of the architecture.

• *Integration*. Efforts must be redoubled to integrate into the globalized economy those developing countries that are still far from benefiting from globalization. Industrial countries are not doing enough to facilitate this integration by, for example, opening their markets or by extending official development assistance.

• *Institutional evolution*. All institutions, including the IMF, need to evolve in line with the demands of the changing global economy, and all countries need a forum to express their views on decisions of a global character that will shape their destinies.

Japan's reforms are crucial for regional, global recovery

In his remarks at the International Finance Seminar, cohosted by the Japan Center for International Finance and the IMF in Tokyo, Camdessus focused on the implications of international monetary reform for Japan.

Japan's formidable achievements and potential have brought it to a position of leadership and first-rank responsibility in the world economy.

• Japan has strongly advocated increases in the IMF's financial resources to ensure that the IMF could play its essential role in maintaining the stability of the international monetary system.

• Even in a time of economic adversity, Japan has been tenacious in the search for effective solutions to the East Asian crisis and, in the Miyazawa Initiative, is providing an invaluable infusion of support to assist the region's nascent recovery.

• Japan is the world's largest provider of official development assistance, as reflected in its contribution to the IMF's financial support for the poorest countries

The Asian crisis laid bare the surprisingly under-developed state of the formal social welfare systems of the countries affected.

Available on the web (www.imf.org)

Press Information Notices (PINs) are IMF Executive Board assessments of members' economic prospects and policies 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. Recently issued PINs include

99/40 Portugal–Macau, May 7
99/41 Chad, May 14
99/42 Iceland, May 20

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. Recent releases include

São Tomé and Príncipe, Letter of Intent, May 3
Nigeria, Memorandum of Economic and Financial Policies, May 4
Ghana, Letter of Intent and Memorandum of Economic and Financial Policies, May 7

Policy Framework Papers are 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

Ghana, May 5

IMF Staff Papers presents, on a quarterly basis, the research work of the IMF staff. Available now on the web is the most recent issue, March 1999, as well as the four issues published in 1998.

Note: The IMF is revising *A Manual on Government Finance Statistics*. As draft chapters become available, they will be posted on the IMF's website for comment. Currently, drafts of chapters 2 and 3 and a synopsis of the entire manual are available.

of the world and the debt initiative aimed at heavily indebted poor countries.

There is no doubt that Japan's role—extended in a spirit of "responsible cooperative internationalism"—will continue and intensify in the future.

Unfamiliar challenges

In the decade that is drawing to a close, the world's financial markets, spurred by new technologies, have become increasingly integrated and globalized, yet more vulnerable to volatility and economic crisis.

Japan has responded to these global trends, even as it has faced unfamiliar challenges. An economy that for several decades had been a front runner in global economic activity has experienced a prolonged slowdown and stress in the financial sector. And looking ahead, Japan will confront—sooner than any other country—the complex issues raised by a rapidly aging population.

In the latter months of 1998, it seemed that global recession was a very real possibility, and indeed, the word "deflation" had increasingly crept into the vocabulary as a risk—perhaps nowhere more so than in Japan. But, thanks to actions by governments around the world, including Japan, the risk of global recession or deflation has receded.

The immediate challenge for the international community is to restore a more evenly distributed pattern of global growth.

Path for Japan

The task of paramount importance that Japanese policymakers now face is to strengthen Japan's economy and thereby help it play its full part in a multipolar world. Policymakers have already taken steps to provide fiscal and monetary support for the economy and to put in place a comprehensive framework for dealing with banking problems.

In dealing with the immediate problems posed by the current downturn, Japanese analysts and policy formulators have correctly identified two basic needs:

- *Maintaining expansionary fiscal and monetary policies until a recovery is firmly under way.*
- *Following through on the resolution of banking sector problems and building on the tangible progress already made.*

Japan's policymakers have identified the need to move forward vigorously with structural reform to increase the vitality of the economy and to lay the basis for a durable recovery, and the "big bang" of financial sector reform is now well advanced. Some corporations have recently announced impressive restructuring plans. These efforts will be supported and accelerated by pushing ahead with other reforms that have been placed on the agenda: an overhaul of the bankruptcy code to facilitate more rapid workouts of corporate debt; reforms to the tax system to encourage reduction of excess capacity and greater labor mobility; and other measures to improve corporate governance. Japan might well consider approaching the period ahead with the mind-set of achieving another "big bang"—this time of corporate reform through a well-defined strategy.

Policymakers in Japan are also acutely aware that, in looking to the future, the country cannot escape the reality of its aging population. Once recovery has become well established, the Japanese authorities will eventually be able to revert to a program of fiscal consolidation—to return to Japan's instinctive preference for prudent fiscal policy. To facilitate this consolidation, it would be desirable to move ahead immediately to put some of the key building blocks in place. Such efforts could focus on overhauling social protection and pension systems, strengthening project selection and implementation procedures for public investment, and restructuring the public administration.

As the end of the century approaches, many challenges confront the international community, the IMF, and Japan. In certain respects, the domestic debate on Japanese economic policy and the international debate on global financial reform are at similar stages: many actions have been initiated, consensus has yet to emerge in a number of others, but a clear need is evident for determined implementation of the decisions that have already been made. In the not-too-distant future, as Japan once again creates the conditions that enable it to draw on its strengths—saving investment, product quality, and technical innovation—Japan is likely to regain its accustomed position as an engine of growth for Asia and the world economy.

What is in prospect is a new model of higher-quality growth solidly rooted in Asian traditions and values.

Higher-quality growth is rooted in Asian tradition

Addressing the thirty-fourth Southeast Asian Central Bank Governors' conference, in Seoul, Korea, Camdessus focused on sustaining Asia's recovery from the recent crisis.

Asia is now emerging from the crisis that engulfed the region just under two years ago, surprising most governments, citizens, investors, and institutions with how rapidly it spread and how severely it affected a number of countries.

Economic prospects

The countries at the heart of the crisis are close to or even past the turning point in their economic activity. Most clearly in Korea, the Philippines, and increasingly in Thailand, there are signs of an upturn in activity. In Indonesia, where it took rather longer for financial stabilization to take hold, economic activity is expected to pick up in the second half of the year. What has made this possible? Once the countries had resolved firmly to strive for financial stabilization, supported by the external financing packages put together by the IMF,

prospects improved dramatically. Stability in foreign exchange markets allowed monetary policy to be eased appreciably. Fiscal policy was relaxed both to stimulate economic growth and, simultaneously, to allow for adequate major expansions in social spending, especially on social safety nets. Tangible evidence of reviving domestic and international confidence can now be seen in the sharp rebounds in equity markets throughout the region in the early months of 1999. But much remains to be done in strengthening the structures of the Asian economies before it can be confidently said that a truly sustained recovery has begun.

International financial reform

Whether this tentative recovery can be extended into a new era of high-quality global growth, in which Asia once again plays a dynamic, leading role, will depend not just on skillful macroeconomic management but also on whether the international community can advance quickly enough with the challenge on which it has embarked to overhaul the architecture of the international financial and monetary system. A strong consensus has emerged during the past six months on many specific aspects of the major building blocks of this architecture:

• Approval of the IMF's *Contingent Credit Lines*, which will make precautionary financing available to countries whose economies are fundamentally sound and well managed, but whose access to capital markets is threatened by the potential effects of contagion.

