CHAPTER 4

Evolution of the Economic Crisis in Emerging Market Economies

The financial crisis in Asia, which began with increasing market pressure on the Thai baht in the first half of 1997, continued to unfold during 1998/99, with the persistence of market turmoil and the depth of the recessions in the affected Asian countries exceeding initial expectations. Political instability, policy reversals, and related social and economic disturbances in Indonesia in May 1998 hindered progress there. At the same time, the further weakening of the Japanese economy had a large negative impact on demand in the region and on international financial market sentiment.

Although initially centered mainly in Asia, the crisis took on a more global character in August 1998, when Russia, faced with mounting market pressures, devalued the ruble and unilaterally restructured its domestic government debt. Subsequently, most emerging markets—and notably Brazil—temporarily lost access to private financing, amid fears of a global credit crunch.

Toward the end of 1998, a measure of calm was restored to financial markets, owing in part to policy programs supported by the international financial institutions. With continued progress on stabilization and reform in the Asian crisis countries implementing IMF-supported programs, currencies strengthened significantly—particularly in Korea—allowing monetary policies to be eased. The Russian authorities engaged in a dialogue with IMF staff following the August 1998 crisis; in late April 1999, they reached a tentative understanding on an economic program that could provide a basis for IMF financial support—which was to be submitted to the IMF's Executive Board following Russia's implementation of a number of policy measures. In Brazil, concern began to grow in late 1998 over the strength of political support for the government's fiscal program, leading to increasing pressures on the real and, in mid-January 1999, to a large devaluation and the end of the crawling peg exchange regime. Measures by the government to strengthen the fiscal program, together with a large increase in interest rates, helped strengthen confidence both in Brazil and abroad in the government's resolve to carry out its program. Subsequently, economic and financial conditions improved significantly.

The IMF's responses to the Asian crisis, and to those in Russia and Brazil and other emerging markets, absorbed a good deal of time in 1998/99. The Board met frequently to evaluate progress in the Asian countries undertaking IMF-supported reform measures (see Box 1), and in December 1998 it discussed a staff assessment of the IMF's response to these countries' crises.[5] That assessment is covered below and is followed by brief descriptions of developments in Russia and Brazil during the financial year and the IMF's response to them. In addition to Board discussions of these country situations, Directors also considered issues surrounding the forestalling and resolution of financial crises at discussions of the world economic outlook, international capital markets, and on various aspects of strengthening the architecture of the international financial system (see Chapters 2, 3, and 5).

IMF-Supported Programs in Asian Crisis Countries

During the year, the IMF published the first systematic, albeit preliminary, internal assessment of the policy response to the Asian financial crisis of 1997–98, focusing on Indonesia, Korea, and Thailand. The Asian financial crisis, according to the staff's assessment, differed from previous financial crises in that it was rooted primarily in financial system vulnerabilities and other structural weaknesses in the context of an unprecedented move toward financial market globalization. Conventional fiscal imbalances were relatively small, and only in Thailand were significant real exchange rate misalignments evident. Despite differences in specific aspects of the crisis in Indonesia, Korea, and Thailand, all three shared weaknesses in financial systems, stemming from weak regulation and supervision and (to varying degrees) a history of heavy governmental

[5]Published as *IMF-Supported Programs in Indonesia, Korea, and Thailand: A Preliminary Assessment,* IMF Occasional Paper No. 178, by Timothy Lane and others (Washington, 1999).

Box 1

Asian Crisis Countries: Developments and IMF Response Through the End of April 1999

Following is a summary of developments in the three Asian crisis countries and the IMF's response to them during 1998/99.

Indonesia

Indonesia's reform program, supported by an IMF Stand-By Arrangement, fell off track because of policy reversals, increasing macroeconomic turmoil, and financial system collapse in the context of severe civil unrest, which led to the resignation of President Suharto on May 21, 1998. Production, exports, and domestic supply channels were disrupted and banking activities paralyzed. The rupiah hit an all-time low of Rp 16,745 against the U.S. dollar in mid-June, with a cumulative depreciation of 85 percent from June 1997. By July 1998, the time of the Board's second review of the IMF-supported program, major dislocations to economic activity were evident. Restoration of the distribution system and strengthening of the social safety net became immediate priorities. Bank-restructuring plans were strengthened to deal with the deteriorating conditions in the financial system, and further steps were taken to facilitate corporate debt restructuring. In view of the deep-seated nature of Indonesia's structural and balance of payments problems, the Executive Board on August 25, 1998, approved the authorities' request to cancel the Stand-By Arrangement and approved an Extended Fund Facility Arrangement. Subsequently, on March 25, 1999, the Board completed the fourth review under the EFF and augmented the program by SDR 714 million (about $1 billion). As of the end of April 1999, policy implementation was generally satisfactory and Indonesia had met the major macroeconomic targets under the program for 1998–99, although progress with financial and corporate restructuring was less rapid than had been hoped. Market sentiment remained fragile, partly reflecting continuing structural problems, political uncertainties, and civil unrest.

Korea

Korea's economic reform program, supported by an IMF Stand-By Arrangement, remained on track during 1998–99, with strengthened market confidence in the new administration's commitment to reforms. As market conditions stabilized, the government successfully launched a sovereign bond issue, capital began flowing into the domestic bond and stock markets and Korea significantly rebuilt its usable reserves. By July 1998, the won had appreciated against the U.S. dollar, permitting the authorities to reduce interest rates to precrisis levels. Structural reforms emphasized the rationalization and strengthening of the banking sector, as well as corporate restructuring. During the year, Korea began repaying loans taken at the onset of the program in December 1997. As of the end of April 1999, the economy showed signs of emerging from the severe downturn of 1997–98, with economic data pointing toward a modest recovery, the pace of which was expected to pick up during the year.

Thailand

The Thai baht, which depreciated substantially in 1997, began to strengthen in February 1998. Monetary policy initially continued to focus on the exchange rate, with interest rates being maintained at a high level until evidence of a sustained stabilization emerged; then, from around mid-1998, rates were lowered substantially to precrisis levels or below. Fiscal policy was also relaxed to support economic activity. Additional measures to strengthen the social safety net were announced, and the approach to financial and corporate restructuring was elaborated and broadened significantly. In April 1999, the IMF completed a sixth review by the Stand-By Arrangement; as a result, Thailand could borrow an additional $500 million from bilateral and multilateral sources, with the IMF contributing SDR 100 million (about $135 million). The additional assistance resulted from Thailand's good policy implementation under the economic program supported by the Stand-By Arrangement, which had further consolidated financial stability. The strengthened exchange rate remained stable, allowing further declines in interest rates, and the external position continued to improve. As a result, inflation had been kept low and the output decline arrested. Broad recovery, however, was delayed owing to continued weakness in domestic demand and a difficult external environment. In this context, the Thai authorities, in March 1999, unveiled a plan to revive domestic demand through additional fiscal stimulus measures. These measures, together with progress in advancing structural reforms, were expected to lead to a resumption of growth in the second half of 1999.

involvement in credit allocation, including through government guarantees; these were reflected in the misallocation of credit and inflated asset prices. Another severe common weakness was large, unhedged, private short-term foreign currency debt in a setting of limited exchange rate flexibility and a highly leveraged corporate sector; in Korea and Thailand, this debt was mainly intermediated through the banking system, while in Indonesia, the corporations had heavier direct exposures to such debt.

The Asian financial crisis plunged the countries affected into deep recessions. In 1998, real GDP fell by an estimated 6 percent in Korea, by 8 percent in Thailand, and by 15 percent in Indonesia (Table 3). The slowdown in economic activity was greater than had been assumed when formulating the programs in 1997, and accordingly the IMF-supported programs in the three countries were subsequently revised.

The slump in 1998 largely reflected the massive withdrawal of foreign capital and flight of domestic capital; the reversal of capital flows necessitated sizable current account adjustments brought about in part by huge currency depreciations, which in turn worsened the debt profile of corporations. Corresponding to the economic slump were massive corrections in these countries' external current account balances. The corrections were especially large in Korea (with a current account adjustment of 15 percentage points of GDP) and Thailand (14 percentage points), but also significant in Indonesia (5 percentage points). In all three countries, the output decline was associated with a collapse in domestic demand, whereas net external demand expanded.

Monetary policy in the Asian crisis countries sought to tread a narrow path between preventing a spiral of depreciation and inflation, on the one hand, and avoiding an excessive liquidity squeeze on the domestic economy on the other. These countries did not attempt to pursue fixed targets for the exchange rate, but only leaned against the substantial depreciation that occurred. At the very start of the crisis, these countries' currencies depreciated sharply (in nominal terms, U.S. dollar per national currency). In Thailand, after an initial 24 percent depreciation during July 1997, a series of smaller (although still substantial) monthly depreciations followed over a prolonged period; these culminated in a 26 percent depreciation from the beginning of December 1997 to mid-January 1998, when the rate bottomed out. In Korea, substantial depreciation was avoided until late October 1997, with the exchange rate then slipping more steeply to its weakest point, in late December 1997. Indonesia's exchange rate, in contrast, depreciated fairly steadily beginning in July 1997, with the cumulative depreciation reaching more than 80 percent by late January 1998. A limited recovery in the next several months was reversed by large further depreciation in May and June 1998, most of which was recovered by mid-October.

To contain and reverse excessive currency depreciation, interest rates were raised sharply, to peaks of some 32 percent and 25 percent in Korea and Thailand, respectively. Once the currencies began to strengthen, however, rates were reduced. By the summer of 1998, interest rates had fallen to slightly below precrisis levels in Korea and Thailand, and about half of the sharp initial currency depreciation had been reversed. In Indonesia, by contrast, monetary developments were already headed seriously off track in December 1997, reflecting political turbulence and extreme financial system weakness followed by macroeconomic turmoil, with spiraling inflation reaching over 100 percent in the early months of 1998, rising risk premiums, continued capital flight, and a collapse of economic activity. By the later months of 1998, however, the situation had improved markedly, with the rupiah recovering more than half of the depreciation that had occurred at the peak of the crisis.

The role envisaged for fiscal policy in the Asian crisis countries shifted with the changing assessment of the economic situation. The initial IMF-supported programs in all three countries included some measure of fiscal adjustment to counter an initial deterioration of

Table 3
Key Economic Indicators: Indonesia, Korea, and Thailand, 1990–99[1]

	Average 1990–95	1996	1997	1998 Est.
Real GDP (percent change)				
Indonesia	8.0	8.0	4.6	–15.3
Korea	7.8	6.8	5.0	–5.8
Thailand	9.0	5.5	–0.4	–8.0
Real total domestic demand (percent change)				
Indonesia	9.3	8.6	6.8	–20.4
Korea	8.4	7.8	–0.8	–18.7
Thailand	10.1	6.2	–7.6	–21.9
Inflation (CPI) (percent change)				
Indonesia	8.7	7.9	6.6	61.1
Korea	6.6	4.9	4.4	7.5
Thailand	5.0	5.9	5.6	8.0
Government balance (in percent of GDP)[2]				
Indonesia	0.0	1.2	0.1	. . .
Korea	–0.3	0.3	0.3	–3.8
Thailand[3]	. . .	2.8	–2.7	–5.3
Current account (in percent of GDP)				
Indonesia	–2.5	–3.3	–1.8	3.0
Korea	–1.2	–4.7	–1.8	13.3
Thailand	–6.6	–7.9	–2.0	11.4
Total external debt (in billions of U.S. dollars)				
Indonesia	86.7	130.2	137.9	. . .
Korea	. . .	164.3	158.1	151.5
Thailand	51.7	90.5	93.4	85.4
Total external debt, short-term (in billions of U.S. dollars)				
Indonesia	8.1	28.0	. . .	. . .
Korea	. . .	93.0	63.2	32.5
Thailand	22.9	37.6	34.8	25.0
Reserves (in billions of U.S. dollars; end of period)				
Indonesia: gross reserves	. . .	. . .	21.5	23.8
Korea: usable reserves	. . .	29.4	9.1	48.5
Thailand: gross reserves	. . .	38.7	27.0	29.5

[1]All data are on a calendar-year basis, except as indicated.
[2]General government balance including the interest costs of financial sector restructuring. Cross-country comparisons are not strictly accurate because of differences in definition.
[3]Data are on a fiscal-year basis.

fiscal positions—with a view to contributing to current account adjustment and thus avoiding an excessive squeeze on the private sector, as well as building room for noninflationary financing of carrying costs of financial sector restructuring. But beginning in early 1998, with gathering signs of the severity of the economic downturn, fiscal deficits were allowed to expand considerably in all three countries. Fiscal policy expansion to support economic activity went progressively beyond the automatic stabilizers and the automatic effects of exchange rate depreciations.

The Board's Assessment

The Board discussed the preliminary staff assessment of IMF-supported programs in the Asian crisis countries in December 1998. Directors agreed that the crisis facing the IMF in Indonesia, Korea, and Thailand was quite different from most instances in which the IMF provides financial support. The crisis originated mainly in deep-seated vulnerabilities in the financial and nonbank corporate sectors. Owing to deficiencies in local financial markets, domestic interest rates remained well above international rates, encouraging excessive external borrowing. Investors viewed the long-standing commitments to exchange rate regimes with limited flexibility—which, in some cases, were maintained even when no longer supported by fundamentals—as assurances of exchange value, thereby encouraging excessive foreign exchange exposure. Creditors had also incorrectly assumed implicit government guarantees against default losses on certain types of loans. Owing in part to inadequate banking regulation and prudential rules, borrowed funds were inefficiently intermediated, contributing to overinvestment, unsustainable asset prices, very high exposure to international capital flows, and serious fragilities in the balance sheets of both financial institutions and nonbank corporations.

These elements made these countries highly sensitive to shifts in market sentiment. Some Directors also noted the role of the operations of highly leveraged institutional investors in aggravating this crisis. Directors felt that forestalling crises of this sort would require a more effective monitoring system, better regulation and supervision of domestic financial institutions, and broader efforts to strengthen the international financial system and to set appropriate incentives for pricing risk. More generally, the IMF was examining a number of these issues in the context of its ongoing surveillance activities—and the IMF's surveillance itself was the subject of an ongoing evaluation by external experts (see Chapter 6).

Comprehensive Approach

Directors agreed that a response to the Asian financial crisis required a comprehensive approach embracing macroeconomic and structural policies as well as external financing. They stressed that structural reforms were an essential part of the overall package, particulary those aimed at addressing financial sector weaknesses and imbalances in corporate finances, improving governance, and strengthening and, in some cases, creating safety nets. Several Directors believed, however, that there may have been scope for a different pacing and sequencing of some of the structural reforms beyond the core financial and corporate sector reforms, or for limiting their number in the first instance, while relegating some to a subsequent poststabilization phase.

