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Recovery from the Asian Crisis and the Role of the IMF

By IMF Staff

June 2000

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I. Introduction

The financial crises that erupted in Asia beginning in mid-1997 are now behind us and the economies are recovering strongly. This rebound did not happen spontaneously, but came about as a result of steadfast policy implementation by the affected countries and large-scale financial support from the international community, especially under IMF-supported programs for Indonesia, Korea, and Thailand. Economic recovery is also pronounced in Malaysia and the Philippines. While, with the benefit of hindsight, the IMF's policy advice to these countries during the emergency was not flawless, corrections and adjustments to circumstances were made promptly, and the strategies adopted proved successful in restoring financial market confidence and stability, and in achieving a resumption of economic growth, in most cases by late 1998. Sustaining the recovery and making long-term progress in reducing poverty depend critically on the continued maintenance of macroeconomic stability and firm implementation of key structural reforms.

This brief updates the paper entitled "The IMF's Response to the Asian Crisis" that was issued in January 1999. It contains four country boxes (one each on Indonesia, Korea, and Thailand, and a fourth that covers Malaysia and the Philippines), and seven pages of charts, the first five on the individual country cases, and the final two on, respectively, the regional perspective and a comparison of macroeconomic developments during the Asian and Tequila crises.

II. New Breed of Economic Crisis

The crises that began in Thailand with a series of speculative attacks on the baht unfolded after several decades of outstanding economic performance in Asia. Although the circumstances varied among the countries concerned, the difficulties stemmed primarily from a combination of macroeconomic imbalances (even though government budgets were broadly in balance and inflation rates were modest), external developments, and weakness in financial and corporate systems. The external imbalances were a reflection both of strong private capital inflows and of high domestic private investment rates, and were exacerbated, prior to the crisis, by appreciation of the U.S. dollar to which the currencies of the countries concerned were formally or informally pegged.¹

The weaknesses of the financial and corporate sectors contained several elements, including pre-existing weaknesses in financial institutions' portfolios; unhedged foreign currency borrowing that exposed domestic entities to significant losses in the event of domestic currency depreciation; excessive reliance on short-term external debt; and risky investments against the backdrop of bubbles in stock and property prices. These elements had been building up in an environment of large private capital inflows and rapid domestic credit expansion in liberated financial systems, where implicit government guarantees (in addition to those entailed in exchange rate pegs) remained pervasive, and supervision and regulation were not up to the challenges of a globalized financial market.

In these circumstances, a change in market sentiment could and did lead into a vicious circle of currency depreciation, insolvency, and capital outflows, which was difficult to stop. Contagion spread rapidly in the region after the devaluation of the baht, as other countries were perceived by investors as facing similar weaknesses that cast doubt on their credit-worthiness. By the time the crises had run their course, a large proportion of the financial institutions and corporations in the affected countries were bankrupt.

III. The IMF-Supported Programs

The IMF was called in to provide financial support for three of the countries most seriously affected by the crisis: Indonesia, Korea, and Thailand. The strategy to address the crisis had

three main components:

- **Financing.** Some US\$35 billion of IMF financial support was provided for adjustment and reform programs in Indonesia, Korea, and Thailand, with the assistance for Indonesia being augmented further in 1998-99. Some US\$85 billion of financing was committed from other multilateral and bilateral sources, although not all of this financing actually materialized. In addition, concerted action was taken (at different stages after the start of these programs, in different countries) to stem private capital outflows.
- **Macroeconomic policies.** Monetary policy was tightened (at different stages in different countries) to halt the collapse of the countries' exchange rates--which went well beyond what might have been warranted by fundamentals--and to prevent currency depreciation from leading into a spiral of inflation and continuing depreciation. The monetary tightening was appropriately temporary: once confidence began to recover and market conditions stabilized, interest rates were lowered. Fiscal policy was essentially to be held firm in the case of Indonesia and Korea, while in Thailand a fiscal tightening was planned to reverse an increase of the deficit the year before the crisis.
- **Structural reforms.** Steps were taken to address the weaknesses in the financial and corporate sectors. Other reforms were intended to alleviate the social consequences of the crisis and set the stage for a resumption of growth.

The macroeconomic projections underlying the initial programs were predicated on the assumption that confidence could be rapidly restored through the presentation of a convincing framework of policies, together with large financing packages. Based on this assumption, growth was projected to slow down but remain positive. The IMF--along with other observers--did not foresee the deep recessions that occurred. In the event, Korea's GDP dropped by 7 percent in 1998, Thailand's by 6 percent, and Indonesia's by 14 percent.