• Considerable headway in the debate on how to involve the *private sector in forestalling and resolving crises*.

• New standards defined, and existing ones refined, in *transparency, standards, and IMF surveillance*.

• In the critical area of *financial sector strengthening*, active use of the Basle Core Principles to assess banking systems and numerous recommendations for better supervision.

In addition, five other general themes have informed the work planned in the coming months: exchange rate arrangements, integration of international financial markets, social policy, debt relief, and adaptation of international institutions to the new challenges posed by globalization.

Reform in Asia rooted in tradition

What would be the effect of applying these principles in Asia, after the full implementation of their own national reform programs? Few observers doubt Asia's potential to return to rapid growth. What is in prospect, however, is not just a return to the successful trends of the past but a new model of higher-quality growth solidly rooted in Asian traditions and values.

• *Independent, competitive private sector*. Weak corporate governance was a serious flaw in many Asian economies. In the near term, given that many corporations are suffering intense liquidity or solvency strains, a priority is to press ahead with corporate debt workouts to establish viable corporations on a sound financial footing. At the same time, governments need to design longer-term strategies to bolster the private sector by phasing out direct state ownership; encouraging foreign involvement in the economy, especially in the financial sector; establishing clear legal frameworks that promote competition and expose companies to bankruptcy; and introducing international standards of accounting and auditing.

• *High standards of public governance and transparency*. If corporate governance is one side of the coin, this is the other. An arm's-length relationship between the government and corporate sectors is essential. The international standards for transparent policy formulation and data dissemination now under preparation will also enhance public sector credibility.

• *Financial system reform*. Financial system weakness was one of the central flaws in the emerging markets crisis. Authorities throughout the region need to give the highest priority to completing the task of reforming the financial sector with sound regulatory and supervisory structures.

• *Progress toward open capital markets*. Strengthening the financial system is an essential precondition for liberalizing capital markets. Also, policymakers should not allow the easing of controls on longer-term flows, especially of direct investment, to lag behind the liberalization of short-term flows.

• *Enhanced social welfare and protection*. The absence of formal social safety nets placed too heavy a burden on the protection provided by the extended family, and many people descended into poverty as the recession deepened. The severity of the crisis has demonstrated that the contribution by the family and by community solidarity has to be complemented by social security systems able to stand the test of major systemic crisis in the context of IMF-supported programs.

Asia's strong traditional values can contribute to high-quality growth in at least three ways:

• clear acceptance of *open competition* as a condition for progress;

• genuine consensus in seeing *sound macroeconomic policies* as a key for success; and

• the importance attached to *saving in private and public finances*.

As recovery resumes, strong macroeconomic conditions and institutional requirements will foster continued strong saving, and this will be all the more desirable, since it is likely that foreign resources may be more constrained and more expensive than in the past, as foreign investors' risk aversion has increased as a result of the crisis. This makes an even stronger case for efficiency gains promoted through a competitive environment and a culture that seeks lasting progress by adopting the most promising technology. ■

Korean response

Comprehensive program, structural measures have helped spur recovery from crisis

In the following interview, Tomás J.T. Baliño and Angel Ubide, authors of IMF Working Paper No. 99/28, The Korean Financial Crisis of 1997—A Strategy of Financial Sector Reform, *discuss Korea's response to the crisis and the lessons it offers for other countries.*

IMF SURVEY: *How would you characterize Korea's financial sector on the eve of the Asian crisis?*

BALIÑO: On the positive side, Korea had a fairly well developed financial system with a large number of institutions offering practically all the services found in developed countries. The system's total assets were equivalent to about three times the country's GDP. But the system also had quite a few weaknesses. It was not very well managed, it was undercapitalized, and it lacked proper risk assessment. Korea's industrial system had been created on the basis of government directives, with the financial system designed to provide the necessary wherewithal. The government traditionally intervened in credit decisions, and banking supervision and regulation were weak. Korea had very capable supervisors, but the system was not geared to monitor the types of risks you have in a developed financial system. All of these factors were further complicated by the system's heavy reliance on short-term capital from abroad.

Baliño: Korea's program was heavily criticized for raising interest rates, but if interest rate spikes last for only a short period, they are not going to drive an enterprise bankrupt and they can help stem capital flight.

IMF SURVEY: *The country's macroeconomic indicators seemed to provide little warning of an impending crisis. What specifically triggered the crisis in Korea?*

UBIDE: The macroeconomic indicators were not flashing any major red lights, and the absence of this warning was one reason for the crisis. Good macroeconomic indicators obscured market perceptions of some of the structural weaknesses. As early as 1996, however, there were signs of difficulties. A deterioration in the terms of trade started creating problems for Korean enterprises and lowered profits. Then, at the beginning of 1997, several major chaebols [large conglomerates] went bankrupt. For the markets, this served notice that the government was no longer ready to save these corporations. In addition, the balance sheets of commercial banks began to deteriorate.

In the course of 1997, the crisis in Thailand and the crash of the Hong Kong SAR stock exchange prompted foreign investors to look at the Korean economy more closely. All of these developments caused a drop in confidence that prompted the reversal in capital inflows.

IMF SURVEY: *How did Korea then respond to the crisis? What key measures did it take?*

BALIÑO: Initially, there was some delay in recognizing the crisis. Some time was lost trying to see if things would improve on their own. Also, the crisis coincided with a national election. But despite the difficult political timing, Korea did manage to put together a program that, in retrospect, was quite well designed and comprehensive—something that may explain why Korea's turnaround has been faster than anticipated. In the short run, the authorities managed to stabilize the funding of banks and of the economy. They gave a blanket guarantee to depositors and sought finance from the IMF, the World Bank, and other international and bilateral sources. And they started negotiations with creditors.

Things started to calm down, and the won began to appreciate, after a successful renegotiation of the short-term foreign debt in early 1998. That was an important step, but fortunately the response to the crisis did not stop there. There was also a program of macroeconomic adjustment. The authorities encouraged people to keep their funds in Korea and stemmed capital outflows by increasing interest rates. Korea's program was heavily criticized for raising interest rates, because some feared this would create problems for the enterprises. To some extent it did, but if interest rate spikes last for only a short period, they are not going to drive an enterprise bankrupt and they can help stem capital flight. Korea also allowed the exchange rate to float after having tried to keep it within a band—an important adjustment.

A key part of the program was measures to address the roots of the problem—the structural weaknesses that had developed over the years and were, in fact, part of a deliberate policy. Major reforms were the strengthening of banking supervision and the restructuring of the financial system. Korea created a consolidated supervisory agency, which was also put in charge of the financial sector restructuring. The authorities started to close down nonviable institutions and recapitalize and restructure the others. In another important step, the authorities began to tackle the problems of the corporate sector, which was much more highly leveraged than in any other OECD [Organization for Economic Cooperation and Development] country.

Looking back, the biggest strength of the program was its comprehensiveness. It took a long-term view as well as addressing immediate problems. Important first

steps were taken to improve transparency and corporate governance, including measures to address cross guarantees among enterprises.