The strategy followed in these programs had emphasized restoring confidence through a combination of broad-based policy measures and external financing. Convincing policy packages were essential, as the official funds available fell far short of the countries' near-term exposure to capital outflows. In light of the potential for short-term capital outflows to continue if efforts to establish confidence were not immediately successful, this strategy involved substantial risk. There was, however, little alternative. Directors cautioned that neither the IMF nor the official community more generally could, or should, try to provide a full guarantee of any country's short-term external liabilities, nor should they risk any undue substitution of official resources for private financing. A number of Directors felt that larger and more front-loaded packages could have helped restore confidence more quickly and thereby limit the economic impact of the crisis. Most Directors, however, emphasized that the scale of official financing had been unprecedented and that financing should neither substitute for, nor delay, the required policy adjustments.

Central Issues of the Crisis

A central lesson of the Asian financial crisis was the importance of ongoing efforts to devise appropriate ways of involving the private sector in preventing and resolving financial crises (see Chapter 5). Indeed, a few Directors thought smaller official financing packages might have acted as a stimulus to greater private sector involvement. Several Directors thought that earlier action should have been taken in these country cases to "bail in" the private sector.

On the issue of capital controls, a few Directors saw advantages in resorting to them, at least on a temporary basis, and, as a last resort, in particularly difficult circumstances. Most Directors, however, believed that attempts to restrict outflows in the midst of a crisis would almost certainly have hindered the restoration of market access for the country concerned and exacerbated contagion to other countries. Several Directors noted that the Asian crisis underscored the need for appropriate sequencing of the liberalization of capital movements, and saw the need for further work on the appropriate regulatory and prudential regimes.

Directors discussed the factors contributing to the protracted process of restoring confidence. Political uncertainties, and in some instances early hesitations on the part of the authorities in implementing policies in line with the programs, had undermined confidence by casting doubt on the authorities' commitment to, and ownership of, the programs. In this connection, besides facilitating earlier diagnosis and corrective measures, more complete and continuous provision of financial information would have obviated the need to release disquieting data in the midst of the crisis.

Program Projections

Directors expressed concern over the severe recessions in the Asian crisis countries and observed that the macroeconomic projections on which the initial programs had been based had greatly underestimated the actual economic downturns. This reflected, in part, the fact that the program projections were predicated on the success of the programs themselves. In the event, capital outflows had far exceeded expectations, forcing massive current account adjustment through precipitous depreciations and a sharp decline in domestic demand. At the same time, given the weakness of other economies in the region—most important, Japan—the increase in exports had proved too small to provide sufficient support for economic activity. In Indonesia and Thailand, deteriorating terms of trade had imposed a large and additional negative shock. Some Directors observed that the underestimation of the economic downturn had adversely influenced policy prescriptions, especially with respect to fiscal policy. To better assess the growth outlook in crisis situations, more attention had to be paid in the future to the experience of earlier crisis situations, as well as to regional interlinkages. To this end, Directors saw as desirable more emphasis on regional approaches to surveillance.

Most Directors agreed that in the midst of the crisis, and in the specific circumstances of these countries, it had been appropriate to formulate these countries' programs on the basis of floating exchange rates. Available reserves had been inadequate to defend a new exchange rate peg. Supporting a pegged exchange rate would have required the full subordination of monetary policy to the exchange rate, which would likely have required substantially higher interest rates than those actually experienced. Moreover, failed attempts to re-peg exchange rates at new levels under crisis conditions would have further eroded credibility.

Monetary Policy

The main goal of monetary policy in the Asian crisis countries had been to avert a depreciation-inflation spiral. In this regard, the programs, after a hesitant start, had been largely successful. Turbulent market conditions required a flexible approach to monetary policy, "leaning against the wind" rather than pursuing a fixed target for the exchange rate. Directors generally endorsed the tightening of monetary policy recommended in the programs in order to arrest and then reverse the excessive depreciation of exchange rates that had occurred. Several Directors pointed out that initially these efforts had been less than successful—owing in part to the hesitant and often uneven monetary policy tightening in the crisis countries—and some Directors argued that the situation had warranted more aggressive and rapid tightening. The eventual degree of monetary restraint was significant but was typical of a crisis situation in which a country's risk premium is driven up by market forces. Most Directors saw the alternative of keeping interest rates low and allowing the currencies to depreciate as riskier, because the likely result would have been an even worse downward spiral rather than a temporary depreciation.

Although Directors expressed concern over reports of a credit crunch in the three Asian crisis countries—with a few concerned that monetary policies had been too tight—most believed that some strains on borrowers were unavoidable in a situation of excessively leveraged firms and large, unhedged foreign currency exposures. Most Directors saw the primary problem as one of distribution of credit in the economy rather than its aggregate amount, with the main lesson being the need to move ahead forcefully with structural reforms in the financial and corporate sectors and to support viable financial institutions in the midst of a banking crisis. Directors welcomed the fact that interest rates in Korea and Thailand had (as of December 1998) moved back to below precrisis levels, and that market conditions in Indonesia were stabilizing.

Fiscal Policy

Directors viewed fiscal policy as having played a quite different role in the three IMF-supported programs from that originally envisaged. Initially, a limited fiscal adjustment was seen as needed to prevent an excessive burden of external adjustment from falling on the private sector, and to help meet the quasi-fiscal costs of financial sector restructuring. After taking into account the unexpected severity of the recessions and the sharp improvements in current account positions, however, the programs' original fiscal targets appeared in hindsight to have been tighter than necessary.

Directors welcomed the adaptation of the IMF-supported programs, particularly the easing of fiscal policy in response to unfolding circumstances, although some thought that the easing should have been quicker as the severity of the economic slowdown became increasingly apparent. It was observed that, in practice, the countries had found it difficult to use fully the scope afforded them for more expansionary budgetary policies under the revised programs because of the time needed to develop new social spending programs, as well as the conflict between rapid shifts in fiscal policy and careful management of the quality of government spending.

Structural Reforms

The nature of the crisis and the complementarity of different reforms had necessitated a comprehensive package of structural measures. These reforms were needed, and continued to be needed, to address the root causes of the crisis and lay the groundwork for sustainable medium-term growth. Many Directors felt that the package of structural reforms in each Asian crisis country was essential to restoring confidence on a sustainable basis, but they acknowledged the difficulties in trying to alter market perceptions with policies that were often politically sensitive and that took time to implement and take effect. Several Directors expressed concern that the programs may have been overloaded with reform measures. In their view, better sequencing and prioritization would have involved certain reforms being left to the second stage of the programs. All Directors, however, stressed the need to address, early in the programs, the core areas from which the crisis had arisen—especially the banking and corporate sectors. Given the comprehensiveness of the reforms pursued, success depended critically on cooperation with other international financial institutions, notably the World Bank and the Asian Development Bank. Directors supported ongoing efforts to strengthen such cooperation. Also, noting the difficulties experienced in securing political consensus for reforms, especially when faced with strong vested interests, the Board emphasized the importance of the IMF's efforts to ensure the authorities' commitment to, and ownership of, the programs.

Governance and Safety Nets

Reforms in governance, together with the host of issues touching on the establishment of appropriate incentives for private market behavior, were also important, as was the need to ensure that the costs of failure were borne by private investors. Weaknesses in these areas were the underlying cause of many of the vulnerabilities that led to the crisis. Directors thus saw improvements in governance as fundamental to fostering reforms in other areas, including financial and corporate restructuring, competition policy, trade liberalization, and privatization.

The establishment and strengthening of social safety nets to cushion the adverse impact of the crisis on the poor was also an essential element of the programs, and Directors welcomed the ongoing improvements in the targeting of social expenditure and the increased efforts of the World Bank in this domain.

Although there were signs that market conditions were stabilizing and indications that the recessions were bottoming out (as of the December 1998 discussion), Directors cautioned that risks remained. They emphasized that resolute and rapid structural reform was key to consolidating the progress and laying the foundation for sustainable growth.

Summing Up

In summing up the main lessons learned from the experience with IMF-supported programs in Indonesia, Korea, and Thailand, Executive Directors highlighted the following points.

Actions to Forestall Crises

- Analyze regularly, in the context of IMF surveillance, the continuing appropriateness of exchange rate regimes in light of changing fundamentals.
- Provide the market continually with accurate, full, and clear financial information, on both public and private sectors, so as to minimize the possibility of negative surprises.
- Strengthen regulatory and prudential regimes in all countries.
- Adapt institutions and regulations in creditor countries so as to better ensure an appropriate pricing of risk and to inhibit "bandwagon" behavior.
- Promote actions to reduce the systemic risk associated with financial market turbulence through, among other things, strengthening disclosure requirements for all investors, including highly leveraged institutions.

Issues Related to Program Design and Implementation

- Base programs on macroeconomic projections that take full account of the likely regional spillovers associated with a crisis and the effects of a crisis in curtailing countries' access to private external financing.
- Undertake further analysis of the particular issues arising in debtor countries from severe banking and financial sector weaknesses in the context of financial crises—including bank closures, government blanket guarantees, moral hazard concerns, and the extent and form of regulatory forbearance in these situations.
- Encourage the authorities to take decisive actions at the outset to demonstrate adequate ownership of, and public leadership in, the programs.
- Communicate and explain to markets and the general public, in the closest possible coordination with the authorities, the full content of the program, while avoiding eliciting unrealistic expectations.
- Exercise flexibility in adapting programs to changing circumstances.
- Secure early agreement with the authorities and other international financial institutions on a com-

prehensive strategy of structural reform, particularly as regards financial and corporate restructuring, with due attention to their timeliness and proper sequencing.

Issues Related to Financing of Programs

- Promote greater involvement of the private sector in forestalling and resolving financial crises.
- Examine further the issue of the appropriate level of official financing and enhance the credibility of official financing packages, in particular by establishing clear understandings on the conditions for disbursement.

A number of the above points, Directors noted, were being explored further, in particular in the context of discussions of the international financial architecture and of the IMF's conditionality guidelines.

Russia and Brazil

In contrast to the success of most other transition countries in initially escaping serious involvement in the emerging market turmoil, *Russia*'s economy fell into crisis in mid-1998. The crisis led to the authorities' decision on August 17, 1998, to devalue the ruble and unilaterally restructure its domestic government debt. Russia's economic predicament—worsened by the emerging market crises and their spillover effects, especially on oil and other commodity prices—mainly reflected the serious and persistent shortcomings in its structural reform and institution-building efforts, repeated slippages in fiscal adjustment and reform, and an excessive buildup of short-term government debt, including to foreign investors.

The Russian authorities succeeded in reducing inflation in the period up to August 1998, owing partly to the pegging of the ruble to the U.S. dollar and a relatively tight rein on monetary policy in the preceding two to three years. Inflationary pressures were also suppressed by the accumulation of budgetary arrears, and domestic (nonbank) and external borrowing to finance budget deficits. The underlying fiscal and structural problems were reflected in large-scale capital flight by domestic residents, even when Russia's economic performance seemed relatively promising. This meant that the increase in external debt was not matched by higher investment and increased export potential.

The government's incentive to address the underlying problems was further weakened by rapidly falling costs of borrowing in both the domestic treasury bill market and international financial market—a reflection of the strong appetite of foreign investors for Russian securities given exchange rate and interest rate policies. By the time that steps to correct the fiscal imbalances were being implemented in earnest, the reversal in foreign investor sentiment following the Asian crisis and a rapid increase in interest rates had put Russia's public debt on a steep growth path. With oil and gas export revenues down by about 20 percent in the first seven months of 1998 (compared with the same period in 1997), the external current account balance was also negatively affected and swung into deficit during this period.

On July 20, 1998, the Executive Board approved financial support totaling SDR 8.5 billion ($11.2 billion) for an anticrisis program, which attempted to lengthen the maturity structure of government debt and intensify structural reform. The financing consisted of an augmentation of Russia's EFF Arrangement by SDR 6.3 billion ($8.3 billion)—of which SDR 4.0 billion was to be made available under the Supplemental Reserve Facility—to support the government's economic program for 1998, and SDR 2.2 billion under the CCFF to compensate for the shortfall in export earnings. The IMF financed the augmentation by borrowing under the General Arrangements to Borrow—the first time the GAB was used by a non-GAB participant.

Measures under the program included a debt exchange (Russian treasury bills swapped for dollar-denominated eurobonds), major fiscal adjustment, actions to address the nonpayment problem and promote private sector development, and a comprehensive approach to banking sector problems. From the time of its introduction, the success of the program depended on whether Russia's revenue and expenditure measures received full parliamentary approval and whether interest rates were brought down by a return of investor confidence. The failure of these conditions to be realized, and the authorities' course of action in response—in particular, the unilateral debt restructuring—aggravated the consequences of the program's breakdown.

By mid-August 1998, with investor confidence lost, international reserves dwindling, and interest rates soaring, the authorities were unable to defend the ruble exchange rate peg or to refinance maturing public debt. The consequences of the crisis and of the ensuing de facto devaluation, payment moratorium on private sector external obligations, and unilateral restructuring of the government's domestic currency debt were severely negative. Over the last five months of 1998, consumer prices rose by more than 75 percent, and the ruble depreciated by about 70 percent against the U.S. dollar. Reflecting the severe financial pressure during the run-up to the crisis and the worsening of the overall economic situation in the postcrisis period, in 1998 as a whole real GDP fell by about 5 percent, and real investment declined by close to 10 percent, with foreign direct investment down to $2.5 billion from $6.2 billion in 1997. The budgetary outlook also worsened: revenues raised by the federal government fell to below 10 percent of GDP in 1998, while the federal government deficit amounted to 6 percent of GDP. During the first quarter of 1999, the Russian authorities had yet to come to grips with many unresolved issues. Monetary policy, however, was tightened during January and February 1999 as the central bank did not extend credit to the government and this contributed to a stabilization of the exchange rate and a slowdown in inflation during this period.

For some months, a dialogue continued between the IMF staff and the Russian authorities—with direct contacts between the most senior authorities on both sides—on Russia's economic problems. As of the end of the financial year, the economy showed signs of recovery from the low point in September 1998 and monthly inflation had decreased—but the debt balance remained unsustainable and, correspondingly, so did the fiscal position. The Interim Committee, at its April 1999 meeting, emphasized that despite recent improvements, vigorous action was needed to tackle the root causes of the Russian crisis—especially persistent fiscal imbalances, structural rigidities, and financial sector weaknesses. Shortly after the Interim Committee meeting in late April, the IMF announced that a tentative understanding had been reached on a new program that could be supported by an IMF Stand-By Arrangement of SDR 3.3 billion ($4.5 billion). It was to be submitted for approval by the Executive Board following the implementation of a number of up-front policy measures, and assuming that agreement would also be reached between Russia and the World Bank on a comprehensive program of structural reform.