In addition to the financial assistance for programs of policy reform in these three countries, the IMF was engaged with other countries in the region that were coping with the crisis:

- extending and augmenting the existing IMF-supported program for the Philippines in 1997, and arranging a stand-by facility in 1998; and
- intensifying its consultations with other countries affected by the crisis and providing policy advice on steps to help ward off contagion. This included support for the authorities' view in China that its exchange rate against the U.S. dollar should be held stable.

IV. Structural Reforms Were Essential to the Programs

Structural reforms were given more prominence than in typical IMF programs. The details of these reforms were formulated in collaboration with the authorities in each country, as well as the World Bank and Asian Development Bank.

The need for financial sector reform was particularly pressing, given the origins of the crisis. The following essential elements were common to policies in all three countries:

- the closure of insolvent financial institutions, to stem further losses;
- the recapitalization of potentially viable financial institutions, often with government assistance;
- close central bank supervision of weak financial institutions; and

- a strengthening of financial supervision and regulation, to prevent a recurrence of the fragilities that had led to the crisis, the objectives being to restore the health of financial institutions and bring supervision and regulation up to international standards. But in all cases standards were raised gradually, in view of the tradeoff between the need to make a convincing step forward and the concern that raising standards too quickly could shock a system already reeling from the crisis.

The need for corporate debt restructuring, including the establishment of viable workout mechanisms, was also considered to be an essential counterpart to the restoration of the health of the financial system. Here progress was slow in all three countries, with adverse consequences for the pace of economic recovery.

In addition, other reforms included:

- efforts to shield poor and vulnerable sections of society from the worst of the crisis, by deepening and widening social safety nets and (notably in Indonesia) devoting substantial budgetary resources to increasing subsidies on basic commodities such as rice;
- measures to increase transparency in the financial, corporate, and government sectors; and
- steps to improve the efficiency of markets and increase competition.

V. Initial Outcomes and Assessment of the IMF-Supported Programs

The IMF-supported programs were initially less successful than hoped in restoring confidence in all three countries, with capital outflows and currency depreciations continuing after the programs were introduced. This was related to a variety of factors, including:

- initial hesitations and policy reversals in program implementation, such as premature rollbacks of monetary tightening, together with political and electoral uncertainties that cast doubt on prospective policies;
- the overwhelming imbalances between reserves and maturing short-term debt. In Korea and Thailand, investors became even more acutely aware of this as information on the level of usable reserves was revealed in connection with the Fund-supported programs; and
- uncertainties over the official financing packages; in particular, the "second lines of defense" for Korea and Indonesia, announced at the outset of their programs, were not disbursed.

With continued capital outflows and falling exchange rates, the countries experienced much deeper recessions than projected. This reflected mainly a collapse in domestic spending, especially private investment. The countries underwent enormous current account adjustments, associated mainly with sharp drops in imports.

Financial markets stabilized in the early months of 1998 in Korea and Thailand, and significantly later in Indonesia. Exchange rates began to recover, and interest rates had declined to below pre-crisis levels by mid-1998. Economic activity then began to turn around in mid-1998 in Korea and later in the other countries. Once they started, the recoveries were unexpectedly robust, especially in Korea, where growth reached 10.75 percent in 1999 as a whole. The recoveries reflected a resurgence of private domestic demand, the collapse of which had produced the recessions.

The experience of the Asian crisis and the results of the policy strategy stimulated fresh

thinking on the international financial system as well as on the appropriate policy response to financial crises. Work is still going on to apply the lessons from the Asian crisis to the IMF's activities. As an early step, the IMF made public in January 1999 a preliminary internal review of the design of, and initial experiences with, Fund-supported programs in Indonesia, Korea, and Thailand.² This study sought to identify those aspects of the IMF's strategy that had worked as expected, and those that needed to be reconsidered. In September 1999, the IMF published a study reviewing its policy advice to Asia on financial restructuring.³

One of the key lessons, shared by most observers, is the need for stronger efforts at crisis prevention. The course of the crisis clearly showed the difficulty of stopping such developments once they have started. Some lessons in this area include the following:

- the failure of the Fund and most other observers to foresee the crisis except in Thailand underscores the importance of strengthened surveillance, particularly with regard to the vulnerability of the exchange rate and the financial system, so that vulnerabilities can be addressed before they become extreme;
- greater transparency of economic and financial developments, through the publication of economic statistics, including financial and corporate indicators and comprehensive data on official reserve assets and liabilities, is essential to help strengthen establish market discipline, and ensure that asset prices and financial flows adjust less abruptly to adverse information. This also helps avoid the revelation of adverse information during a crisis;
- the crisis raised new questions regarding the appropriate pace and sequencing of capital account liberalization. In particular, it demonstrated the risks of liberalizing the capital account before ensuring the soundness of the domestic financial system. Another sequencing issue is that some countries had liberalized short-term capital flows before liberalizing long-term flows; in particular, the continued regulation of foreign direct investment in some cases promoted a composition of capital flows that heightened vulnerability; and
- there is no evidence that the crisis originated in moral hazard. Mexico's IMF-supported program of 1995, portrayed by some critics as a signal to markets that emerging market countries could count on a bailout from the Fund, in fact had no perceptible effect in Asian financial markets: at that time, investors apparently saw events in Mexico as having no relevance to the Asian tigers.

How are the **policy responses to the crisis** to be judged?

- tight **monetary policies**, when firmly applied, did work in reversing exchange rate pressures and preventing inflationary spirals. In Korea and Thailand, the following pattern emerged: after a period of negative real interest rates, currency depreciation, and rising inflation at the outset of the Fund-supported programs, interest rates were raised to high levels in real terms for a few months. Market conditions stabilized, currencies recovered, and interest rates were lowered to below pre-crisis levels; a cycle of inflation and depreciation was thus avoided. Indonesia, in contrast, maintained negative real interest rates through the middle of 1998, with rampant monetary expansion associated with banking collapse and political and social turmoil. The collapse in its currency was much more severe and drawn-out than in the other countries. These experiences cast serious doubt on the claim by some critics that monetary tightening was counterproductive and even accelerated the currency depreciations;
- in hindsight, the programs' initial **fiscal objectives**, based partly on the assumption (held by

most observers at the time) of moderate economic slowdowns, were too tight. They were adjusted, as it became clear that the countries were entering severe contractions, and the collapse in private demand was generating massive current account surpluses. In all three countries, the easing began in early 1998, i.e., only two months after the start of the programs in Indonesia and Korea. In retrospect, this easing should have come earlier, particularly as these countries had entered the crisis with strong fiscal positions and low public debt. While fiscal policy was not a major cause of the recessions, it could have done more to counteract the decline in private demand, which in turn appears to have been driven largely by the balance sheet effects of the crisis itself;

- as noted, **structural reforms** were clearly needed to restore confidence on a firm basis, by addressing some of the root causes of the crises. But the programs did not initially focus sharply enough on the financial sector and corporate issues; this focus came later, as the linkages were better understood. More generally, the experience raises issues regarding the focus of structural reforms as well as their pace and sequencing. Some of these issues were resolved as the programs unfolded: some reforms were delayed while others, seen as less essential, were winnowed out;
- the experience with financial sector restructuring also highlighted the need for clear **government guarantees of bank deposits** in the event of a crisis. This figured, in particular, in the closure of 16 banks in Indonesia in November 1997. These banks were deeply insolvent and there is little doubt that they needed to be shut promptly to prevent a hemorrhage of public money to support them. But no announcement was made at the time regarding the treatment of depositors in possible future closures of other banks, which were generally understood to be very likely. This partly reflected concern that a full and well-publicized guarantee could have led to moral hazard. In hindsight, these concerns should have been subordinated to the danger of imminent banking system collapse. Uncertainty regarding the scope of prospective government guarantees appears to have been a major factor accelerating bank runs--until January 1998, when a blanket guarantee of all bank liabilities was announced;
- initially the programs relied mainly on a tightening of monetary conditions and other measures aimed at a restoration of confidence to stem the outflow of private capital. A more heavy-handed approach, possibly involving capital controls, was not pursued partly on the grounds that it could have exacerbated contagion. But as confidence was not restored quickly, concerted **private sector involvement** (PSI) became necessary in all three countries to stem capital outflows. In Thailand, the authorities reached an early understanding with foreign banks to maintain credit lines to their Thai subsidiaries; Korea's major bank creditors were pressed to keep their money in place in December 1997, a few weeks after the program had begun; and in Indonesia, there was a de facto standstill on corporations' external debt servicing, and later a framework was established for restructuring this debt. This experience raised questions of whether PSI should have been organized sooner--notably in Korea, where a funding crisis loomed a few weeks after the initial program was introduced. The experience also gave impetus to work on establishing modalities for PSI that can be activated in the event of a crisis, but also with a view to underpinning confidence and thus helping forestall crises.