IMF Survey: *Korea avoided the bank runs that have characterized other Asian crisis countries. How did it manage to maintain public confidence in its banking system?*

Ubide: Korea made a very important move at the beginning of the crisis. With the idea of instilling confidence in depositors and foreign investors, it extended a blanket guarantee to almost all deposits of the banking sector. The authorities also announced publicly a guarantee for foreign liabilities of the financial system. They basically decided to insure the stability of the financial system while they reformed it. This gave depositors and foreign investors a lot of security and gave the authorities some room to devise a plan. They could then close several merchant banks and two major commercial banks and reform the supervisory system while depositors and foreign investors remained more or less calm. The second key step was the renegotiation of the foreign debt. That gave Korea a lot of breathing space to close ailing banks and deal with the process of reconstructing the financial system.

Finally, the Koreans made many other decisions. Within a month or so, all the major building blocks of the program were in place. Half of the country's merchant banks had been closed; major commercial banks that were in trouble had at least begun to present reform programs; and major supervisory issues were being dealt with. The authorities took bold and swift action from the very beginning, and the markets found these actions credible.

IMF Survey: *What began as a currency attack in Korea ultimately affected monetary policy and the real sector. How did the country manage to contain the damage in these sectors?*

Ubide: In a crisis of this magnitude, it's clear some damage will be done. But Korea did manage to contain it for two major reasons.

First, Korea managed to avoid a sharp monetary expansion that would later have translated into higher inflation. Korea did not have to provide much liquidity support to the banks, and when it did so, it was sterilized more or less successfully. Korea experienced no major bank runs, and thus banks did not need a lot of money to pay back depositors.

Also, a part of the government's intervention program was to purchase nonperforming loans from the banks and place them in a specialized agency. The authorities paid for these nonperforming loans with bonds rather than cash. Rather than sell these bonds to obtain cash and lend to the public—something that would have resulted in an increase in the money supply—the banks decided to hold the bonds, which were perceived as safer and thus more attractive at the time. Together these measures avoided an explosion of monetary aggregates—something that often happens in major banking crises.

In terms of the impact on the real economy, there is the question of whether a credit crunch follows a banking crisis. Banks do have to adjust their portfolios, but in Korea the recapitalization needs were phased in, so that banks did not have to sharply cut lending to adjust to the capitalization requirements. They were able to adjust their portfolios gradually and thus avoid a major reduction in lending.

Ubide: Korea made a very important move at the beginning of the crisis. To instill confidence, it extended a blanket guarantee to almost all deposits.

In addition, the government provided public funds for recapitalization, thus easing that process. And it put in place specific devices to help those in the economy that were suffering the most—namely, small and medium enterprises and exporters. The authorities provided funds through a discount window especially for small and medium enterprises, gave some government guarantees for these enterprises, and also encouraged export financing. In doing so, they alleviated the credit crunch that results when lenders are too afraid to lend, even to trustworthy clients.

IMF Survey: *Did Korea learn from earlier problems in crisis countries or were the authorities more fortunate in their policies or resources?*

Baliño: There was little, if any, time to learn from the other crises in Asia. Everything happened so quickly. But bank runs are as old as banks. There were quite a few things that someone who had looked at these problems could have anticipated. And the Koreans already had a plan to reform their financial system. A presidential commission some years earlier had looked at the structure of the financial system and recommended strengthening the Bank of Korea and setting up a separate financial supervisory agency, for example. But a lot of the steps that must be taken in a crisis are painful. They are difficult to accomplish in a democratic society unless there is a full-blown crisis that forces you to do it. Look at the U.S. savings and loan difficulties.

Ubide: In addition, Korea already had in place some of the instruments to deal with a crisis. The country had, for example, a working bankruptcy law. In contrast, Indonesia had to redraft its bankruptcy laws in the middle of the crisis. In some aspects, the infrastructure to deal with a crisis was more firmly in place in Korea than in some other countries.

Baliño: Korea also had the advantage of having very well trained civil service and banking officials. There was no lack of technical expertise; it was chiefly a mat-

ter of changing some policies, and those changes required quite tough measures.

IMF Survey: *Are there lessons for other countries from Korea's experience?*

Baliño: Clearly, it's always best to avoid a crisis. Capital mobility can be beneficial, but there are also risks that have to be taken into account. In Korea, the heavy dependence of the corporate sector on short-term external finance and the very high debt-equity ratios were dangerous; they left the country vulnerable to a sudden change in market sentiment. Obviously, too, government interference with credit decisions is risky, because if these loans go sour, the government cannot ignore the problem. It has to address it. Also, hiding problems doesn't help. Had Korea's financial system been more transparent, the market and the regulatory agencies may not have prevented the crisis but would at least have helped ensure that it was a smaller crisis that could have been dealt with earlier.

A country also needs a professional banking supervision institution that truly focuses on prudential issues. In Korea and in many other countries, the "supervisory" agencies were also charged with trying to develop the economy—or even trying to develop the financial system. As a consequence, the potential for conflict of interest was very high.

There are lessons, too, on how to address problems once they materialize. Expecting problems to sort themselves out when the economy improves is a risky strategy. It is more likely that financial institutions will dig themselves deeper into a hole, and it will become more costly to extract them. And when you have a truly systemic crisis like Korea, sometimes a blanket guarantee for deposits can help stabilize the situation until you can address the core problems.

Also, expect eventual costs to exceed original estimates. Banks may report a certain amount of nonperforming loans, but when you examine the data and look at the credit files, you will almost always find the problems are more extensive. So, be prepared to pay a significant amount of money. Here, Korea had an advantage. Its solid macroeconomic situation allowed it to rehabilitate its financial system without creating a huge debt problem. And looking forward, develop the best possible financial supervision and regulation you can, meet international standards, and avoid institutions being created to circumvent regulations.

IMF Survey: *Can the momentum for structural reform be sustained now that capital is flowing back to Korea?*

Baliño: In Korea and other countries, there could be a degree of complacency as the crisis abates. People may think they have done a lot and now it's time to relax. Some people, of course, stop taking their antibiotics as soon as they feel better. The great risk is that they will fall ill again. But many of the steps Korea has taken are irreversible. Structural reforms are going to be the lasting legacy of this crisis. There are going to be an independent supervisory agency, more transparent financial statements, and a market keeping an eye on what goes on. The Koreans know, like everyone else, that a lot of these capital flows are coming back because Korea is seen as a country undertaking serious reform. This crisis has demonstrated that capital can flow out again if the market sees conditions deteriorate.

Many of the steps Korea has taken are irreversible. Structural reforms are going to be the lasting legacy of this crisis.

Over the next year, Korea will implement more rigorous standards for loan classification, which will force banks to be better capitalized. And Korea will be affected by changes in the international environment. There is more international pressure for greater disclosure of information and a stronger recognition of the importance of strong banking supervision and regulatory agencies. As a result of this and earlier crises, investors are looking at countries more carefully. The fact that an OECD country like Korea—the eleventh largest economy in the world—would be on the brink of default has been a wake-up call for everyone.

But it is also clear that these reforms are difficult. Progress in the corporate sector has been slower than in the financial sector, though some financial sector reforms are putting pressure on the corporate sector. There are entrenched interests and the economy has to keep producing, so reforms such as corporate restructuring cannot be done overnight or even in a year or two. It will take time. But the Korean people are sensitized to this problem. This crisis was a painful one for them, not only in terms of lost output but also in terms of how Korea is perceived vis-à-vis the rest of the world. I think they will be careful to avoid a repetition of this crisis. ■

Copies of IMF Working Paper No. 99/28, *The Korean Financial Crisis of 1997—A Strategy of Financial Sector Reform*, by Tomás J.T. Baliño and Angel Ubide, are available for $7.00 from IMF Publication Services. See page 170 for ordering information.