Another focal point of the global financial crisis was *Brazil*, where the first wave of contagion from the emerging market crisis peaked in October 1997. The government responded quickly and was able to stem the outflow of capital by tightening monetary policy and announcing a strong fiscal policy package, promising 2½ percent of GDP in tax increases and spending cuts. Fiscal efforts slipped, however, and financial market concerns about the sustainability of the fiscal position were renewed. As a result, Brazil was hit hard by contagion from the Russian crisis in August 1998 when international investors again reassessed the risk of their exposure to emerging markets. Interest rate spreads jumped and capital flows to emerging markets virtually dried up.

To stem foreign exchange reserve losses of $2.8 billion in August 1998 and $21.5 billion in September, the Brazilian authorities increased official interest rates to nearly 43 percent and announced several fiscal measures. Although the pressure on the real eased, the measures did not offer sufficient relief, and the authorities began discussions with IMF staff on an adjustment program that could receive financial support from the international community.

The subsequent IMF-led international financial package announced in November 1998 resulted in commitments of balance of payment support totaling $41.5 billion, toward which the IMF committed a three-year Stand-By Arrangement equivalent to SDR 13 billion ($18.1 billion). As public sector imbalances were at the root of the problem, the IMF support was linked to a policy package aimed at producing large primary surpluses—on the order of 2½–3 percent of GDP—to halt the rise in the ratio of public debt to GDP by 2000. About two-thirds of the improvement in the government's finances was to come from revenue measures.

Initially, financial pressures abated, but they increased again in December 1998 when the authorities encountered strong resistance in Congress to the needed social security reforms and also owing to fears that monetary policy was insufficiently tight to stop continued capital outflows. At the beginning of January 1999, when the state of Minas Gerais announced that it sought to renegotiate the payment terms of its debt with the federal government, market confidence in Brazil's fiscal stabilization plan fell further, with a renewed surge in the interest rate spread. When a number of other Brazilian states joined the request of Minas Gerais, the net capital outflow intensified to $1.2 billion on January 12. This led the authorities, first, to widen the real's exchange rate band on January 13 and, when this did not stop the financial outflows, to allow the currency to float two days later. The currency initially depreciated by more than 40 percent against the U.S. dollar and remained under pressure until early March.

The key challenge facing Brazil in the wake of the collapse of its exchange rate peg was the need to address public sector imbalances. The Real Plan had succeeded in reducing inflation between 1994 and 1998 but not in containing the fiscal deficit. The fiscal deficit, estimated to have reached 8 percent of GDP in 1998, also contributed to a widening of the external current account deficit, to 4½ percent of GDP in 1998. The combination of these two growing deficits, together with the structure of public debt—which made the government's finances very sensitive to changes in short-term interest rates and the exchange rate—made Brazil vulnerable to changes in investor sentiment. Ultimately, the twin deficits also contributed to widespread sentiment in financial markets that the crawling peg was not sustainable.

The IMF-supported economic program was revised following the devaluation in mid-January 1999. The two pillars of the revised program were strengthened fiscal adjustment and movement away from the exchange rate as an anchor for the system toward an inflation target. The authorities enhanced the original program's comprehensive structural reform agenda—in such areas as social security, civil service reform, tax policy, budgetary procedures and fiscal transparency—and were proceeding as well with a substantial privatization program (see also Chapter 7). The government was also committed to cushioning the impact of the decline in economic activity on the poor and vulnerable, by safeguarding well-targeted social programs from budget cuts.

On March 30, 1999, the Executive Board approved completion of the first and second reviews under Brazil's Stand-By Arrangement, in support of the government's revised economic program. The approval meant that Brazil could obtain a further SDR 3.6 billion ($4.9 billion), bringing its total borrowings from the IMF under the program to SDR 7.1 billion ($9.6 billion). The authorities were also expected to draw $4.9 billion under a facility arranged by the Bank for International Settlements (BIS) and a loan from the Government of Japan. External financing prospects had improved further as a result of recent or expected disbursements under special programs from the World Bank and the Inter-American Development Bank and of the commitment made by Brazil's major private bank creditors to maintain their exposure to Brazil.

The April 1999 Interim Committee communiqué expressed support for the Brazilian authorities' revised economic program and stressed the importance of its full implementation, as well as the continued support of the private financial community.

CHAPTER 5

Strengthening the Architecture of the International Financial System

The financial crises in the emerging market economies of Asia, followed by those in Russia and Brazil, gave powerful impetus to proposals to strengthen the architecture of the international financial system to ensure that the potential benefits of globalization are realized by all member countries. Such proposals were a major focus of the Executive Board's attention in 1998/99. A clear consensus had developed, both in the IMF and in the international financial community, in favor of strengthening the global financial system to reduce the risks posed by institutional weaknesses and the volatility of capital flows, and to facilitate access to capital markets by those countries that had yet to benefit from globalization.

The Board's work program leading up to the spring 1999 meeting of the Interim Committee was ambitious in its consideration of various aspects of strengthening the global financial architecture. At the same time, other institutions and forums were also actively considering some of these aspects. By the end of April 1999, broad agreement had been reached on several key elements in strengthening the global financial architecture and important reforms had been introduced in a number of countries. The IMF itself took actions in several areas. It substantially increased the transparency of its policies and activities, approved a decision on Contingent Credit Lines to help protect well-managed economies from the effects of financial market contagion, and contributed to the establishment of standards of good practice in key policy areas. Nonetheless, as the Interim Committee noted in its April 1999 communiqué, some issues had to be developed further and several of the proposals had yet to be implemented.

Proposals commanding broad support from the international community, which required the involvement of many players to be implemented successfully, included:

- promoting transparency and accountability, and developing and disseminating internationally accepted standards and codes of good practice—including strengthening the Special Data Dissemination Standard (SDDS), notably with respect to international reserves and external debt;
- strengthening financial systems, including through better financial market supervision;
- paying greater attention to the orderly liberalization of capital markets;
- involving the private sector more fully in forestalling and resolving crises;
- ensuring the appropriateness of exchange rate regimes; and
- ensuring the adequacy of the IMF's resources.

With respect to international standards, Executive Directors noted that while the private sector had a major role to play in encouraging the adoption of standards, the official sector could help strengthen incentives to adopt standards and help focus efforts to improve transparency. Most Directors considered that some form of monitoring of the observance of standards could play a useful role to this end; some Directors pointed to the role that market participants could also play in assessing compliance.

Board members shared the view that all aspects of a strengthened architecture are interdependent. These include observance of internationally accepted standards and principles; the choice of exchange rate regime and the strengthening of supervisory frameworks; better data; greater transparency of countries' policies and the IMF's assessments of them; and strengthened financial systems. All are also integral to an orderly process of capital account liberalization, to reduce the volatility of private sector flows, and to strengthen financial systems. Moreover, the private sector, national governments, and international institutions and forums would have to work together in this endeavor. National authorities would have to ensure that standards are established and met, that supervisory and regulatory agencies are strengthened, and that vulnerabilities are minimized through better management of macroeconomic and financial policies. At the same time, private financial institutions and corporations need to adhere to new standards that are being set, and the IMF and other international institutions and forums would have to ensure that their efforts are mutually reinforcing and effective.

A complement to the strengthened architecture of the international financial system is strengthened social policies. Countries need to be better prepared to absorb the impact of the inevitable changes that occur in a dynamic market economy and to allay some of the hardships and maximize the benefits of a globally integrated financial system. The IMF had worked closely with other institutions in establishing social safety nets in recent programs in Asia. More would need to be done by the international community, however, including developing codes of good practices in social policies, where the World Bank has taken the lead,[6] and in developing social safety nets before a crisis strikes.

This chapter describes the consensus achieved and progress made with regard to the main elements of a strengthened architecture through the end of April 1999.[7]

Transparency, Standards, and Surveillance

Making the policy process more transparent is an important pillar of a strengthened global financial architecture, as greater transparency helps foster better decision making and economic performance by member countries and by international institutions. Here, the IMF has a dual role: to encourage member countries to be more transparent, and to be more open about IMF policies and advice to members—while at the same time respecting the legitimate need for confidentiality and candor in its policy discussions with members. Transparency also entails greater openness by the private sector, as many of the standards (e.g., accounting, auditing, bankruptcy, corporate governance, and securities market regulation) are ultimately implemented at the level of individual firms. Although questions remain—such as on offshore centers and on the appropriate level of disclosure and regulation of highly leveraged institutions—progress has been achieved on a number of fronts.

Improving Transparency and Accountability of the IMF and Member Countries

In the past two years, the Executive Board adopted a series of measures to improve substantially the transparency of the IMF's activities and its members' policies. Actions included:

- Development of a policy on the release of Public Information Notices (PINs) following Board discussions of member countries' Article IV consultations.[8] Members are actively encouraged to consent to their release, and PINs were released for more than 70 percent of Article IV consultations during 1998/99.
- Release of documents related to the Initiative for the Heavily Indebted Poor Countries and solicitation of public comment on the HIPC Initiative, as well as on the conclusions of the internal and external evaluations of the IMF's Enhanced Structural Adjustment Facility. The IMF's preliminary assessment of IMF-supported programs in Asia has also been released to the public.
- Commissioning external evaluations of the IMF's surveillance and economic research activities—expected to be completed by the summer of 1999 and subsequently published.
- Regular publication of information on the IMF's liquidity position and on members' accounts with the IMF on the IMF's website.

In March and April 1999, the Executive Board approved additional initiatives to enhance transparency. These included:

- Establishing a presumption that member countries would release Letters of Intent, Memoranda of Economic and Financial Policies, and Policy Framework Papers underpinning IMF-supported programs.[9]
- Releasing the Chairman's concluding statement emphasizing key points made by Executive Directors following Executive Board decisions on the use of IMF resources by a country.
- Establishing a pilot project ending on October 4, 2000, for member countries' voluntary public release of Article IV staff reports (including combined Article IV and use of Fund resources reports).
- Providing a systematic approach for the public release of PINs following Executive Board discussions of papers on policy issues.
- Expanding public access to the IMF's archives. This includes reducing the waiting period for Executive Board documents to 5 years from 30 years and for other archived documents to 20 years.

[6]World Bank, *Principles of Good Practice in Social Policy: A Draft Outline for Discussion and Guidance,* April 14, 1999, DC/99-4 (Washington, 1999).

[7]For updates on progress with the main elements of a strengthened international financial architecture, see "A Guide to Progress in Strengthening the Architecture of the International Financial System" on the IMF's website (http://www.imf.org).

[8]PINs are issued (1) at the request of a member country, following the conclusion of the bilateral Article IV consultation, to make known the views of the IMF; and (2) at the decision of the Board, following policy discussions in the Executive Board.

[9]Letters of Intent and Memoranda of Economic and Financial Policies are prepared by the member country. They describe the policies that a country intends to implement in the context of its request for financial support from the IMF. 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 resources under the ESAF, as well as associated external financing needs and major sources of financing.

Box 2

Strengthening the SDDS and Improving Access to Debt Data

On March 26, 1999, the IMF announced that its Executive Board had strengthened the Special Data Dissemination Standard (SDDS) established in 1996. Key decisions included:

- Strengthening the prescriptions for the international reserve data category, including dissemination of detailed information on reserve assets and information on reserve-related liabilities and other potential drains on reserves. The Board prescribed disseminating full data corresponding to the new reserve template monthly, with a lag of not more than one month; data on total reserve assets would still be prescribed for dissemination monthly with a lag of not more than a week. The dissemination of data for the full template weekly, with a one-week lag, will be encouraged;
- Introducing a separate category for external debt that could include quarterly disaggregation by sector and maturity. The transition period will be determined after further consultation with countries, users, and international organizations;
- Setting a three-year transition period for disseminating data on the international investment position;
- Staff monitoring of subscribing countries' observance of key SDDS commitments, namely, the data dimension (i.e., the coverage, periodicity, and timeliness of release of data) and the provision of advance release calendars, indicating clearly the timetable for release of key data;
- By the end of 1999, requiring mandatory hyperlinks between the IMF's Dissemination Standards Bulletin Board and national summary data pages on the Internet, to facilitate monitoring and help meet the needs of data users; and
- Establishing a quarterly certification by subscribers of the accuracy of the metadata on the Dissemination Standards Bulletin Board.

The *Inter-Agency Task Force on Finance Statistics,* chaired by the IMF, has implemented a joint presentation of external debt statistics from the BIS, the OECD, the World Bank, and the IMF to meet the general need for more comprehensive, timely, and accessible data, particularly for shorter maturities. This presentation is available on the external websites of all of these organizations.

In terms of next steps, the Board plans to:

- Review the experience with the pilot program for release of Article IV consultation reports within 18 months and the policy on access to archives in two years; revisit the issue of PINs for use of IMF resources cases and the release of use of IMF resources staff reports in six months.
- Continue to review the experience with IMF-supported programs and IMF surveillance.
- Take stock of the external evaluation activities undertaken for the ESAF, IMF surveillance, and IMF economic research activities with a view to considering proposals on future activities and modalities of external evaluation toward the end of calendar year 1999.

Developing Standards for Use by Members

As an important means of strengthening the international financial system, the IMF is seeking to foster the development, dissemination, and adoption of internationally accepted standards, or codes of practice, for economic, financial, and business activities. During 1998/99, the IMF made considerable progress in developing and refining voluntary standards in the areas of direct operational concern to the IMF (data dissemination; transparency of fiscal, monetary, and financial policies; and, in conjunction with others, banking supervision):

- *The Special Data Dissemination Standard (SDDS)*—a standard of good practice in the dissemination of economic and financial data for member countries with, or seeking, access to international capital markets—was strengthened, notably with respect to international reserves, external debt, and procedures for monitoring observance of the standard (see Box 2). As of the end of April 1999, there were 47 subscribers to the SDDS.
- Work will continue on the *General Data Dissemination System* (GDDS), which is targeted at those member countries not in a position to subscribe to the SDDS.
- A manual on fiscal transparency to assist members in implementing the *Code of Good Practices on Fiscal Transparency: Declaration on Principles* has been approved. The Code, Manual, questionnaire, and self-evaluation report are available on the IMF's website. A dedicated electronic mailbox has also been set up so that country authorities can seek assistance with assessing the transparency of their fiscal management systems and formulating plans to improve fiscal transparency.
- A draft *Code of Good Practices on Transparency in Monetary and Financial Policies* is well advanced. The Code was developed by the IMF, in collaboration with the BIS, a representative group of central banks, other financial supervisory and regulatory agencies, the World Bank, the Organization for Economic Cooperation and Development (OECD), and academics. Following Board review of the draft Code in April 1999, it was placed on the IMF's website as a consultative document.
- On banking supervision, a draft handbook on the methodology for assessing implementation of the *Basle Core Principles* was being developed by a working group—including the IMF and the World Bank—for early consideration by the Basle Committee on Banking Supervision.