VI. Signs and Substance of Recovery

The economic recovery of most of the crisis countries has been more rapid than anticipated by many observers. The pessimistic scenarios developed during the height of the problems have been avoided. Sound macroeconomic management has been crucial to help strengthen external positions, stabilize financial markets, and facilitate an early return to growth. While the unfinished structural reform agenda in all Asian crisis countries remains large,

the efforts of governments to address these difficult issues have contributed to the strong recovery.

- strong real output growth is now occurring in most of the crisis countries, generated by private consumption and exports and some new private investment. In Korea, the economic upturn that began in the last quarter of 1998, less than one year after the darkest days of the crisis, is expected to deliver growth of 8 percent in 2000 and there is upside potential to this forecast. Thailand's economy should grow by 5 per cent this year. In Indonesia, where political turmoil and poor policy implementation impeded recovery, the economy began to grow again in late 1999 and real GDP is expected to increase by 4 percent this year.
- monetary policies in the region remain accommodative, for the most part, in order to underpin economic growth. In many cases, real and nominal money market interest rates are below pre-crisis levels. Interest rates began declining in Korea and Thailand in early 1998 and in Indonesia in mid-1999, as currency pressures eased. However, private sector credit growth in the region remains relatively modest, partly because financial institutions have enhanced their risk-appraisal capabilities and adopted a more cautious approach to new lending.
- fiscal consolidation is occurring gradually as recovery takes hold; budgetary deficits are being eliminated, despite the costs of financial sector reforms, and policies are returning to the principles of minimizing domestic financing and avoiding excessive public debt. While efforts are being made to expand social spending, cuts have been achieved in inefficient infrastructure projects and other unproductive spending, including military appropriations. Steps are being taken to reform tax systems, especially through the removal of tax exemptions to broaden the revenue base and a revamping of the tax administration to increase the efficiency of collection and reduce corruption.
- external current account positions remain in surplus, in part because of competitiveness gains and strong world demand for electronics, which are offsetting increased import demand associated with faster growth. Higher oil prices are tending to reduce trade surpluses in the oil-importing countries of the region, while boosting the trade surpluses of Indonesia and Malaysia. Exchange rates have recovered from their crisis lows but remain well below pre-crisis levels in real effective terms, underpinning competitiveness.
- official international reserves have been rebuilt, making the countries less vulnerable to external shocks. Korea's reserves, which had fallen perilously low in December 1997, had risen to US\$85 billion by end-April, 2000, and the country has returned to the international capital markets. In Thailand, international reserves now stand at more than double the stock of outstanding short-term external debt, in sharp contrast to the situation in 1997.
- most regional equity markets have experienced gains since the depths of the crisis, although they remain well below pre-crisis levels in dollar terms.
- the crisis countries have begun to implement important structural reforms: weak banks and other financial institutions have been closed, merged or recapitalized, and supervision has been strengthened; monopolies have been broken up; foreign ownership restrictions have been eased; corporations are being held to higher standards of governance and disclosure; and laws have been passed or amended to strengthen central bank independence, competition policy, bankruptcy procedures, and anticorruption measures.

VII. What is Still Required to Maintain Growth With Equity?

Despite recent achievements, there are continuing concerns as to whether the economic

recovery will lead to sustained growth, or whether vulnerabilities may reemerge. While the track record may be better than some critics predicted, structural reforms have not proceeded as rapidly as desired. It is essential to ensure the completion of the large unfinished agenda of structural reforms. This is a major and difficult task, for which political support may not always be forthcoming. It is important to prevent reform fatigue and complacency setting in because of the recent strong economic performance. It remains necessary to:

- accelerate financial sector restructurings. This needs to include finalization of the recapitalization of commercial banks, improved loan recovery, and asset sales. The resulting revenue will help offset the high budgetary cost of restructuring;
- intensify corporate restructuring, focussing on restoring viable corporate balance sheets, both through work-outs with creditors that provide for debt restructuring and operational restructuring to restore competitiveness and profitability. Progress may still prove more difficult than in financial sector rebuilding, partly due to the more limited role of the government; it will, even in the best of circumstances, be a protracted process.
- complete a legal commercial framework for a modern economy, including new laws on bankruptcy and competition policy and the creation of institutions capable of enforcing them, as well as ensuring central bank independence.
- continue the process of market opening and deregulation, including further trade liberalization and simplification of business licensing requirements. These measures are needed to improve the environment for private investment, especially to attract new foreign direct investments and enhance productivity growth.
- extend social safety nets and investment in human capital, helping to preserve social stability through targeted subsidies, education and health programs, and employment creation.