Selected IMF rates

Week beginning	SDR interest rate	Rate of remuneration	Rate of charge
May 10	3.32	3.32	3.77
May 17	3.34	3.34	3.80

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 January 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

Conference participants discuss financial reform

(Continued from front page) University addressed an issue crucial to all the countries affected by the crises of recent years—that of short-term capital flows. After studying the relationship between the size of crises and that of countries' short-term debt, they found that the ratio of short-term debt to international reserves was very high in all the crisis countries except Malaysia. Few analysts doubt that the large exposure to short-term debt left East Asian countries vulnerable to sudden changes in market sentiment and market panic. Even though there is growing agreement on this relationship, Rodrik and Velasco said, there has hitherto been relatively little theoretical and empirical work linking short-term debt, vulnerability, and crises. In their paper, they constructed a model of the simultaneous determination of debt maturity and the term structure of interest rates. From this, they concluded that policymakers should keep an alert eye on both debt composition and the ratio of short-term liabilities to available liquid assets. The authors then considered ways in which illiquidity might be avoided.

Joseph E. Stiglitz, the World Bank's Chief Economist, and Amar Bhattacharya, Senior Adviser in the Bank, placed the debate on a stable and equitable global financial system in a broader perspective. They focused on five key issues: the importance of improving transparency and disclosure, the need to reduce incentives that encourage excessive borrowing, the role of liquidity, ways to deal with recurrent financial crises, and the importance of strengthening social safety nets.

Dani Rodrik

Historically, the responses to financial crises sought to address small shocks rather than major crises, and, as a consequence, they have been inadequate. Many of the crises were the result of market failures and irrationalities in the broader sense, and policy responses must therefore take these deviations from simplistic free-market models into account, Stiglitz said.

It follows that government has an important role in developing standards and promoting transparency and in ensuring that the release of information is comprehensive. Every country needs to have bankruptcy laws; the question is not whether there should be such regulations, but rather what form they should take, he said.

Social issues

In the keynote address opening a session on social issues in development, Lawrence Summers—recently nominated U.S. Secretary of the Treasury—described some of the political and economic lessons he had learned since entering government and suggested areas in which further work needed to be done to improve the resolution of economic and financial crises in developing countries. He began by asking how global integration could be reconciled with other crucial objectives, noting that the three imperatives in making decisions to resolve economic and financial crises were obtaining the benefits that integration brought (through increased trade and investment), respecting national sovereignty, and pursuing public purpose (to compensate for market failures).

Lawrence Summers

Summers noted that some observers on the political or economic right had little trouble reconciling all three, because they deemphasized the third imperative and advocated minimal government. Global visionaries on the left also found reconciliation easy to achieve, because they were convinced that national sovereignty should not be allowed to stand in the way of increased national and global regulation. Thoughtful people in the middle of the political spectrum, including those charged with developing policies to resolve economic and financial crises in developing countries, had considerably more trouble effecting a resolution. They faced a complex set of trade-offs rather than clear precedents and had to make difficult judgments without either adequate background information or much time for reflection.

He observed that one problem policymakers faced was how to encourage policy regimes in developing countries that would "discourage inappropriate encouragement of short-term capital." Capital controls, such as those that Chile had recently used, were one policy option, but Summers cautioned that in some developing countries, "short-term capital is the only kind you [national authorities and domestically owned firms] can get." Summers suggested that institutional arrangements should be developed to provide developing countries with the longer-term capital flows they needed to emerge from crises and achieve sustainable growth. He also called for sharper thinking by international financial institutions and other aid providers about how the frequently cited objective of providing adequate social safety nets could best be achieved.

Transition economies

In his keynote address on transition economies, Joseph Stiglitz said that a decade ago many transition countries in Central and Eastern Europe had been regarded as being "on the cusp of success," but their future remains bleak today, with Estonia, Hungary, Poland, and Slovenia being the notable exceptions. Russia had done particularly badly; in an apparent contradiction of the laws of economics, it registered simultaneous output declines and increasing inequality of incomes. As a result, the number of Russians living in poverty soared from 2 mil-

lion at the start of the transition to 66 million. In stark contrast, China has achieved great success in both economic development and in making the transition from central planning to a market-oriented economy.

Stiglitz noted that early in the transition, Eastern and Central Europe and the countries of the former Soviet Union had placed excessive reliance on "textbook economics" and too little on the political and economic environments in which transition was to take place. There had been a strong political imperative for transition economies to move quickly on reform to prevent their slipping back toward communism, and this had led to hasty and poorly conceived privatization and restructuring efforts. He observed that experience had now made it painfully clear that privatization alone could not create a market. Restructuring efforts that threw large numbers of people out of work had failed to generate new manufacturing and service sector investment and thereby to create large numbers of new jobs. Economist Joseph Schumpeter's notion of "creative destruction" did not seem to apply to many transition countries, and creating new enterprises capable of achieving high productivity and sustainability proved to be quite difficult.

Joseph Stiglitz

Stiglitz said that privatization in the absence of a reliable regulatory environment had led to asset stripping in transition economies, particularly those with open capital markets that facilitated transfers of capital abroad. The need for better corporate governance was particularly acute, since transition's "institutional blitzkrieg" approach had destroyed the old forms of social capital in these countries without creating new ones. In China, by contrast, the stakeholder privatization of state-owned enterprises—dividing them into smaller, yet functional business units—had worked rather well, and corporate governance had been much less problematic.

Stanley Fischer, First Deputy Managing Director of the IMF, and William Easterly of the World Bank presented a joint paper, "Inflation and the Poor," in which they investigated attitudes toward inflation. Using data from a 1995 survey of 38,000 respondents in 42 countries and applying regression techniques, the authors reached several tentative conclusions regarding prevailing views on various economic concerns. They concluded that inflation hurts the poor more than people with higher incomes and that economically disadvantaged people—the poor, the uneducated, and unskilled workers—were more likely to mention inflation as one of their "top concerns" than those with more advantages. Fischer and Easterly also concluded that high inflation tended to lower the income share of the bottom 20 percent of a country's population and the real minimum wage, while tending to increase poverty. They stated that the results outlined in their paper "present further indirect and direct evidence that the poor suffer more from inflation than the rich." ■

Paul Gleason
Assistant Editor, IMF External Relations Department

Copies of most of the papers presented at the conference and related materials are available on the World Bank's website: www.worldbank.org/research/abcde.

Recent publications

Books

Economic Policy and Equity, edited by Vito Tanzi, Ke-young Chu, and Sanjeev Gupta ($27.00)

Transforming Financial Systems in the Baltics, Russia, and Other Countries of the Former Soviet Union, edited by Malcolm Knight, Arne B. Petersen, and Robert T. Price ($24.50)

IMF Staff Papers

IMF Staff Papers, Vol. 46, No. 1 (March 1999) ($54.00 for four issues; $27.00, academic rate).