The next steps in developing and refining standards include:

- For the SDDS, refining proposals on the transition period for observance of the new prescription on external debt, following further consultation with countries, users, and other international organizations; examining the inclusion of macro-prudential indicators in the SDDS; implementing the agreed monitoring procedures; and reassessing prescriptions for the periodicity and timeliness of reserve data dissemination in the context of the next review of the SDDS, to be conducted toward the end of 1999.
- Efforts are under way to encourage all countries to make assessments of fiscal transparency. For those countries where a lack of fiscal transparency affects policy formulation and implementation, national authorities are being encouraged to identify weaknesses and improve their practices, with technical assistance provided where necessary.
- Further work in developing the *Code of Good Practices on Transparency in Monetary and Financial Policies* will be undertaken with the expectation that a revised version be submitted for Interim Committee endorsement at the 1999 Annual Meetings. A supporting paper setting out examples of good practices will be developed to help members seeking to improve the transparency of their monetary and financial policies.

Role of Standards in IMF Surveillance

Following up an Executive Board discussion on standards and IMF surveillance in July 1998, the Board considered further the role of the IMF in relation to standards. The main areas of emerging consensus within the Executive Board as of the end of April 1999 included:

- Standards relevant for the functioning of domestic and international financial systems cover a range of areas, including data dissemination; fiscal, monetary, and financial policy transparency; banking regulation and supervision; securities and insurance regulation; accounting and auditing; bankruptcy; and corporate governance.
- The official sector can play a role in strengthening incentives for adopting standards—including by some form of monitoring the extent to which countries observe them—and in helping focus efforts on improving transparency.
- The focus in monitoring observance of standards may need to go beyond disclosure of elements of particular standards, and also consider, to the extent feasible, the substance of members' policies relative to the standard.
- Care should be taken in the approach to monitoring to ensure it does not undermine the IMF's traditional role as confidential advisor.

The issues and practical modalities in the preparation of "transparency reports"—which summarize the degree to which an economy meets internationally recognized disclosure standards—as recommended by the Group of Twenty-Two and Group of Seven, were complex. To help illuminate practical considerations involved in monitoring observance of standards, a first round of experimental case studies of transparency practices of individual member countries was prepared by the IMF staff and published.[10] Given the complexity of the issues, the Executive Board agreed that a second round of experimental case studies—covering a wider range of countries, including those where implementation of standards is less advanced—should be undertaken to help develop the IMF's role in this area, with a view to having concrete proposals by the 1999 Annual Meetings.

A few issues that required further consideration were:

- The role of the IMF in monitoring observance of international standards in areas of direct operational (or core) concern. The IMF has expertise that would allow it to assess members' observance of international standards in four core areas: data dissemination; transparency of fiscal policy; transparency of monetary and financial policies; and, with other organizations, banking supervision.
- The IMF's involvement with other standards that fall outside its direct operational (noncore) concern and expertise. Other noncore standards—accounting, auditing, bankruptcy, corporate governance, insurance and securities regulation—are also important for the effective operation of financial systems. Standard-setting bodies in a number of these noncore areas are not likely to be in a position to assess independently the observance of the standards they have developed. For noncore areas to be monitored, other international financial organizations or groups of organizations would need to provide systematic or widespread assessments of these standards.[11]
- Using the expertise of other organizations in particular areas and drawing this work effectively into the IMF's surveillance, to better identify vulnerabilities.

Strengthening Financial Systems

Strengthening financial systems is an essential element of the new architecture. To this end, the IMF, the

[10]The two experimental studies along the lines of transparency reports (for Argentina and the United Kingdom) and a third (for Australia) are posted on the IMF's website, along with a solicitation for public feedback.

[11]The World Bank is developing systems for assisting countries to assess structural sources of vulnerability and providing support for institutional strengthening and capacity building; see World Bank, *Strengthening the Underpinnings of the Market Economy: International Standards, Principles and Best Practices, and the Role of the World Bank,* April 22, 1999, DC/99-10 (Washington, 1999).

Box 3
Enhanced IMF–World Bank Financial Sector Collaboration

In recognition that more effective collaboration between the IMF and the World Bank is important in strengthening financial systems, the *Financial Sector Liaison Committee* (FSLC) was established in September 1998 to enhance such collaboration. The aim of the collaboration is to ensure that the IMF and the Bank deliver high-quality, sound, and timely advice to countries and that expert staff from both institutions are used in the most effective way.

The Committee has:

- initiated actions to enhance coordination of both IMF and Bank work programs, developed guidelines and procedures for information sharing, and incorporated internationally recognized standards and sound practices in the work program; and
- agreed, in principle, to coordinate a joint financial sector monitoring and assessment program aimed at improving evaluations of the health and vulnerabilities of member countries' financial systems.

The Committee plans to develop further the proposal for collaboration in the form of jointly conducted "financial system stability assessments" that would draw on the resources and feed into the work programs of both institutions.

World Bank, the Basle Committee on Banking Supervision, other key international groupings, and financial supervisors across various regions have stepped up efforts in developing and disseminating international principles and good practices of sound financial systems. Key actions undertaken during the financial year included:

- Review by many *national financial supervisory and regulatory agencies* of their ongoing procedures to enhance oversight of financial sectors in light of recent events, including with respect to highly leveraged institutions.
- Review by the *Basle Committee* of gaps in existing work, including data-related issues, dealing with weak banks, safety nets, licensing, governance, and legal and judicial issues; establishment of a task force, with input from the IMF and World Bank, to review the 1988 Capital Accord, which defines the amount of capital international banks have to set aside against different categories of loans; and issuance by the Basle Committee of reports on standards for banks' interactions with highly leveraged institutions.
- The establishment of the *Financial Stability Forum* to strengthen cooperation among international organizations, regulatory associations, and expert groups with responsibilities in financial regulation and oversight, and review areas of vulnerability on an ongoing basis. The forum set up three working groups to focus on highly leveraged institutions, offshore financial centers, and the potential problems for countries associated with short-term capital flows.
- Actions by the *IMF* and the *World Bank* to ensure effective collaboration, particularly with regard to the financial sector (see Box 3).
- Completion by the *International Accounting Standards Committee* (IASC) of its work program in developing a core set of international accounting standards that could be adopted for international cross-border listings.
- Progress by the *OECD* in finalizing principles of corporate governance.

In addition to the efforts on developing standards and good practices, the legal environment in which financial systems operate must be efficient and effective. To this end, several countries have taken welcome actions to improve their bankruptcy laws and procedures, but there is still a need to press ahead more broadly on this front. In this context, the IMF staff has prepared a report on orderly and effective insolvency procedures, which identifies and discusses key issues that arise for all countries regarding the design and applicability of such procedures. The World Bank also intends to develop guidelines for effective insolvency regimes for developing countries. In addition, the United Nations Commission on International Trade Law (UNCITRAL)—which has proposed a model law on cross-border insolvency and has contributed to the IMF report—has expressed strong interest in collaborating with the IMF and World Bank in this area. The Interim Committee, in its April 1999 communiqué, welcomed the IMF's work in the area of insolvency laws and called on the IMF to continue collaborating with the World Bank, UNCITRAL, and other relevant institutions in promoting effective insolvency systems. While noting the voluntary nature of the new standards, the Committee also encouraged countries to adopt them as they were being developed.

Capital Account Issues

Although there is a broad consensus that financial integration, including capital account liberalization, brings substantial benefits, such liberalization carries risks and must be managed carefully. In 1998/99, the Board took up the issue of capital account liberalization on two occasions,[12] with the later session—in March 1999—addressing members' experiences with the use of capital controls and their liberalization. The Board agreed that:

[12]Published as *Capital Account Liberalization: Theoretical and Practical Aspects,* IMF Occasional Paper No. 172, by a staff team led by Barry Eichengreen and Michael Mussa (Washington, 1999).

- Capital account liberalization must be fully supported by a consistent macroeconomic framework, including monetary and exchange rate policies, and by an adequate institutional setup to strengthen the ability of financial intermediaries and other market participants to manage risk and to support monetary and exchange rate policies.
- Notwithstanding this general principle, countries had followed diverse approaches to the speed and sequencing of capital account liberalization. Directors' views also differed on the usefulness and effectiveness of capital controls.

Experience from the crises of the last two years had highlighted that, in many cases, poorly sequenced or poorly supported liberalization and inconsistent monetary and exchange rate policies lay behind the accumulation of imbalances that preceded the crisis in emerging markets. Excessive accumulation of short-term debt and highly leveraged positions in the banking and corporate sectors left the economies vulnerable to external shocks or a loss of confidence. Poor risk assessments and herd behavior on the part of investors also contributed to increased vulnerability.

The experience from the crisis also underscored that once the financial turmoil began, and especially after it intensified following the Russian crisis in August 1998, even countries with seemingly appropriate policies were buffeted by volatile international capital markets. Countries that maintained consistent monetary and exchange rate policies, and that supported liberalization with financial sector reforms, were better able to handle capital inflows and subsequent reversals.

While supportive of the aim of further liberalization of capital flows, the Executive Board, at its March 1999 meeting, discussed the use and effectiveness of controls and found it helpful to distinguish between controls over capital outflows and over inflows.

Most Directors concluded that the reimposition of controls on capital outflows was not an effective policy instrument in a crisis. To be effective for even a short time, controls had to be wide ranging and strict; yet the more this was the case, the more likely they were to interfere with commercial transactions and debt service and, therefore, to discourage debt rollovers and new inflows. Thus, resort to controls on outflows was generally seen as likely to increase the severity of the external adjustment and have long-lasting damaging effects on countries' access to international finance. Several Directors, however, considered that, in a crisis, the reimposition of controls on capital outflows—together with the appropriate involvement of the private sector and in the context of a broader adjustment effort—could play a useful role.

There was considerably more debate over the effectiveness of disincentives or controls on capital inflows. Although the impact of such controls on the total volume of inflows was controversial, there was more evidence supporting the view that with controls the composition of inflows shifts toward the longer end of the market. Countries using controls on inflows, however, had not avoided severe capital flow reversals when policies were inappropriate. Directors thus stressed that controls on inflows were not a substitute for more fundamental policy action and, when adopted, had to be part of a broader policy package. A case could be made that controls on inflows might be justified on prudential grounds in situations of a weak domestic institutional and regulatory environment, and as a means of coping with external market pressures. Nevertheless, it was emphasized that it was generally preferable to address prudential difficulties directly to avoid the risk to financial systems and the impact of capital controls on the efficient mobilization and allocation of financial resources.

In terms of next steps, Directors agreed that:

- To draw conclusions for best practices, IMF staff would continue to refine its analysis and review the experience of countries with the use (and the effectiveness) of specific controls, as well as their experiences with liberalizing different components of the capital account.
- Further efforts would be made to ensure that IMF surveillance focuses on the appropriate sequencing of capital account liberalization, and that effective safeguards are in place to help ensure the resilience of the economy, particularly the financial sector, to possible shocks.
- Work to improve the reporting and monitoring of capital flows would continue, including assisting countries to improve monitoring of private sector short-term flows, particularly with respect to interbank credit lines.

Involving the Private Sector in Forestalling and Resolving Crises

The effort to better involve the private sector in crisis prevention and resolution is seen as critical in bringing about a more orderly adjustment process, limiting moral hazard, strengthening market discipline, and helping emerging market borrowers protect themselves against volatility and contagion. In 1998/99, the IMF's Executive Board, together with the international community, considered various proposals for involving the private sector.

The experience of the past two years suggests that the case-by-case approach has achieved a degree of success, although some Directors thought it would be appropriate to adopt a framework for involving the private sector in which rules would be clarified for private financial markets ex ante. In large part, the approach in such countries as Brazil, Indonesia, Korea, and Thailand relied on a combination of strengthened economic

Box 4
Measures for Involving the Private Sector in Resolving Crises

Ex Ante Measures

Private contingent credit lines that could be drawn on in times of difficulty, if fairly priced, could provide efficient insurance against adverse market developments, including liquidity risk, and could contribute to effective burden sharing during periods of stress. At the same time, in complex financial markets, hedging strategies of private financial institutions could lead to offsetting transactions with the country concerned, or shift pressures to other markets, or both. Members should be encouraged to explore contingent credit lines with private financial institutions.

Call options in interbank credit lines could provide a contractual basis for extending maturities under specified conditions. However, interbank credit lines are often a key source of short-term liquidity for countries, and the triggering of such options could lead to a loss of maturing short-term credit lines in advance of a call, thereby worsening liquidity difficulties.

Debt-service insurance, including instruments commonly known as “structured notes” that can be adapted to generate a debt-service burden that varies countercyclically *against* overall economic developments of the country, could help reduce the risk of crisis. Such instruments are more likely to be feasible for members that have highly concentrated exports (such as many oil or primary commodities exporters), where contracts can be linked mainly to external developments.

Official guarantees of new debt through full or partial guarantees of new sovereign or private debt instruments may hold promise at times when market access is very limited, for example, while emerging from a crisis. Questions can be raised about the effectiveness of guarantees, however. The World Bank recently reviewed its experience with guarantees and proposed a limited policy-based guarantee program; the experience with this program will be assessed at a later date.

Other Measures

Concerted rollovers of external debt, in Korea, against a background of hemorrhaging official reserves, successfully stabilized a critical situation and facilitated a restructuring of interbank claims into sovereign guaranteed bonds. Korea’s success, however, reflected some special circumstances and could be difficult to replicate elsewhere. In deciding on such operations, the international community must pay special care to the danger that concerted operations in one case could lead creditors to withdraw credit lines in advance of a crisis elsewhere for fear of a concerted rollover.