Working Papers ($7.00)

99/48: *The Egyptian Stock Market: Efficiency Tests and Volatility Effects,* Mauro Mecagni and Maged Shawky Sourial

99/49: *Algeria: The Real Exchange Rate, Export Diversification, and Trade Protection*, Piritta Sorsa

99/50: *Long-Range Exchange Rate Dynamics: A Panel Data Study*, Karl F. Habermeier and Mario Mesquita

Policy Discussion Papers ($7.00)

99/3: *The Role of the Currency Board in Bulgaria's Stabilization*, Anne-Marie Gulde (see pp. 171–172)

IMF Staff Country Reports ($15.00)

99/27: Hungary—Selected Issues

99/28: Samoa—Statistical Appendix

99/29: San Marino—Recent Economic Developments

99/30: Switzerland—Selected Issues and Statistical Appendix

99/31: Kyrgyz Republic—Recent Economic Developments

99/32: Republic of Poland—Selected Issues

99/33: Cambodia—Statistical Annex

Publications are available from IMF Publication Services, Box XS900, IMF, Washington, DC 20431 U.S.A. Telephone: (202) 623-7430; fax: (202) 623-7201; e-mail: publications@imf.org.

For information on the IMF on the Internet—including the full texts of the English edition of the *IMF Survey*, the *IMF Survey*'s annual *Supplement on the IMF*, *Finance & Development*, an updated *IMF Publications Catalog*, and daily SDR exchange rates of 45 currencies—please visit the IMF's website (www.imf.org). The full texts of all Working Papers and Policy Discussion Papers are also available on the IMF's website.

Bulgarian experience

Currency boards can play useful role in economic stabilization effort

On July 1, 1997, the Bulgarian authorities introduced a currency board as part of a stabilization effort aimed at quelling the economic turmoil of the past several years and runaway inflation. In a recent study, The Role of the Currency Board in Bulgaria's Stabilization, *Anne-Marie Gulde of the IMF's Monetary and Exchange Affairs Department discusses the process leading to the choice of a currency board as a stabilization instrument, its design and implementation, and the lessons to be drawn from its relative success.*

Background and initial conditions

In late 1996, Bulgaria was in the midst of a banking crisis that had been smoldering since at least 1995. Traditional stabilization programs had been unable to stem the high fiscal and quasi-fiscal deficits, and the country was entering a period of hyperinflation. Support for the government was slipping in the wake of the failure of the most recent stabilization effort in July 1996.

Fueled by liquidity injections to support the weakening banking system, continued central bank financing of the budget deficit, and faltering confidence in the Bulgarian currency (the lev), inflation soared to an annual rate of almost 500 percent in January 1997 and more than 2,000 percent in March. Moreover, in an effort to soften the fall of the exchange rate—which depreciated from lev 487 to lev 1,588 per U.S. dollar in the first quarter of 1997—the central bank had depleted its international reserves to the equivalent of less than two months of imports. Real output, which had grown in 1994 and 1995, fell by more than 10 percent during 1996.

Structural problems, especially in the banking sector, were severe. Gulde cites a review undertaken in 1996 that found that out of 10 state banks accounting for more than 80 percent of banking sector assets, 9 had negative capital, and more than half of all state banks' assets were nonperforming.

By late September 1996, about one-third of the Bulgarian banking sector had been closed down as the result of two rounds of interventions and closures by the Bulgarian National Bank (the central bank). At the time of the September closures, the Bulgarian National Bank announced that the remaining financial institutions would remain open. Thereafter, the central bank reacted to the intensification of banking sector problems by continuing to inject liquidity into the system, thus further fueling inflation. By the end of the year, according to Gulde, the banking sector remained—at best—in a state of "fragile stability."

New stabilization approach

According to Gulde, the perception was developing that a renewed stabilization attempt—if it was to be credible—would require a visible, rule-based system, such as a currency board (see box, below). In addition, stabilization would be successful only if it prevented financial indiscipline, reduced the government's overwhelming interest rate burden, and increased the attractiveness of the lev. Any dramatic change in policy, moreover, would require a high degree of official ownership of reform programs and widespread public support.

Against this background, an IMF mission in November 1996 initiated discussions with the Bulgarian authorities and major interest groups on the merits of a currency board. Given the complexity of the issues involved and the ongoing political problems, the decision, design, and preparation phases were protracted, Gulde notes, lasting from November 1996 through mid-1997. The preparation included supporting measures, in particular, a strengthening of the supervisory capabilities of the central bank.

In addition to the supporting policy measures, the near hyperinflation of late 1996 and early 1997—although costly—was crucial for the eventual viability of the currency board. It reduced the real value of the domestic debt

What is a currency board?

A currency board permits a country to pursue a visible anti-inflationary policy. It combines three elements:

- a fixed exchange rate to an "anchor currency";
- automatic convertibility—or the right to exchange domestic currency at this fixed rate whenever desired; and
- a long-term commitment to the system, often set out directly in the central bank law.

A currency board can be credible only if the central bank holds enough official foreign exchange reserves to at least cover its monetary liabilities. In this way, financial markets and the public can be assured that every domestic currency bill is backed by an equivalent amount of foreign currency in the official coffers. Demand for a "currency board currency" will therefore be higher than for currencies without a guarantee. In case of disturbances, the adjustment mechanism works through changes in money supply within the currency board country—a contraction in the case of flight into the anchor currency—that will lead to interest rate changes that will, in turn, induce a move of funds between the domestic and the anchor currency. The exchange rate guarantee implied in the currency board rules ensures that the necessary interest rate changes and the attendant costs for the economy will be lower than they would be under a fixed exchange rate.

The Bulgarian experience highlights the ability of a credible rule-based system to bring about rapidly changing perceptions and economic behavior.

overhang, which had initially been a threat to a balanced budget, negating the need for recourse to the central bank. The high inflation also gave banks some breathing space by rapidly devaluing the size of their domestic currency liabilities and increasing the real value of their holdings of dollar-denominated government bonds.

Design and implementation

The key features of a currency board that need to be decided upon at the beginning of the planning process are the peg currency, the exchange rate level, the currency board's organizational structure, and the exact operating principles and instruments. In the Bulgarian case, Gulde notes, these issues were all debated at some length.

Anchor currency. Heated discussions between proponents of the U.S. dollar and the deutsche mark delayed a final decision until late spring of 1997 when a government-appointed committee of experts made the final decision in favor of the deutsche mark (and the euro after the deutsche mark entered the European Economic and Monetary Union).

Exchange rate level. The level of the exchange rate—lev 1,000 per DM 1—was officially decided on June 5, 1997. This was close to the market rate that prevailed at that time.

Organizational structure. To impart the greatest possible transparency to the organization of the currency board, the Bulgarian policymakers adopted the "Bank of England model." This involved the reorganization of the Bulgarian National Bank into an issue department and a separate banking department. The issue department holds all the bank's monetary liabilities, including deposits of the banking department. These liabilities are backed by assets in foreign exchange and gold, which cover at least the full value of the liabilities at all times.

A separate banking department was set up to provide the currency board with "excess coverage"—that is, more foreign exchange than was needed to cover the central bank's monetary liabilities. These funds are kept as the banking department's deposit with the issue department and can be used to make collateralized loans to commercial banks in the case of an acute liability crisis. The full accounts, including of the issue and banking departments, are published monthly.

Legal basis. The existing central bank law was changed to provide an adequate legal basis for the new arrangement. The new legislation, which became effective on July 1, 1997, contains key provisions on structure and management, operations and monetary functions, and relations between the Bulgarian National Bank and the state.

Stabilizing framework. Recognizing that a change in the law would not by itself gain credibility for the currency board, the authorities adopted measures to address the most likely "stress factors." To avoid large-scale monetary financing of the budget, the plan included a fiscal reserve account and tight fiscal rules.

To increase credibility in the banking system, the currency board plan allowed the option of limited, yet sizable, assistance through the banking department, in an amount of $300 million (equal to about one-fifth of Bulgaria's foreign reserves at the inception of the currency board). In addition, the banking law was strengthened, giving the central bank more clearly established rights in dealing with problem banks. The program also included important adjustments to relevant prudential regulations, complemented by a major technical assistance program to enhance banking supervision. Finally, under the stabilization program, the authorities recapitalized one large state bank before moving to the currency board and pledged to renew efforts to privatize the remaining state banks.

Lessons from Bulgaria

The introduction of the Bulgarian currency board, on July 1, 1997, went smoothly and, according to Gulde, has proceeded with virtually no attempts to "test the system." Under the currency board, inflation fell to 13 percent in mid-1998 and further to 1 percent by the end of the year. Reserves recovered to more than $3 billion (equivalent to nearly 6.4 months of imports) from less than $800 million. The central bank's basic interest rate, which had been above 200 percent at the height of the banking crisis, fell to 5.3 percent in October 1998. Notwithstanding its close economic ties with Russia, Bulgaria's stabilization process was not significantly disrupted by the Russian crisis in mid-1998.

The Bulgarian experience highlights the ability of a credible rule-based system to bring about rapidly changing perceptions and economic behavior. Nevertheless, Gulde concludes, the experience underscores three cautionary lessons:

- A currency board is a simple monetary arrangement, but it requires more and different preparations than other types of stabilization programs. Since the changes required can be time-consuming, such an arrangement may not be possible when other preconditions have not been fulfilled.
- Because legal changes are involved, a currency board requires broad legislative support. In Bulgaria, such support was generated by near hyperinflation, which focused attention on the need for a "radical" solution, as well as a determined consensus-building effort.
- A currency board is only one element of a stabilization program. While it can help eliminate macroeconomic imbalances, its long-term effectiveness depends equally on the successful implementation of appropriately designed supporting measures. ■

Copies of IMF Policy Discussion Paper (PDP) 99/3, *The Role of the Currency Board in Bulgaria's Stabilization*, by Anne-Marie Gulde, are available for $7.00 each from IMF Publication Services. See page 170 for ordering information.

Press releases

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

Ghana: ESAF

The IMF has approved a three-year loan for Ghana under the Enhanced Structural Adjustment Facility (ESAF), equivalent to SDR 155 million (about $209.4 million) to support the government's economic reform program for 1999–2001. The loan will be disbursed in seven installments—the first equivalent to SDR 22.2 million (about $29.9 million) and available immediately.

Medium-term strategy and 1999 program

The main objectives of the 1999–2001 program are to consolidate the achievements already made in macroeconomic stability and accelerate the pace of structural reform. Real GDP growth is projected to increase to 6 percent. The government intends to bring inflation down to 5 percent or less; reduce the current account deficit, including grants, to 2.5 percent of GDP; and bring gross official reserves to the equivalent of three months of imports.

The objectives of the 1999 program are to obtain real GDP growth of 5.5 percent, end-of-period inflation of 9 percent, an external current account deficit, including grants, of about 2.5 percent of GDP, and gross official reserves equivalent to three months of imports. To achieve these objectives, domestic budget financing will be limited to about 2.8 percent of GDP, and the primary domestic balance is expected to show a surplus of about 3.5 percent of GDP. Monetary growth in 1999 will support the inflation and balance of payments objectives.

Structural reforms

Ghana intends to take significant steps to liberalize the cocoa and energy sectors, accelerate the divestiture of state enterprises, and strengthen the banking system. Public sector reforms will be carried out to limit the scope of government to core areas, in particular, agriculture, the social sectors, and basic infrastructure.

Addressing social needs

Ghana's economic program emphasizes education and health, since the government believes the levels of growth required to reduce poverty will be difficult to achieve without significant increases in labor productivity. Expenditure programs have been designed for education and health and are being implemented with donor support. A national poverty-reduction plan for 1999–2001 is being prepared in collaboration with donors.

Members' use of IMF credit
(million SDRs)

	Apr. 1999	Jan.– Apr. 1999	Jan.– Apr. 1998
General Resources Account	**3,962.10**	**5,024.23**	**4,196.32**
Stand-By Arrangements	3,917.34	4,013.32	3,243.77
SRF	3,636.09	3,636.09	3,000.00
EFF Arrangements	10.66	567.79	952.55
CCFF	34.10	443.12	0.00
ESAF Arrangements	**122.87**	**330.51**	**400.94**
Total	4,084.97	5,354.74	4,597.26

Note: SRF = Supplemental Reserve Facility
EFF = Extended Fund Facility
CCFF = Compensatory and Contingency Financing Facility
ESAF = Enhanced Structural Adjustment Facility
Figures may not add to totals shown owing to rounding.

Data: IMF Treasurer's Department

Ghana: selected economic and financial indicators

	1996	1997	1998 Program	1998 Preliminary	1999[1]	2000[1]	2001[1]
	(annual percent change)						
Real GDP	4.6	4.2	5.6	4.6	5.5	6.0	6.0
Consumer price index (annual average)	46.6	27.9	15.5	19.3	10.0	6.4	5.0
	(percent of GDP)						
Domestic primary balance	0.3	3.2	3.8	3.6	3.5	3.6	3.7
Current account balance (including official grants)	–4.7	–8.8	–4.2	–3.5	–2.9	–2.5	–2.4
	(months of imports)						
Gross international reserves	4.4	2.6	2.7	2.5	2.7	2.8	3.0

[1]Program.

Data: Ghanaian authorities and IMF staff estimates and projections

Ghana joined the IMF on September 20, 1957. Its quota is SDR 369.0 million (about $498.6 million), and its outstanding use of IMF resources currently totals SDR 230.1 million (about $310.9 million) at end-February 1999.

Press Release No. 99/16, May 3

Guyana: HIPC

The IMF and the World Bank agreed that Guyana has met the requirements to receive about $410 million in nominal debt-service relief from its external creditors under the Heavily Indebted Poor Countries (HIPC) Initiative. Of this amount, about $40 million (equivalent to $34.5 million in net present value terms) will be provided by the IMF. The decision on debt relief has the support of the Inter-American Development Bank (IDB), Guyana's largest external creditor.

Guyana reached its completion point under the initiative on May 14. In net present value terms, relief from all of Guyana's creditors will be worth about $256 million, equivalent to 24 percent of total debt outstanding at the end of 1998. This assistance under the HIPC Initiative will reduce the external debt burden, free budgetary resources, and allow Guyana to deepen its development efforts.

The IMF assistance will take the form of a grant deposited into an escrow account to be used to cover part of the debt service falling due to the IMF. This will cover about 26 percent of Guyana's annual debt service to the IMF on average over the next nine years. All other multilateral and Paris Club creditors of Guyana have provided satisfactory assurances of their participation in that package.