Restructuring international sovereign bonds raises difficult issues, which need to be considered case by case. In practice, there is a trade-off between the immediate cash flow relief associated with bond restructuring and the resulting reduction over the medium term in the country’s ability to mobilize resources from private creditors.

policies, official financing, and varying approaches to the private sector. In Korea, Indonesia, and Ukraine, moral suasion by the international community helped secure continued private sector financing in support of countries’ adjustment programs. Brazil reached voluntary agreement with commercial bank creditors to maintain their exposure. As a result of such cooperative efforts, exposures were maintained and some burden sharing achieved, but questions remained as to the general applicability of these efforts and whether they could have adverse effects (see Box 4).

At a March 1999 discussion, the Executive Board generally agreed that more had to be done to create market-based incentives and instruments for the private sector to remain involved.

Intensifying Efforts at Preventing Crises

Preventing financial crises is key and is the primary responsibility of member countries working in collaboration with the IMF and with the international community. In addition to implementing appropriate macroeconomic and structural policies, countries’ efforts need to be aimed at improving the environment for private sector risk assessment and decision making by enhancing the flow of information and the regulatory environment, and by limiting implicit and explicit guarantees to the private sector. Directors agreed on the following main elements:

- Countries should maintain an appropriate debt profile, by avoiding the excessive accumulation of short-term debt or an excessively rigid debt structure, and by ensuring adequate levels of both official reserves and banking system liquidity to help provide for orderly handling of a temporary reduction in capital market access. Countries should establish or strengthen systems for the high-frequency monitoring of private external liabilities, to better monitor short-term capital flows, and to provide early warning of emerging difficulties.
- Countries should exercise appropriate restraint with respect to the official sector’s off-balance-sheet transactions, including the use of financial derivatives, and should ensure that the supervisory authorities take account of financial entities’ vulnerability to financial derivatives. The IMF staff will give more attention to potential vulnerabilities associated with debt structures and financial derivatives in the context of both surveillance and the use of IMF resources.
- Effective communication between emerging market borrowers and private capital markets should be

maintained. Such contacts have proved their worth during periods of market stress in Latin America. The IMF should consider ways to help member countries establish regular communication with their creditors—including assessing along with other international organizations the creation of creditor-debtor councils—giving due attention to potential problems such as insider information. The IMF is also seeking to expand its regular contacts with markets.

Measures to Facilitate Private Sector Involvement

Prevention needs to be buttressed by measures designed and adapted ex ante to better ensure the involvement of the private sector in crisis avoidance or orderly resolution. Such measures put in place before the event can help facilitate the orderly resolution of balance of payments pressures. These include mechanisms that effectively precommit private sector participants to maintain or provide additional net exposure, or reduce debt-service burdens, in times of crisis, while limiting moral hazard and the distortion to markets in normal times. Mechanisms are also needed for dealing with extreme situations when ex ante measures do not deliver the needed support and it is not possible to agree on an orderly refinancing or debt restructuring.

In considering options, two main principles are that contracts should be honored and that care is required to ensure that solutions adopted to help avoid or resolve a crisis in one case do not have broader adverse effects that could potentially cause more difficulties than they solve.

In addition to proposals that would seek to reduce any bias that might exist in the short-term interbank credit markets, and to modify the terms of bond contracts, several measures have been proposed (see Box 4).

As of March 1999, agreement seemed to be emerging within the Board in three areas:

(1) *Encourage the reassessment of capital standards by the Basle Committee* to include measures to reduce the perceived bias toward short-term interbank credit lines from industrial countries to emerging market banks. (The Basle Committee on Banking Supervision (BCBS) subsequently announced reforms of the Basle Capital Accord in June 1999.)

(2) *Move forward with modification of bond contracts.* This could be done by including sharing clauses, provisions for the modification of terms by qualified majorities, and collective representation provisions, or other modifications to achieve the same objectives. British-style trust deed bonds contained such clauses and could serve as a useful model for future issues, but they were not the only model. While consideration was being given to this issue in other forums, little progress had occurred. This suggests that some form of concerted action by major industrial countries to encourage emerging market borrowers to modify the terms of their new issues was required. Another approach would be to rely upon a demonstration effect, through the inclusion of new contractual terms in international bond issues by the Group of Ten. This would seek to establish the new instrument as an industry standard and could reduce the costs associated with its use.

Consideration should also be given to a coordinated regulatory requirement for new sovereign issues admitted to domestic markets to meet specified minimum conditions regarding contractual provisions. A concerted regulatory approach, intended to reflect systemic concerns, may go beyond the traditional role of security market regulators to protect investors. For its part, the IMF would encourage members to include terms that would facilitate restructuring in bond issues. These steps could be complemented by efforts to build a consensus in support of these changes among the financial institutions involved in issuing and underwriting sovereign bonds.

(3) *Consider contingent financing and debt-service insurance.* Borrowers should explore with their creditors possibilities for private contingent credit lines[13] and other debt instruments that provide additional liquidity, or reduce debt-service burdens, in periods of severe balance of payments difficulties.

In extreme situations, if ex ante mechanisms put in place fail to deliver the needed support in sufficient amounts, efforts to reach agreement on voluntary debt restructuring fail, and pressures in the external accounts do not abate, members may be faced with a need to consider some combination of a default on sovereign bonds and the imposition of exchange controls. Such measures could interrupt the ability of nonsovereign states to service their external debts. There is little modern experience with restructuring sovereign bonds or with renegotiating private debt caught up in exchange controls, so it is difficult to predict how the process would unfold. To permit the IMF to support a member's adjustment policies during the possibly protracted period of debt negotiations that could follow such action, the IMF's financing assurances and arrears policies have been modified so as to permit the IMF to lend, case by case, into arrears. Certain issues remain for the Board to resolve, however, regarding the conditions under which the IMF would proceed.

Ways must also be explored to ensure that, in extreme situations, the process of debt negotiation following default, even if protracted, remains orderly.

[13]Argentina and South Africa, among others, have entered into financing agreements with consortiums of foreign commercial banks with the aim of creating a mechanism to provide liquidity in times of crisis.

Some Directors felt that there was little danger of creditors resorting to litigation on a scale that could effectively disrupt a country's adjustment efforts, or the capacity of the IMF to support those efforts. Others, however, saw a possibility that creditor litigation could block progress toward orderly debt restructuring and challenge the IMF's ability to provide effective support for a member's adjustment efforts. Against this background, further consideration could be given to the possibility of adopting some mechanism to allow the official community to endorse a temporary stay on creditor litigation, possibly through an amendment of Article VIII, Section 2(*b*) of the IMF's Articles of Agreement.

The Interim Committee, at its April 1999 meeting, asked the Board to continue its work on all of these issues, including on ways to ensure more orderly debt workouts.

Systemic Issues

In strengthening the architecture of the international financial system, several Board discussions in 1998/99 addressed a number of systemic issues. In these discussions, the IMF's objective was to contribute to the analysis of exchange rate regimes, propose ways to improve the functioning of the financial system, and adapt its financial facilities, resources, and organization to the evolving international monetary system.

Implications of Capital Mobility and Exchange Rate Volatility

The profound changes that the international monetary and financial system has undergone since the Bretton Woods agreement, in particular over the last two decades, raise broad systemic issues. In the preliminary discussion on IMF-supported programs in East Asia, one lesson drawn was that the stable exchange rates of the countries affected may have led borrowers and creditors alike largely to disregard currency risks, perceiving that they were implicitly guaranteed against related losses. Adoption of a more flexible exchange rate regime is no panacea, however, and regardless of the regime, vulnerabilities will continue to exist and standards for strengthened financial systems and improvements in transparency will still be required.

Before the 1999 Annual Meetings, the Board plans to address these issues. In the area of exchange rate regimes, the focus will be on the volatility of the exchange value of major currencies, the scope for measures to moderate such volatility, and the consequences for the exchange rate policies of emerging market economies. As for asset markets, the focus will be on the systemic aspects of major swings in capital flows to developing countries and on possible general, systemic, measures to moderate the boom phase of the cycle on the side of lenders as well as of borrowers, including some of the measures discussed above for strengthening financial systems and improving transparency and accountability.

Developing IMF Facilities

Progress was made in 1998/99 in adapting the IMF's facilities to the new international environment. The Board reviewed the Supplemental Reserve Facility in January 1999 with an eye to ensuring that the IMF would be ready to respond promptly and effectively to a member's need for balance of payments financing.

At the same time, the IMF also explored ways in which it could support members whose economies are fundamentally sound and well managed but that are concerned about the potential effects of contagion on their access to capital markets. In this regard, the Board agreed in April 1999 to establish the instrument of Contingent Credit Lines. This addition to the Supplemental Reserve Facility is intended to play an important role in preventing crises, including by creating further incentives for the adoption of strong policies and adherence to internationally recognized standards, encouraging the constructive involvement of the private sector, and thereby reducing the risks of financial market contagion (see Box 5).

Strengthening IMF Resources

To play its role in safeguarding the stability of the international monetary system effectively, the IMF needs sufficient financial resources. To this end, important actions were taken during the financial year:

- The New Arrangements to Borrow came into force on November 17, 1998. The combined amount of resources available to the IMF under the NAB and the General Arrangements to Borrow is SDR 34 billion (about $46 billion), double the amount under the GAB alone.
- The IMF quota increase under the Eleventh General Review of Quotas came into effect on January 22, 1999, raising overall quotas to SDR 212 billion (about $290 billion) from SDR 146 billion (about $200 billion). The increase in usable quota resources enabled repayment of amounts borrowed earlier under the GAB and NAB. At the end of April 1999, the IMF's liquidity ratio stood at 89 percent, compared with 45 percent a year earlier.

Beyond these actions, a special SDR allocation has been proposed, through an amendment of the IMF's Articles of Agreement, and is in the process of acceptance by the IMF's membership. Securing full financing for the ESAF and the IMF's participation in the HIPC Initiative remains a major challenge, however. Further efforts are urgently needed to ensure that the IMF has adequate resources to support the structural adjustment programs of the poorest member countries and to provide agreed debt relief.

Box 5

To Tighten Defenses Against Contagion, IMF Establishes Contingent Credit Lines

At the end of April 1999, the Executive Board agreed to provide Contingent Credit Lines (CCL) for member countries with strong economic policies as a precautionary line of defense readily available against future balance of payments problems that might arise from international financial contagion. The approval of financing under the CCL would signal the IMF's confidence in the member's economic policies and in the member's determination to adjust them as needed should contagion hit.

The CCL was established for a two-year period and will be reviewed after one year's experience. It is intended to serve as a new instrument of crisis prevention by:

- creating further incentives for members to adopt strong policies, notably debt management and sustainable exchange rate policies, and adhere to internationally accepted standards;
- encouraging the constructive involvement of the private sector, thereby containing the risks of financial market contagion while taking into account the potential impact on the IMF's liquidity; and
- signaling the IMF's willingness to provide financing to a member struck by contagion.

The CCL provides short-term financing to help members overcome the exceptional balance of payments financing needs that can arise from a sudden and disruptive loss of market confidence owing to contagion—that is, circumstances that are largely beyond the member's control and arise primarily from adverse developments in international capital markets consequent upon developments in other countries. It takes the form of an addition to the IMF's existing decision on the Supplemental Reserve Facility (SRF). A key difference is that the SRF is to be used by members already in the throes of a crisis, whereas the CCL is a preventive measure intended solely for members concerned about potential vulnerability to contagion but that are not facing a crisis at the time of commitment.

The IMF has ensured the effective use and safeguarding of IMF resources by establishing the following criteria for access to the CCL:

- at the time of Board approval of a commitment of CCL resources, the member is implementing policies considered unlikely to give rise to a need to use IMF resources and is not already facing contagion-related balance of payments difficulties;
- the member's economic performance has been assessed positively by the IMF in the last Article IV consultation and thereafter, taking into account its progress in adhering to relevant internationally accepted standards; in particular, the member should have subscribed to the Special Data Dissemination Standard and be judged to be making satisfactory progress toward meeting its requirements;
- the member should be maintaining constructive relations with private creditors with a view to facilitating appropriate private sector involvement and should have made satisfactory progress in limiting external vulnerability through management of its external debt and international reserves; and
- the member should submit a satisfactory economic and financial program, including a quantified framework, which the member stands ready to adjust as needed.

When a member requests actual use of CCL resources, a special "activation" review will be conducted expeditiously by the Board. At such reviews, the Board needs to ascertain that the member, having successfully implemented its program to date, is nevertheless severely affected by a crisis stemming from contagion and is committed to adjusting its policies as needed.

The CCL is not subject to general IMF access limits, but commitments under the CCL are expected to be in the range of 300–500 percent of the member's quota in the IMF, unless otherwise warranted by exceptional circumstances, and with due regard to the IMF's liquidity position.

CCL commitments are to be made for up to one year. At the time of the special activation review, the Board would decide on the amount to be released immediately and on the phasing of the balance remaining and the associated conditionality. Countries drawing under the CCL are expected to repay within one to one and one-half years of the date of each disbursement (the Board may extend this repayment period by up to one year). During the first year following the first drawing of CCL resources, the member will pay a surcharge of 300 basis points above the rate of charge on regular IMF drawings. (The rate of charge is a weighted average of short-term interest rates in the domestic money markets of the five countries whose currencies make up the SDR valuation basket.) The surcharge increases by 50 basis points every six months thereafter up to a maximum of 500 basis points.

Institutional Reform and Strengthening or Transforming the Interim Committee

During the financial year, the Board considered proposals for strengthening the Interim Committee or transforming it into a policymaking Council of the IMF's Board of Governors. Directors held diverse views on the Council. Most Directors, at a March 1999 discussion, were still unconvinced of the merits of establishing a Council, noting that the Interim Committee—despite the absence of decision-making powers—in effect already discharged the responsibilities envisaged for the Council. Several felt that the current institutional structures provided the necessary legitimacy and accountability, and that emphasis should be placed on enhancing these structures, as well as, more broadly, on the pressing issue of reform of the international monetary system. Some Directors thought that further analysis was needed to come to a judgment on the establishment of a Council and noted the need to explore the impact of the Council on the work and responsibilities of the Executive Board. A few other Directors, however, felt it was important to involve IMF members at a political level to make decisions on key strategic issues. These Directors felt that, in particular, this would strongly underline legitimacy and ownership in the IMF's decisions and the accountability of the institution.

At its April 27, 1999, meeting, the Interim Committee agreed that the IMF should remain at the center of the international monetary system, while improving, in a pragmatic manner, the modus operandi of its institutional components and its cooperation with other institutions and forums. The Committee asked the Executive Board to explore further the scope for institutional improvements, including the Interim Committee, and to report back at its fall 1999 meeting.