Since the HIPC Initiative was approved in September 1996, seven countries have qualified for exceptional assistance. Total nominal debt-service savings are projected at about $6 billion for these countries. Assistance to Uganda, Bolivia, and Guyana—the first three countries that have so far obtained debt relief under the initiative—amounts to about $1.8 billion in nominal terms.

In the case of Guyana, the substantial resources released from debt servicing under the HIPC Initiative amount to about 3½ percent of GDP (10 percent of public sector revenue) on average a year during 1999–2003 and 2 percent of GDP (5½ percent of public sector revenue) during 2004–09. This will provide room for additional expenditures in social and poverty-alleviation areas, which will help the government in its efforts to halve the number of people in poverty by 2015.

Following a mid-term review of the first year of the ESAF-supported program under these new parameters, the IMF Executive Board approved on May 12, 1999, a new disbursement of SDR 9.0 million (about $12.1 million) of the total SDR 53.8 million (about $72.7 million) originally committed. The completion of that mid-term review was one of the conditions for Guyana to reach the completion point of the HIPC Initiative.

Press Release No. 99/17, May 14

The Extended Fund Facility provides assistance for adjustment programs over longer periods than under Stand-By Arrangements.

Stand-By, EFF, and ESAF Arrangements as of April 30

Member	Date of arrangement	Expiration date	Amount approved	Undrawn balance
			(million SDRs)	
Stand-By Arrangements			**32,746.62**	**8,609.44**
Bosnia and Herzegovina	May 29, 1998	May 28, 1999	60.60	36.36
Brazil[1]	December 2, 1998	December 1, 2001	13,024.80	5,969.70
Cape Verde	February 20, 1998	April 19, 1999	2.10	2.10
El Salvador	September 23, 1998	February 22, 2000	37.68	37.68
Korea[1]	December 4, 1997	December 3, 2000	15,500.00	1,268.75
Philippines	April 1, 1998	March 31, 2000	1,020.79	633.40
Thailand	August 20, 1997	June 19, 2000	2,900.00	500.00
Uruguay	March 28, 1999	March 28, 2000	70.00	70.00
Zimbabwe	June 1, 1998	June 30, 1999	130.65	91.45
EFF Arrangements			**11,401.03**	**7,319.61**
Argentina	February 4, 1998	February 3, 2001	2,080.00	2,080.00
Azerbaijan	December 20, 1996	December 19, 1999	58.50	15.80
Bulgaria	September 25, 1998	September 24, 2001	627.62	470.72
Croatia, Republic of	March 12, 1997	March 11, 2000	353.16	324.38
Indonesia	August 25, 1998	November 5, 2000	5,383.10	2,259.40
Jordan	April 15, 1999	April 14, 2002	127.88	117.22
Kazakhstan	July 17, 1996	July 16, 1999	309.40	154.70
Moldova	May 20, 1996	May 19, 1999	135.00	72.50
Pakistan	October 20, 1997	October 19, 2000	454.92	379.09
Panama	December 10, 1997	December 9, 2000	120.00	80.00
Ukraine	September 4, 1998	September 3, 2001	1,645.55	1,288.90
Yemen	October 29, 1997	October 28, 2000	105.90	76.90
ESAF Arrangements			**4,185.88**	**2,156.13**
Albania	May 13, 1998	May 12, 2001	35.30	23.53
Armenia	February 14, 1996	December 20, 1999	109.35	20.93
Azerbaijan	December 20, 1996	January 24, 2000	93.60	17.55
Benin	August 28, 1996	January 7, 2000	27.18	14.50
Bolivia	September 18, 1998	September 17, 2001	100.96	84.13
Burkina Faso	June 14, 1996	September 13, 1999	39.78	6.63
Cameroon	August 20, 1997	August 19, 2000	162.12	54.04
Central African Republic	July 20, 1998	July 19, 2001	49.44	41.20
Congo, Republic of	June 28, 1996	June 27, 1999	69.48	55.58
Côte d'Ivoire	March 17, 1998	March 16, 2001	285.84	161.98
Ethiopia	October 11, 1996	October 22, 1999	88.47	58.98
The Gambia	June 29, 1998	June 28, 2001	20.61	17.18
Georgia	February 28, 1996	July 26, 1999	166.50	27.75
Ghana	June 30, 1995	June 29, 1999	164.40	27.40
Guinea	January 13, 1997	January 12, 2000	70.80	23.60
Guyana	July 15, 1998	July 14, 2001	53.76	44.80
Haiti	October 18, 1996	October 17, 1999	91.05	75.88
Honduras	March 26, 1999	March 25, 2002	156.75	96.90
Kyrgyz Republic	June 26, 1998	June 25, 2001	73.38	43.00
Macedonia, FYR	April 11, 1997	April 10, 2000	54.56	27.28
Madagascar	November 27, 1996	November 26, 1999	81.36	54.24
Malawi	October 18, 1995	December 16, 1999	50.96	7.64
Mali	April 10, 1996	August 5, 1999	62.01	0.00
Mongolia	July 30, 1997	July 29, 2000	33.39	27.83
Mozambique	June 21, 1996	August 24, 1999	75.60	12.60
Nicaragua	March 18, 1998	March 17, 2001	148.96	67.27
Niger	June 12, 1996	August 27, 1999	57.96	9.66
Pakistan	October 20, 1997	October 19, 2000	682.38	417.01
Rwanda	June 24, 1998	June 23, 2001	71.40	47.60
Senegal	April 20, 1998	April 19, 2001	107.01	71.34
Tajikistan	June 24, 1998	June 23, 2001	100.30	60.00
Tanzania	November 8, 1996	February 7, 2000	181.59	29.38
Uganda	November 10, 1997	November 9, 2000	100.43	43.52
Yemen	October 29, 1997	October 28, 2000	264.75	140.75
Zambia	March 25, 1999	March 24, 2002	254.45	244.45
Total			**48,333.53**	**18,085.18**

[1]Includes amounts under Supplemental Reserve Facility.
EFF = Extended Fund Facility
ESAF = Enhanced Structural Adjustment Facility
Figures may not add to totals owing to rounding.

Data: IMF Treasurer's Department

Foreign direct investment to developing Asia is buoyant despite crisis

Foreign direct investment (FDI) flows to developing Asia weathered the storm of the Asian financial crisis, according to new data compiled by the United Nations Conference on Trade and Development (UNCTAD). Flows in 1998 declined a modest 7 percent for the first time since the mid-1980s, but the drop was due almost entirely to sharply decreased inflows into Indonesia and Taiwan Province of China. In 1998, FDI flows to the region were $78 billion, down from $84 billion in 1997.

Intensified efforts to attract FDI

Governments in the region have acted to attract FDI by further opening certain industries to it and relaxing rules with respect to ownership, mode of entry, and financing. At the regional level, in October 1998, ASEAN (Association of South East Asian Nations) members agreed on the establishment of the ASEAN investment area and have taken measures to set up the ASEAN free trade area.

Mergers and acquisitions are increasingly important to the region as a mode of entry for foreign direct investment. In particular, in the five countries (Indonesia, Korea, Malaysia, the Philippines, and Thailand) directly hit by the financial crisis, significant increases took place in merger and acquisition activity. In 1998, the press release states, the share of these economies in total cross-border majority-owned mergers and acquisitions in developing Asia surged to 73 percent in 1998 from 37 percent in 1996.

Activity across the region

China remained the largest FDI recipient in the region, receiving flows of $45.5 billion, representing 58 percent of total FDI flows to the region, UNCTAD reports (see chart). China intensified its investment promotion efforts at the beginning of 1998 by revising its industrial guidelines for FDI and resuming previously abolished incentives for foreign investors in industries likely to attract FDI.

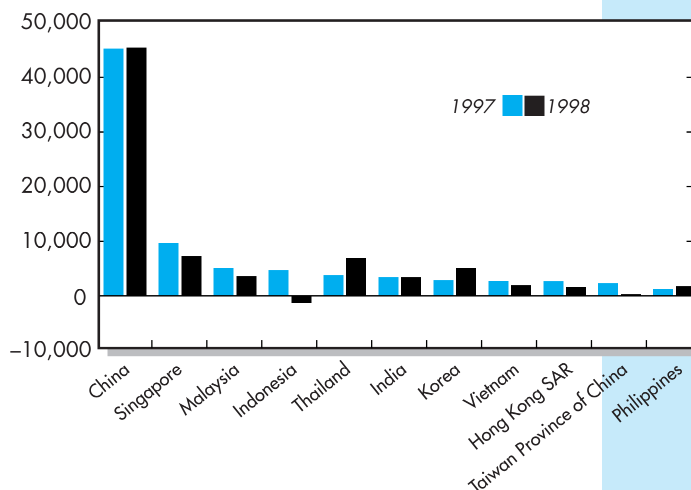
Singapore narrowly held its position as second highest FDI recipient, experiencing a 15 percent reduction in inflows to $7.3 billion, according to UNCTAD. The government of Singapore responded to a slowdown in its domestic economy by adopting tax concessions to reduce business costs and spending more on infrastructure projects. An unprecedented flood of FDI into Thailand and Korea put them into third and fourth place, respectively, even though their economies were among the most severely affected by the Asian financial crisis.

Among the four newly industrializing economies in the region (Hong Kong SAR, Singapore, Taiwan Province of China, and Korea), only Korea performed better in 1998 than the year before, owing to sweeping liberalization measures and cheap assets, and received its largest-ever volume of FDI inflows of $5.1 billion. FDI flows declined in the other three newly industrializing economies as a result of the slowdowns in their domestic economies and the regional situation.

As a group, the five countries (Indonesia, Malaysia, the Philippines, Thailand, and Vietnam) that received the most FDI from ASEAN economies took the worst hit in 1998, primarily due to the disinvestment in Indonesia. Their share of total FDI in developing Asia declined to 17 percent in 1998 from an annual average of 24 percent during the first half of the decade.

Foreign direct investment flows

(billion U.S. dollars)



Data: UNCTAD

Outlook for 1999

The decline of FDI approvals in 1998 and the first quarter of 1999, according to UNCTAD, indicates that flows to the region may continue to decline in 1999, particularly if China does not maintain its formerly high level. But FDI should remain above the average for the decade in 1999, and in the longer run, FDI growth will resume, the report concluded. ■

The text of the UNCTAD press release is available on the organization's website (www.unctad.org).

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BIS report

Recent trends in foreign exchange, derivatives markets detailed in new study

Global *foreign exchange market* turnover—spot transactions, forward operations, and foreign exchange swaps—reached an estimated daily average of $1.5 trillion in April 1998, according to the Bank for International Settlements' (BIS) triennial *Central Bank Survey of Foreign Exchange and Derivatives Market Activity*. This figure, adjusted for local and cross-border double counting and taking into account estimated gaps in reporting, represented a growth of 26 percent since April 1995, a sharp slowdown from the 45 percent increase during 1992–95. However, when adjusted for differences in the dollar value of nondollar transactions, the report notes, growth accelerated to 46 percent in 1995–98 from 29 percent in 1992–95. Forward instruments had a dominant market share of 60 percent, compared with 56 percent in April 1995. The U.S. dollar was the most actively traded currency by a wide margin, being involved in 87 percent of all transactions worldwide, up from 83 percent in 1995.

Derivatives markets

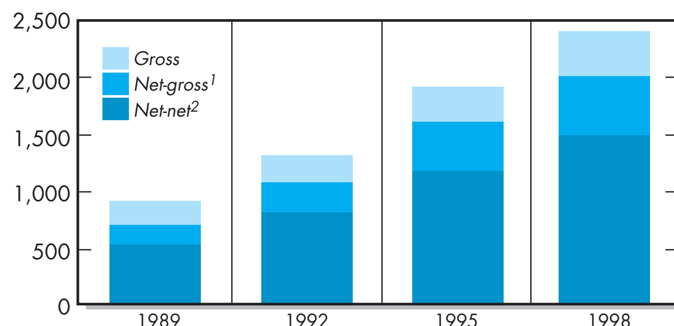
In April 1998, the worldwide daily turnover in *foreign exchange and interest rate derivatives* contracts, including traditional foreign exchange derivatives instruments traded over the counter, was estimated at $1.3 trillion, according to the report. This represented, in constant dollar terms, a growth of 66 percent since April 1995. Foreign exchange activity, where high turnover is due largely to the very short term nature of most contracts, outpaced that in interest rate products by a wide margin.

One measure of derivatives markets is notional amounts outstanding—the notional value of all deals concluded and still open at the end of June 1998—which gives a clearer picture of market size, the report states. Worldwide positions in over-the-counter financial derivatives covering all categories of market risk stood at $72 trillion. Within the over-the-counter market, interest rate instruments dominated, representing 67 percent of notional amounts, while exchange rate instruments made up 31 percent. Instruments based on equities and commodities made up the remaining 2 percent.

Another measure of the size of derivatives markets is gross market values, defined as the costs that would have been incurred if the contracts had been replaced at market prices on June 30, 1998. That figure, amounting to $2.6 trillion at the end of June 1998, represented 3.6 percent of total notional amounts, but varied considerably across individual market segments, from less than 1 percent for forward rate agreements to 15 percent for equity-linked options, the report states.

Measures of global foreign exchange market activity

(average daily turnover; billion U.S. dollars)



[1]Net-gross is adjusted for local interdealer double counting.
[2]Net-net is adjusted for both local and cross-border interdealer double counting.

Data: Bank for International Settlements

Parameters

The report was expanded in 1998 to 43 countries from 26 countries in 1995. Several changes in the report were introduced in the coverage of derivatives to ensure consistency with the new regular consolidated derivatives market statistics in the Group of 10 industrial countries introduced at the end of June 1998. Because data on exchange-traded business are collected by the BIS from the exchanges themselves, the report was limited to over-the-counter markets. Also, information relating to amounts outstanding differed from the 1995 survey in the reporting date (end-June changed from end-March) and in the reporting basis (worldwide versus location of reporters). Currency developments also had an important impact on the data, which are reported in current dollar terms.

Financial environment

The results of the survey should be considered in the context of the financial environment in 1998, the report observes. In particular, global market sentiment shifted sharply between the first and second halves of the year. In the first half, the report notes, positions were in the final phase of a long buildup in a widening range of segments; the summer brought with it the Russian crisis and an unprecedented wave of unwinding of positions, notably in foreign exchange and fixed income markets. The run-up to the single European currency added to this shift by tending to boost transactions in early 1998, while caution characterized the lead-up to the introduction of the euro on January 1, 1999. ■

The full text of the report is available on the Bank for International Settlements website (www.bis.org).