CHAPTER 6

Surveillance

Central to the IMF's purposes and operations is its oversight of the effective operation of the international monetary system. Accordingly, the IMF's Articles of Agreement direct it to exercise firm surveillance over the exchange rate policies of its member countries. To carry out this mandate, the IMF typically analyzes the appropriateness of each country's economic and financial policies for achieving orderly economic growth and assesses the consequences of these policies on other countries and for the global economy. In recent years, fundamental shifts in the global economy—such as the rapid growth of private capital markets, increased regional and monetary integration, and the implementation of current account convertibility and market-oriented reform in many countries—have heightened the importance of effective and timely surveillance. These changes are being mirrored in increased responsibilities for the IMF (see Box 6).

Typically, IMF surveillance has focused on encouraging countries to correct macroeconomic imbalances, reduce inflation, and undertake key trade, exchange, and other market reforms. But depending on the situation in each country, a much broader array of structural and institutional reforms—so-called second-generation reforms—have increasingly been seen as necessary for countries to establish and maintain private sector confidence and lay the groundwork for sustained growth. These areas include strengthening the efficiency of the financial sector, improving data collection and disclosure, making government budgets and monetary and financial policy more transparent, promoting the autonomy and operational independence of central banks, and promoting legal reforms and good governance. (Chapter 5 discusses initiatives in many of these areas.)

Traditionally, the IMF has conducted surveillance on two levels:

- *Bilaterally*—through Article IV consultations, generally conducted annually, with member countries; and
- *Multilaterally*—through reviews of developments in the international monetary system based principally on the staff's World Economic Outlook exercises and its periodic discussion of developments in international capital markets and financial systems. (See Chapters 2 and 3 for reviews of these Board discussions.)

More recently, the IMF has also undertaken surveillance on a regional basis, for example, through its discussion of developments in the European Economic and Monetary Union and in the West African Economic and Monetary Union. Also, in 1998/99, the Board discussed the experience to date with growth and disinflation in the economies in transition to market-oriented systems.

To ensure more continuous and effective surveillance, the Board supplements its scheduled, systematic monitoring with regular informal sessions—sometimes monthly, or even more frequently—on significant developments in selected countries and regions. In 1998/99, in addition to its discussions on Article IV consultations with member countries, which took 173 hours of Board time, the Board met 29 times—a total of over 87 hours—on policy issues related to surveillance (including discussions of the World Economic Outlook, transparency in members' policies and surveillance, and staff-monitored programs). The Board also meets regularly to discuss world economic and financial market developments. These continuing assessments by the Board inform and guide the work of IMF staff on member countries and are communicated to national authorities by Executive Directors.

Bilateral Surveillance

The IMF conducts consultations with its member countries, as mandated under Article IV of its Articles of Agreement, generally every year, to review each member's economic developments and policies. An IMF staff team visits the country, collects economic and financial information, and discusses with the authorities the economic developments that occurred since the last such visit, and the monetary, fiscal, and structural policies that the country is following. The Executive Director for the member country usually par-

Box 6
External Evaluation of IMF Surveillance

Because surveillance is so central to the IMF's activities, the Executive Board, in mid-1998, agreed to engage a group of three independent external experts to conduct an evaluation of IMF surveillance over members' policies, to assess the effectiveness of such surveillance, and to make recommendations for improvements. The experts were requested to include in their evaluation all channels and instruments of IMF surveillance.

The external evaluation addresses four broad questions:

- How effective is surveillance in identifying the macroeconomic, structural, and financial weaknesses and imbalances in member countries and in the world economy that obstruct sustainable noninflationary economic growth and external viability?
- Are the policy recommendations of the Board and the IMF staff relevant, realistic, and timely?
- What impact do these recommendations have on members' policies?
- How appropriate are the surveillance procedures, the resources and staff skills employed, the interactions with member country authorities, and the ways in which the Executive Board's surveillance conclusions are disseminated?

The outside experts began their work in July 1998 and are expected to complete their report in the summer of 1999.

ticipates. The staff normally prepares a concluding statement or memorandum summarizing the discussions with the mission and leaves this statement with the authorities. If a country decides to release the staff's concluding statement to the public, the IMF makes the statement available on its website. Back at IMF headquarters, the staff prepares a detailed written report describing the economic situation in the country and evaluating the country's policy stance. The Executive Board then discusses this report. The views expressed by the Directors during the meeting are summarized by the Chairman of the Board (the Managing Director), and the summary is later issued as an IMF "summing up." The IMF sends the summing up to the country as the record of what was said at the meeting and, if the country agrees, also releases the summing up to the public, together with introductory background material, as a Public Information Notice. In 1998/99, the Board conducted 125 Article IV consultations with member countries, 91 of which resulted in the issuance of a PIN (see Table 4); PINs are also available on the IMF's website.[14]

In addition to Article IV consultations, the Board carries out surveillance in its discussions of ongoing IMF financial arrangements in support of members' economic programs and financial arrangements intended as precautionary. Other means of surveillance are informal staff-monitored programs and the enhanced surveillance procedure.

- *Precautionary Arrangements.* Members agree with the IMF on a Stand-By or Extended Arrangement but do not intend to use resources committed under these arrangements unless circumstances warrant. The country has the right, however, to draw on the resources provided it has met the conditions agreed upon in the arrangement. Such arrangements help members by providing a framework for economic policy and highlighting the IMF's endorsement of its policies, thereby boosting confidence in them. They also assure the country that IMF resources will be available if needed and provided the agreed conditions are met.
- *Informal Staff-Monitored Programs.* Under these programs, the IMF staff monitors the country's economic program and meets regularly with the country's authorities to discuss the policies undertaken. The IMF does not, however, formally endorse the member's policies or provide financial assistance under such programs (see also Chapter 7).
- *Enhanced Surveillance.* This involves close and formal monitoring by the IMF, without constituting formal IMF endorsement of the member's economic policies. The procedure was initially established to facilitate debt-rescheduling arrangements with commercial banks, but it has also been used in other situations.

Global and Regional Surveillance

During the financial year, the Executive Board met on three occasions to discuss the World Economic Outlook and twice to consider reports on developments in international capital markets (see Chapters 2 and 3). On regional surveillance, the Board considered a wide range of issues related to the European Economic and Monetary Union during the year, as well as developments in the West African Economic and Monetary Union.

European Economic and Monetary Union

In April 1998, the Interim Committee welcomed the creation of the European Economic and Monetary Union as one of the most important international monetary developments in the post–Bretton Woods period. EMU was expected to have powerful implications for the international monetary system, based on the promise of a dynamic and integrated economy of 300 million people. Its single currency, the euro, backed by strong macroeconomic policies and a European Central Bank committed to low inflation, held the promise of gaining importance second only to the U.S. dollar.

[14]The PINs are also published three times a year as *IMF Economic Reviews.*

Table 4
Article IV Consultations Concluded in 1998/99

Country	Board Date	PIN Issued	Country	Board Date	PIN Issued
Albania	May 13, 1998	—	Macau	March 25, 1999	May 7, 1999
Algeria	July 24, 1998	August 24, 1998	Macedonia, FYR	June 19, 1998	—
Angola	February 24, 1999	—	Madagascar	February 8, 1999	March 2, 1999
Argentina	March 3, 1999	March 11, 1999	Malawi	December 17, 1998	December 30, 1998
Australia	October 28, 1998	November 17, 1998	Mali	February 10, 1999	February 25, 1999
Austria	June 17, 1998	June 24, 1998	Marshall Islands	June 26, 1998	—
Azerbaijan	June 26, 1998	August 17, 1998	Mauritania	January 29, 1999	—
Bangladesh	October 28, 1998	—	Mauritius	June 1, 1998	June 29, 1998
Belarus	July 24, 1998	—	Mexico	September 4, 1998	—
Belgium	February 12, 1999	March 8, 1999	Micronesia, Federated States of	June 26, 1998	August 27, 1998
Belize	August 28, 1998	September 22, 1998	Mongolia	November 23, 1998	—
Benin	July 6, 1998	October 23, 1998	Myanmar	June 5, 1998	—
Bolivia	September 18, 1998	October 2, 1998	Namibia	January 8, 1999	—
Bosnia and Herzegovina	May 29, 1998	July 14, 1998	Nepal	February 8, 1999	February 24, 1999
Brunei Darussalam	January 6, 1999	—	Netherlands	June 12, 1998	June 24, 1998
Bulgaria	February 19, 1999	March 10, 1999	Niger	August 28, 1998	—
Burkina Faso	May 18, 1998	June 12, 1998	Nigeria	June 12, 1998	—
Burundi	January 8, 1999	January 28, 1999	Norway	January 15, 1999	February 1, 1999
Cambodia	March 17, 1999	April 6, 1999	Oman	June 10, 1998	July 21, 1998
Cameroon	April 7, 1999	April 15, 1999	Pakistan	January 14, 1999	January 27, 1999
Canada	January 22, 1999	February 5, 1999	Panama	December 16, 1998	January 5, 1999
Central African Republic	July 20, 1998	August 11, 1998	Paraguay	January 8, 1999	January 29, 1999
Chad	March 29, 1999	May 14, 1999	Peru	June 3, 1998	June 22, 1998
Chile	January 25, 1999	February 3, 1999	Poland	March 11, 1999	April 8, 1999
China, P.R. of	July 29, 1998	—	Portugal	October 26, 1998	November 2, 1998
Colombia	December 9, 1998	December 11, 1998	Romania	September 15, 1998	October 6, 1998
Croatia	July 10, 1998	July 27, 1998	Rwanda	June 24, 1998	September 1, 1998
Cyprus	July 24, 1998	August 14, 1998	Samoa	February 17, 1999	March 12, 1999
Djibouti	June 1, 1998	—	San Marino	February 25, 1999	March 11, 1999
Dominica	August 25, 1998	September 22, 1998	São Tomé and Príncipe	July 13, 1998	—
Egypt	January 11, 1999	—	Saudi Arabia	July 1, 1998	—
Eritrea	July 13, 1998	—	Senegal	November 25, 1998	—
Fiji	September 14, 1998	October 1, 1998	Seychelles	July 17, 1998	—
Finland	August 28, 1998	September 10, 1998	Singapore	March 15, 1999	March 26, 1999
France	October 28, 1998	November 11, 1998	Slovenia	January 7, 1999	January 22, 1999
Gabon	January 15, 1999	—	Solomon Islands	June 10, 1998	July 16, 1998
Georgia	July 27, 1998	September 11, 1998	South Africa	July 17, 1998	September 2, 1998
Germany	September 2, 1998	September 18, 1998	Sri Lanka	July 27, 1998	August 12, 1998
Ghana	December 2, 1998	January 12, 1999	St. Lucia	March 23, 1999	April 8, 1999
Greece	August 5, 1998	August 10, 1998	Swaziland	January 11, 1999	March 8, 1999
Grenada	March 23, 1999	April 2, 1999	Sweden	September 14, 1998	September 25, 1998
Guatemala	May 27, 1998	—	Switzerland	February 22, 1999	March 1, 1999
Haiti	July 20, 1998	September 10, 1998	Syrian Arab Republic	June 15, 1998	—
Honduras	September 14, 1998	—	Tajikistan	December 17, 1998	December 21, 1998
Hong Kong SAR	January 29, 1999	February 11, 1999	Tanzania	February 8, 1999	March 31, 1999
Hungary	February 22, 1999	March 4, 1999	Thailand	June 10, 1998	June 25, 1998
India	August 31, 1998	September 22, 1998	Tonga	October 23, 1998	November 9, 1998
Indonesia	March 25, 1999	April 13, 1999	Trinidad and Tobago	June 15, 1998	June 24, 1998
Iran, Islamic Republic of	March 19, 1999	—	Tunisia	June 17, 1998	June 26, 1998
Ireland	October 14, 1998	October 22, 1998	Turkey	August 6, 1998	August 13, 1998
Israel	March 12, 1999	March 23, 1999	Turkmenistan	June 19, 1998	—
Jamaica	July 15, 1998	August 10, 1998	Ukraine	March 26, 1999	April 27, 1999
Japan	August 5, 1998	August 13, 1998	United Arab Emirates	November 4, 1998	—
Jordan	April 15, 1999	—	United Kingdom	March 3, 1999	March 7, 1999
Kazakhstan	June 24, 1998	July 1, 1998	United States	August 3, 1998	August 7, 1998
Kenya	May 22, 1998	—	Uruguay	September 3, 1998	September 18, 1998
Korea	May 29, 1998	June 19, 1998	Uzbekistan	September 4, 1998	—
Kuwait	January 29, 1999	February 22, 1999	Vanuatu	August 5, 1998	September 16, 1998
Kyrgyz Republic	March 3, 1999	March 29, 1999	Venezuela	June 17, 1998	—
Lao People's Dem. Rep.	June 15, 1998	July 7, 1998	Yemen, Republic of	March 23, 1999	April 15, 1999
Libya	February 25, 1999	—	Zambia	March 25, 1999	April 29, 1999
Lithuania	July 13, 1998	July 21, 1998			
Luxembourg	May 13, 1998	June 1, 1998			

Box 7
The Stability and Growth Pact

In June 1997, the European Council concluded negotiations on the Stability and Growth Pact to secure budgetary discipline in member states during the final stage of the European Economic and Monetary Union. The Pact covers both the implementation of the excessive deficit procedure specified in the Maastricht Treaty and the medium-term surveillance of fiscal policies.

Under the excessive-deficit procedure, EU countries that breach the 3 percent of GDP reference value for the general government deficit are deemed to be in excessive deficit, unless exceptional circumstances apply, and will receive advice from the Economic and Financial Council of Ministers of the European Union (ECOFIN) on correcting the excessive deficit. Failure to follow up effectively on this advice will result in fines for countries in the euro area.

Countries are also expected to submit medium-term stability programs, updated annually, that identify how governments plan to meet and maintain the Pact's medium-term objective of general government positions that are near balance or in surplus.

Foreseeing wide-ranging changes, the Interim Committee requested the Executive Board to examine further the implications of EMU for IMF operations.

The Board met on several occasions during 1998/99 to discuss various EMU-related issues. It discussed the economic policy challenges facing the euro area; the operational and legal aspects of EMU for the IMF; euro-area monetary and exchange rate policies in the context of Article IV consultations with euro-area countries and discussions with the European Central Bank; and the impact of EMU on selected non-EU countries.

Policy Challenges Facing the Euro Area

At an August 1998 meeting, Directors discussed the policy challenges facing the euro area. In many ways, they noted, circumstances were favorable to the introduction of the euro on January 1, 1999, as the economic recovery in the euro area appeared to have gathered greater momentum and was increasingly driven by domestic demand. Moreover, low inflation and substantial reduction of fiscal imbalances would, if sustained, help Europe achieve the extended growth needed to make inroads into its chronic unemployment problem. But several Directors emphasized that to reduce unemployment to acceptable levels, and ensure the lasting success of EMU, much remained to be done to improve the flexibility of labor and product markets. Against this background, the Board considered how policies could best consolidate the achievements in economic convergence to date and capitalize on them.

The euro area was well equipped to deal with economic policy challenges, with three pillars for ensuring effective policy coordination: the ECB, with its mandate of price stability; the Stability and Growth Pact (see Box 7), which embodied a commitment to sound fiscal policies; and the multilateral scheme for surveillance over labor policies agreed to at meetings of the European Council in June 1997 in Amsterdam, and in Luxembourg in November and December 1997. In this regard, Directors recognized that the final responsibility for individual fiscal and structural policies would remain at the national level.

Establishing credibility was a key challenge facing the ECB, Directors agreed. While the impressive performance of the national central banks in recent years provided a basis for confidence in this regard, many Directors cited some initial challenges in setting up a workable framework to guide monetary policy. The ECB would need to adjust its policy instruments pragmatically and explain clearly, frequently, and transparently the factors influencing its policies so as to clarify to the markets and the broader public the consistency of its actions with its mandate to ensure price stability in the euro area. Several Directors considered that cyclical divergences should not pose a major problem for monetary policy; they would diminish over time as a common monetary policy was implemented and as economic integration proceeded.

The conduct of national fiscal and structural policies was critical, not only for economic prospects in individual economies, but also for the euro area as a whole, as national policies would have inevitable spillover effects on other countries via their implications for the single monetary policy and the exchange rate of the euro. Several Directors observed that a number of cyclically advanced economies were either pursuing expansionary fiscal policies in 1998 or not taking sufficient advantage of favorable cyclical conditions to strengthen their medium-term fiscal policies. Tighter fiscal policies in these countries would help prevent the emergence of appreciable inflation differentials and real exchange rate swings with the union.

Allowing fiscal policy to play an effective countercyclical role was important for moderating cyclical swings in demand at the national level, thereby helping keep cyclical divergences in check in the future. Against the background of past tendencies toward procyclical fiscal policies, Directors saw as critical a commitment to the Stability and Growth Pact's goal of providing countries room to deal with normal cyclical divergences while keeping general government deficits below 3 percent of GDP.

Consistent with the Stability and Growth Pact, a medium-term fiscal position of near balance was appropriate at the time for most countries, although surpluses were warranted in a few countries. Although a less ambitious medium-term fiscal target might be sufficient to provide room for the automatic stabilizers in normal cyclical fluctuations, a number of considerations warranted going beyond this; these included adequate scope for discretionary countercyclical policies and of providing room for dealing with interest rate shocks, general uncertainty in the measurement of output gaps, and helping prepare public finances for the longer-term challenges associated with population aging.

Although there were some differences across countries, the convergence process in recent years had brought the euro area much closer to a satisfactory medium-term position. Nevertheless, the deterioration in the projected general government primary structural balances, especially for 1998, pointed to the still-significant risk that some countries would not achieve the medium-term goal of the Stability and Growth Pact and that some policymakers might focus too much on actual rather than cyclically adjusted deficits, leading them to introduce expansionary measures during economic upswings.

Against this background, Directors thought that governments needed to provide convincing evidence in their budgets for 1999 and in the stability programs to be presented to the EU's Council of Economic and Finance Ministers by the end of 1998 that fiscal positions would be brought into line with the medium-term goal of near balance, or surplus, not later than 2001. This was particularly important for those countries with high levels of public debt. The objective would entail a relatively moderate pace of fiscal adjustment, providing the opportunity to focus also on reform of fiscal systems—including pension and welfare schemes—as part of a broad package of structural reforms addressing the root causes of Europe's high unemployment and low labor participation rates. Directors noted that spending reforms could have a direct impact on incentives in the labor market, but they were also essential for creating scope for cuts in taxes and social security contributions. Initial reforms, the Board believed, should focus on reductions in primary expenditures.

At their August 1998 discussion, Directors underscored the importance of complementing fiscal reforms with other structural changes aimed at enhancing the flexibility of the real economy. Accelerated action was needed to achieve greater product and labor market flexibility to help reduce the high level of structural unemployment. Many Directors observed that countries had made progress in addressing structural rigidities, but it was not sufficient to have a noticeable impact on structural unemployment in most countries. It was essential, in the Board's view, that institutional and market structures also allow sufficient flexibility to deal with asymmetric shocks.

In view of the key role of national economic policymaking in determining the overall policy mix in the euro area, and the associated potential for spillover effects, Directors emphasized the importance of effective coordination of national economic policies. Some Directors, however, thought that current practice in the European Union, bolstered by the Stability and Growth Pact, balanced appropriately the need to limit policy spillovers with the need to provide scope to adapt policies to national circumstances. Directors underlined the role that IMF regional surveillance could play in fostering a desirable overall stance of policies and an appropriate policy mix. Such efforts had to be complemented by IMF consultations with individual countries.

In reflecting on the course of interest rates in the future, Directors observed that, for the euro area as a whole, a slack-absorbing recovery (as of the end of August 1998) was still in its early stages and that considerable spare capacity remained. Moreover, price inflation was low; developments in wages and monetary aggregates gave little ground for concern about inflation prospects; and the historically low long-term interest rates indicated that fears of inflation were also absent from the markets. These considerations on their own warranted keeping short-term interest rates in the core countries of the exchange rate mechanism (ERM) stable, with rates in other euro-area countries converging toward this level. Directors pointed to downside risks associated with developments in Russia and Asia, as well as the weakening in several emerging markets, which argued against premature tightening of monetary policy; an increase in interest rates would, therefore, have to await a further maturing of the recovery and a clearer indication of the effects of external factors. The Board agreed to a wait-and-see approach to interest rate policy.

Operational and Legal Aspects for the IMF

In September 1998, the Board discussed the operational and legal aspects of EMU for the IMF. The transfer of monetary powers by members of the euro area to EMU institutions, Directors agreed, would not affect their countries' legal relationship with the IMF under its Articles of Agreement, as the IMF is a country-based institution. Euro-area members would remain members of the IMF in their own individual capacity as countries. Nevertheless, the exercise of the individual rights and fulfillment of the obligations of members may be affected by the adoption of a common currency and the transfer of competencies to common institutions within the euro area.

With regard to operational aspects of EMU for IMF surveillance, Directors noted that EMU, and particularly the adoption of a single monetary policy under the responsibility of an independent European Central Bank, had important implications for IMF surveillance. As economic policies of the euro area would have

Box 8
IMF Grants Observer Status to European Central Bank

On December 22, 1998, the Executive Board granted observer status at the IMF to the European Central Bank (ECB), effective January 1, 1999. The ECB was invited to send a representative to attend Board discussions on the following topics:

- IMF surveillance under Article IV over the common monetary and exchange rate policies of the euro area;
- IMF surveillance under Article IV over the policies of individual euro-area member countries;
- the role of the euro in the international monetary system;
- the world economic outlook;
- international capital markets reports; and
- world economic and market developments.

The ECB was also invited to send a representative to Board meetings on the agenda items recognized by the ECB and the IMF to be of mutual interest in fulfilling their mandates.

important effects on other countries, Directors agreed that the IMF's responsibility to conduct surveillance over members' external and exchange rate policies required intensifying discussions with EU and euro-area institutions, especially the ECB.

Directors agreed that while Article IV consultations with euro-area members would proceed as usual, these could not be completed without discussion of such core policies as monetary and exchange rate policies that fall within the IMF's mandate. It was decided, therefore, that discussions with the representatives of the relevant EU institutions—the ECB, and also the Council of Ministers and the Economic and Financial Committee, especially on matters related to the policy mix and the exchange rate—would need to take place as part of Article IV consultations with individual euro-area countries. The modalities envisaged included twice-yearly staff discussions with the EU institutions responsible for common policies in the euro area, and an annual IMF staff report and Board discussion on the monetary and exchange rate policies of the euro area in the context of Article IV consultations with these countries. To the extent possible, the discussions with individual euro-area countries would be clustered around the discussions with the EU institutions.

To provide transparency on the IMF's surveillance of EMU, Directors agreed that, subject to the consent of the members concerned, Public Information Notices could be issued following the conclusion of the Board discussion on euro-area surveillance.

Directors agreed that effective communication of relevant EU institutions' views in Board discussions would be important for enhancing IMF surveillance over the euro area, and they called for granting the ECB observer status at the IMF (see Box 8). Directors highlighted the implications for national and regional data and information provision to the IMF from the move to the euro and directed the staff to make the necessary arrangements, particularly with the ECB and the Statistical Office of the European Union (Eurostat), for regular and timely transfer of data sets.

Euro-Area Monetary and Exchange Rate Policies

In March 1999, following the January 1 launch of the euro, Executive Directors discussed for the first time the monetary and exchange rate policies of the euro area in the context of Article IV consultations with euro-area countries. EMU offered participating countries and the world economy potential for greater economic stability and performance, and much had been done already by euro-area authorities to establish the foundation for realizing these benefits: a solid framework had been put in place to guide both monetary and fiscal policies; price stability had been achieved, and seemed secure for the foreseeable future; headway in fiscal consolidation had been made in satisfying the Maastricht convergence criteria; and the internal market program had substantially increased market integration in the European Union. Important challenges remained, however—in particular, the need for further fiscal adjustment and for national authorities to address urgently the structural rigidities impeding employment and economic growth.

The tasks facing euro-area policymakers had been complicated by the weakening of short-term growth prospects in the preceding six months. While policymakers' sights should remain firmly fixed on medium-term requirements, policies also had to be adequately attuned to supporting domestic demand. The euro area required a sustained period of strong domestic demand to help close a sizable output gap and absorb the cyclical component of unemployment. Moreover, most Directors believed that the euro area should play a greater role in supporting global demand.

Board members thought that, with price stability well assured and room for the operation of automatic fiscal stabilizers limited in many euro-area countries by the need for further fiscal adjustment, any easing should come from monetary policy. Short-term interest rates in the euro area had declined significantly over the past year, providing welcome support for economic activity. The case for a further interest rate reduction had increased in recent months, given the continuing uncertainties regarding the strength of the expected economic recovery in the euro area, the further heightening of global economic risks, and the continued downward pressures on inflation in the euro area. Directors agreed the European Central Bank should act decisively if the slowdown appeared to be persisting. In particular, a reduction in interest rates would be warranted if the global environment deteriorated further, if consumer confidence weakened significantly, or if a recovery in industrial confidence did not materialize.

Directors felt that the depreciation of the euro since its introduction reflected the continuing strength of the U.S. economy and uncertainties about growth prospects in the euro area.

Directors underlined the importance, at the early stages of the ECB, that the public understand and have confidence in the monetary framework, given the uncertainties in the outlook for the euro area and the global economy. They generally commended the work done in elaborating the ECB's approach to monetary policy, which was both sensible and pragmatic in light of the uncertainties of the change in regime. Several Directors felt that the ECB needed to specify an explicit lower bound for inflation to help improve policy discipline and accountability. The ECB had made important strides in communicating with the public, and Directors encouraged its efforts to develop further its communication strategy. In particular, many thought that the ECB had to provide greater detail of its assessment of inflation prospects and be more forthcoming in explaining how it would adapt monetary policy to changing economic conditions, including changes in inflation within the range that defines price stability. A few Directors indicated that there were limits to what could be conveyed by such statements of intent, given the complex considerations that went into monetary policy decisions, and that greater public understanding of the ECB's monetary policy would come from seeing the ECB in action and listening to its explanations for its actions.

Many Directors felt that an understanding of how the ECB was likely to respond to macroeconomic developments was important for fiscal authorities in gauging the appropriate stance of fiscal policy. While the appropriate fiscal stance in specific countries depended on a range of economic considerations addressed in individual Article IV consultations, the need for further fiscal consolidation in a number of euro-area countries—especially those with relatively large deficits or debts—and the lack of underlying fiscal adjustments in 1998 and in budgets for 1999 constrained the extent to which automatic stabilizers could be allowed to operate in the face of weaker activity. At the same time, the appropriate use of stabilizers also depended on the pace of economic activity and on the degree of support provided by monetary policy. It was especially important in the prevailing uncertain macroeconomic environment, Directors generally emphasized, that the mix resulting from fiscal and monetary policies fosters an appropriate level of aggregate demand in the euro area.

Demand management alone, however, would not provide the antidote to the slow growth and high unemployment that had plagued the euro area. Determined reforms of government spending and taxation systems and a forceful attack on structural rigidities were essential if unemployment was to be lowered substantially. Moreover, early action on these fronts would both boost confidence and ease the task of policymakers in tackling the current cyclical weakness.

Many Directors noted that countries' medium-term stability programs generally relied on cyclical improvements and declining interest spending to reduce further fiscal deficits, and that they had not planned even the relatively modest annual adjustments in primary structural balances sufficient to realize balanced fiscal positions in 2001–02. Moreover, the modest curtailment of spending growth planned by most countries left insufficient room for tax cuts. These Directors stressed that more ambitious medium-term fiscal strategies would bolster the credibility of the Stability and Growth Pact, provide the monetary authorities with greater room for maneuver, and help prepare for the effects of population aging.

In the area of structural reform, some countries had made good headway in labor market reform and some further progress had been achieved in recent years in strengthening the European Union's internal market, including through increased competition in telecommunications and liberalization in the utilities sector. Progress in attacking the root causes of high unemployment, however, had been disappointing. Countries had to train the large number of unskilled workers, many without recent job experience; address pervasive rigidities in labor and product markets; cut the heavy tax burden on labor; and reduce disincentives resulting from the interaction of generous unemployment and welfare benefits, their long duration, and inadequate tests of the availability for work of those receiving benefits. A number of Directors also emphasized that further trade liberalization, especially in agriculture, would contribute to a more efficient allocation of resources and help maintain price stability.

Directors were reassured that the ECB considered euro-area financial institutions in sound financial condition in the face of the recent global financial crisis, with no evidence of a credit crunch. Nevertheless, given the increasing integration of European financial markets and the mushrooming of complex operations, existing arrangements had to be reviewed to assess their capability to deal effectively with any rapidly emerging financial problems in European markets. It was especially important to ensure the efficient and rapid flow of information between the national supervisory authorities and the European central banking system.

On April 27, 1999, the Interim Committee welcomed the start of the European Economic and Monetary Union, which should contribute to financial stability and sustainable growth in the euro area and globally. It also welcomed the early April reduction by the European Central Bank of all three of its leading interest rates. The Committee emphasized the importance of open and competitive markets as a key component of efforts to sustain growth and stability in the global economy. Committee members urged the euro area to attack the root causes of high unemployment. An appropriate policy mix to support stronger domestic demand, accompanied by structural reforms in labor, capital, and product markets, was essential for enhancing growth and employment prospects, especially in the medium term, in order for the euro area to be a major source of growth in the world economy.

Impact of EMU on Selected Countries

In July 1998, the Board considered the impact of EMU on selected countries outside the European Union—Eastern and Central Europe, the Mediterranean Basin, and the CFA franc zone.[15] While Directors noted the significant benefits of EMU for non-EU countries over the medium term, they stressed the need for these countries to pursue financial and structural policies that would minimize the risks and maximize the opportunities arising from the euro's introduction. To mitigate possible trade- and investment-diversion effects that could result from reduced transaction costs within the euro area, non-euro countries had to strengthen structural reforms aimed at increasing the openness and competitiveness of their economies. Stronger competition from EU financial markets would also heighten the need for non-EMU partner countries to strengthen their financial sector reforms.

Several Directors considered capital account liberalization a high priority for potential members of the EU. In this connection, they underlined the need for orderly and well-sequenced liberalization, giving high priority to financial sector restructuring. The Board also emphasized the importance of EU countries, for their part, maintaining open trade regimes to broaden and deepen trade and investment relations with other countries. As to the possible risk of short-term exchange rate volatility that could adversely affect those countries with close trade linkages to the EMU or with large euro-denominated debt, Directors generally considered that the likely continuation of strong monetary policy credibility under the EMU meant that such a risk was not a major cause for concern.

Directors looked forward to further discussions of the implications of EMU for IMF surveillance. They saw the need to address the possible spillover effects more explicitly in the IMF's surveillance over euro-area members, particularly with respect to addressing structural rigidities and maintaining appropriately tight fiscal stances. They also saw the need for greater attention to the implications for non-EU countries of changes in economic and financial conditions in the euro area and to financial sector issues. In certain cases, increased integration in the world economy could mean that greater attention to the choice of exchange rate arrangements would be appropriate. Given that EMU and access to the EU would constrain the framework, design, and implications of macroeconomic policies for future EU members, Directors agreed that IMF surveillance should help these countries by offering them appropriate policy advice on complementary macroeconomic and structural reforms—including with regard to creating a legal and institutional framework and steps to increase the flexibility of markets.

West African Economic and Monetary Union

Executive Directors met in May 1998 to discuss strengthening IMF surveillance of regional developments in Africa by establishing a formal dialogue between the IMF and the regional institutions in the West African Economic and Monetary Union (WAEMU). The economic performance of WAEMU members had improved since the devaluation of the CFA franc in January 1994; nonetheless, Directors felt that the sustainability of the favorable performance hinged upon the pursuit of sound macroeconomic policies and the intensification of structural reforms. They emphasized the importance of continued progress in raising investment—particularly private investment—which remained low relative to GDP by the standards of other developing countries.

The overdue exchange rate realignment of 1994 had helped improve the competitive position of the region and had resulted in a strong increase in the growth of output and exports. Directors also noted that, although the real exchange rate had tended to appreciate since 1994, the competitive position of the WAEMU remained broadly adequate. However, the evolution of competitiveness indicators would need to be kept under close review. Moreover, several Directors recognized that trade liberalization reforms could adversely affect a country's external position; such effects would be relevant in assessing the need for balance of payments assistance in the context of a comprehensive adjustment program.

The monetary policy of the Central Bank of West African States (BCEAO) had contributed to the macroeconomic stability of the region, including the stability of the exchange rate peg, which had been modified only once since 1948. There was general agreement on the constraints placed on regional monetary policy by the fixed exchange rate regime and on the absence of scope for monetary policy at the national level. While agreeing that the indirect monetary policy instruments

[15]The staff paper was published as R. Feldman and others, *Impact of EMU on Selected Non-European Union Countries,* IMF Occasional Paper No. 174 (Washington: IMF, 1998).

introduced since 1993 seemed broadly adequate, Directors emphasized the importance of continued efforts to enhance their effectiveness. They also acknowledged the role of the ceilings on monetary financing of governments and pointed to the importance of strictly adhering to them in the context of fiscal consolidation.

The quality of financial intermediation in the WAEMU area would benefit from a stronger functioning of the regional interbank market, the introduction of a single zone-wide licensing agreement for banks in the WAEMU, and more competition between financial institutions. Directors also underscored the importance of improving the functioning of the judiciary system. While recognizing that the quality of bank supervision in the Union was on the whole adequate, Directors stressed the importance of promptly completing bank-restructuring programs under way in a number of WAEMU countries. They recommended that governments seek full privatization of the banking system and give prompt attention to raising capital ratios to international standards.

The Board supported steps by the WAEMU countries toward liberalizing the region's trade regime through the adoption of a common external tariff, which would become fully effective by January 2000. They agreed that the tariff structure should contribute to raising potential output in the Union as a whole by improving productivity, enhancing competition, and promoting the integration of the region into the world economy. Directors considered that government revenue shortfalls stemming from trade liberalization efforts—in particular, the introduction of the new external tariff—should be addressed primarily through the elimination of tax and customs duty exemptions and further efforts to strengthen tax administration and collection.

Directors welcomed the efforts under way for harmonizing indirect taxation and adopting a common investment code aiming at eliminating, or at least reducing substantially, exemptions from customs duties or value-added tax. They also encouraged the authorities to pursue other ongoing efforts at improving the overall business environment.

The Executive Board encouraged the authorities to sustain efforts to promote regional convergence of economic performance, in line with the provisions of the WAEMU Treaty. While noting the progress made over the last two years toward observing convergence criteria on the fiscal balance, the domestic contribution to public investment, and payments arrears reduction, Directors encouraged strong efforts toward broadening convergence so as to promote stability and growth. They welcomed the efforts under way to create a common budgetary framework, and a set of comparable economic indicators, and emphasized that progress in the timely availability of reliable data on the national accounts, domestic debt, and the balance of payments was essential to enhance surveillance.

Experience of Transition Economies

In November 1998, the Executive Board discussed the experience with growth and disinflation in transition economies. Directors noted that economic recovery in the transition economies had been mixed and that countries were at different stages of transition (see Box 9). For a number of the Central European and the Baltic countries, the transition was far advanced, with their economic problems and issues progressively more similar to those faced by middle-income market economies; here, progress on structural reforms played a key role. On the other hand, for most of the countries of the Commonwealth of Independent States (CIS), and to some extent for those in southeast Europe, a long unfinished agenda of market-oriented reforms remained.

In some of the Central European and Baltic countries—such as Poland, Hungary, Estonia, and Latvia—economic recovery might be running ahead of itself, Directors observed, which was generating risks of overheating and reversals of capital flows. In the future, growth should depend more on the mobilization of savings and their efficient intermediation by the financial sector—which underlined the need to put the banking system on a sound footing. Much more effort was needed to rationalize, and perhaps reduce, still-expensive social programs, while ensuring the provision of adequate safety nets.

With regard to the CIS, and to some extent countries in southeast Europe, the task at hand varied from completing the large-scale privatization and a meaningful imposition of hard budget constraints in Bulgaria (and even more so in Romania) to making a serious start with reform in Belarus and Turkmenistan, and restarting the reform process in Uzbekistan. Persistence was essential, in particular with adequate follow-through in areas of fiscal and financial sector reform. Privatization was a key mechanism for achieving efficiency and new growth, but this could only be achieved if countries managed to impose hard budget constraints, while establishing a legal framework to ensure the protection of property rights and the application of the rule of law.

Directors agreed that rapid disinflation had been achieved by many transition economies during 1993–97, at minimal output cost. This had been possible because strong stabilization packages had been introduced at a relatively early stage, before inflation expectations had taken root. The small inflation inertia was due to the limited use of wage and price indexation and the rapidity of price liberalization. Disinflation from high inflation levels, as well as the reduced varia-

Box 9

Conference on the Transition Experience

During February 1–3, 1999, the IMF held a conference, "A Decade of Transition: Achievements and Challenges," on the transition in central and eastern Europe. Its purpose was to identify lessons from the 10-year transition experience and distill them into better policies and more effective reforms for an increasingly diverse group of transition economies.

IMF Managing Director Michel Camdessus opened the conference by discussing the legacy of the past decade of transition, looking at the future agenda, highlighting the importance of enforcing the rule of law, and focusing on key questions for the future.

The first session of the conference reviewed the experience with inflation and growth. Transition countries in Europe had seen a striking reduction in inflation in the early 1990s, which led to robust output growth. Most of these economies, especially in central Europe and the Baltics, had made good progress on growth and now faced issues similar to those of middle-income market economies, although a long agenda of unfinished reforms remained. The objective in all transition countries should be good economic governance; in many, the government had not pulled back far enough from intervention in economic activity, and yet was not involved enough in providing law and order. Growth rates in the Asian economies in transition (China, Mongolia, Lao People's Democratic Republic, and Vietnam) were generally greater than those of countries in central and eastern Europe. Growth had generally been fastest in areas where reforms were most far-reaching, especially in agriculture, and these countries had the benefit of more favorable initial conditions than in Europe—specifically, a relatively large agricultural sector and rural labor surpluses.

Participants at a second session, on structural reforms, concluded that privatization had generally improved financial and operating performance, but its mixed record—especially in the countries of the former Soviet Union—had fueled questions about its method and outcomes. Speakers agreed there was no alternative to privatization and that the state should channel its energies into more effective privatizations, for example, by seeking ways to enlarge capital and ensure sales to strategic investors. On banking sector reform, three pillars to effective bank restructuring were identified: corporate governance, competition, and prudential regulation and supervision. The last was not optimal in any country in the region, but strong performers shared a number of features, such as having applied effective foreign and domestic bank entry and exit regulations during liberalization and new private commercial banking. Weak performers in banking sector reform also shared characteristics, for example, a lack of competition, poor asset quality, a lack of sector-specific expertise, significant state ownership, low levels of corporate lending, and an unstable macroeconomic environment.

The third session addressed the need for countries in transition to build institutions that support a market-oriented economy. Conference speakers noted that total capital inflows to transition countries had risen to significant levels, and early reliance on exceptional financing had given way to foreign investment and other flows, which are enhanced by a positive legal and political climate.

The role of government changes during a country's transition, speakers noted; shock therapy was the first step in adjustment but the more difficult step was the slow process of developing new institutions, changing incentives, and completely rethinking the role of government.

Conferees also discussed the underground economy, which may account for more than 40 percent of total GDP in several countries of the former Soviet Union, and over 20 percent in many others. It is not high taxes that drive firms underground, speakers noted, but rather excessive regulatory discretion, weak rule of law, and corruption. To break the cycle whereby regulatory discretion leads to hidden firm activity, reduced public revenues, weakened legal institutions, and thus greater opportunities for corruption, governments need to reduce regulatory discretion, reform bureaucracies, simplify and enforce laws, create an independent judiciary, and enhance government transparency and public oversight.

The transition to market economies has been accompanied by a large increase in income inequality, since income from self-employment and property (which is traditionally unequal) now makes up a larger proportion of national income, while some former state employees remain unemployed and social transfers sometimes fail to reach the poor.

At the end of the three-day conference, it was clear that transition economies' experience with privatization, income inequality, and institutional needs was becoming increasingly diverse (partly because of historical and geographical differences), and that the achievement of macroeconomic stabilization, while widely recognized as necessary, was only the first step in the transition process. The vital next stage for these countries was to strengthen or create the legal, fiscal, and regulatory infrastructures—and incentives—needed for the operation of a market economy.

IMF Deputy Managing Director Shigemitsu Sugisaki summarized the conference by noting some underlying themes:

- Fiscal and monetary stability are essential for successful transition.
- A sound financial sector is an indispensable component of macroeconomic stability.
- Privatization is key to forming a viable market-oriented economy.
- Measures to address income inequality are increasingly important.
- At the heart of the transition process is the complex and time-consuming task of institution building that helps states support market-oriented economies.

tion of inflation, had enhanced the medium-term growth prospects of the transition economies.

Directors noted that the hardening of budget constraints, together with central bank independence and a tightening of limits on central bank credit to the government, had been at the core of the stabilization packages. Although the link between fiscal performance and further disinflation at moderate inflation levels was less clear, even here disinflation could be impeded by fiscal policies that led to overheating or put the long-term solvency of public finances at risk. In this respect, Directors encouraged the countries that had successfully disinflated to implement structural reforms to strengthen their long-term fiscal positions.

Some Directors believed that, while the lack of inflation anchors had not impeded fast disinflation, their continued absence might expose monetary policy to undue pressures at a later stage of the transition, while a few others questioned the relevance of inflation targeting in the context of transition. Directors agreed that the risk of a reacceleration of inflation could be minimized by institutional reforms aimed at enhancing the independence of the central bank and the transparency of monetary policy.

On the role of monetary anchors, Directors agreed that exchange rate pegs might have contributed significantly to prolonging the moderate inflation phase in some countries. A few also noted the possible drawbacks of exchange rate pegs—pointing in particular to the possible increase in the volatility of capital flows as these countries made progress on the road to market economies—and argued for imparting some flexibility in the exchange rate arrangements. In this regard, greater attention could be given to the costs and benefits of different exchange rate systems in the context of the overall macroeconomic situation and the stage of transition, including the issue of exit strategies.

Sustaining low inflation rates also required the establishment of a strong financial system. Indeed, financial instability rooted in weak banking systems was critical in explaining the few episodes of relapses into high inflation during 1993–97.

Directors were concerned about the fallout from the crisis in Russia, which came to a head in August 1998. The crisis in Russia had reinforced the lessons that could be derived from the experience with transition:

- incomplete structural reforms to strengthen property rights and governance jeopardize the sustainability of financial stabilization; and
- the cost of incomplete reform in terms of lost output and renewed inflation can be severe.

Directors suggested that these considerations be taken into account in the design of future IMF-supported programs.

In all countries, the vital task of securely establishing good economic governance still remained, in particular in the CIS and southeast European countries. While in many countries the government had not pulled back sufficiently from intervening in economic activity, the authorities had perhaps pulled back too far in such areas as enhancing a secure climate based on the rule of law. Poor economic governance had delayed structural reforms, which in turn inhibited the economic recovery and constrained the development of a new, more dynamic business sector. In the area of structural reforms, Directors stressed the need for close cooperation between the IMF and the World Bank to achieve the most efficient and consistent support for the stabilization efforts of the transition countries.