Regional initiatives can also be helpful in supporting sustained economic growth and stable financial relations among participating countries. In this vein, the recent "Chiang Mai Initiative" among ASEAN members and China, Korea, and Japan is an important example of enhanced regional cooperation, through which countries in temporary financial difficulties will be able to obtain foreign exchange from their neighbors through swap and repurchase arrangements. While the details of these facilities still need to be worked out, they should help to complement the work of the IMF and fit well into a strategy of addressing economic issues of the region.

With the above actions in place, and preservation of financial stability through appropriate macroeconomic policies, the Asian crisis countries are likely to emerge stronger than before and fitter for the competitive global environment of the twenty-first century: the countries' economies will be more market-oriented and more transparent; their financial institutions will be stronger and better regulated; their corporate enterprises will be more competitive; and their social safety nets will be substantially improved.

Box 1. Thailand

The Asian crisis first emerged in Thailand in 1997 as the baht came under a series of increasingly serious speculative attacks and markets lost confidence in the economy. On August 20, 1997, the IMF's Executive Board approved financial support for Thailand of up to SDR 2.9 billion, or about US\$4 billion, over a 34-month period. The total package of bilateral and multilateral assistance to Thailand came to US\$17.2 billion. Thailand

drew US\$14.1 billion of that amount before announcing in September 1999 that it did not plan to draw on the remaining balances, in light of the improved economic situation.

In the early stages of the program, the Thai authorities adapted monetary policy to a managed float of the baht; fostered the restructuring of distressed financial institutions, including the closure of 56 bankrupt finance companies; enacted budget cuts to free up resources to help finance the restructuring and to support improvement in the current-account position; deepened the role of the private sector in the Thai economy; and sought to attract foreign capital through other reform measures.

The rapid spread of the Asian crisis in late 1997-bringing a larger-than-expected depreciation of the baht, a sharp economic downturn and adverse regional economic developments--warranted revisions to the Thai program. The revisions were undertaken through a series of program reviews conducted in close consultation with the Thai authorities. In the context of a recession, whose severity was unforeseen, they aimed to restore economic growth, ensure the continued restructuring of the Thai economy, and protect those elements of society most vulnerable to the economic downturn.

Monetary policy focused on both supporting exchange-rate stability and fostering an economic recovery. As the baht began to steady, the Thai authorities reduced interest rates. By mid-1998, money market interest rates began to approach pre-crisis levels, and first deposit, and then lending rates, started to drop as well. By September 1999, money market rates reached their lowest levels in over a decade.

Fiscal policy shifted in the face of the economic slowdown. While the first letter of intent called for a government budget surplus equal to 1 percent of GDP in 1997/98, beginning in February 1998 the program began targeting a fiscal deficit. The targeted deficit (excluding interest costs of financial sector reform) grew from 2 percent to 6 percent by April 1999, although the actual deficit for 1998/99 is estimated to have been under 5 percent (inclusive of interest costs of financial sector reform, amounting to almost 2 percent of GDP, the deficit was about 6.5 percent). Much of the increased spending focused on boosting social safety net programs to ensure the protection of Thais affected by crisis. While fiscal stimulus remains important for the time being, over the medium term, fiscal consolidation will be needed to reverse the rise in public debt.

Financial sector restructuring has remained a key policy area throughout the Thai program. In the early stages, the program concentrated on the liquidation of finance companies, government intervention in the weakest banks, and the recapitalization of the banking system. In 1998, the reform effort accelerated, with a focus on privatizing the intervened banks, disposing of assets from the finance companies and restructuring corporate debt. The authorities made great strides by strengthening the institutional framework, including through the reform of the bankruptcy act, foreclosure procedures and foreign investment restrictions. However, non-performing loans remain at a high level, underpinning the need to accelerate corporate debt and bank restructuring.

Thailand's economy returned to positive growth in late 1998, and GDP growth reached over 4 percent in 1999 and should grow by 4.5-5.0 percent in 2000. The balance of payments is expected to remain strong in the near term, even as the current-account surplus declines as the recovery proceeds. Foreign-exchange reserves remain within the \$32-34 billion range envisioned in the program. With output recovering and reserves restored to comfortable levels, the authorities treated the IMF loan as precautionary and made no further drawings after September 1999. The stand-by arrangement expired on June 19, 2000.

Selected Economic Indicators

	1996	1997	1998	1999*	2000**
	(Percent change)				
Real GDP Growth	5.9	-1.7	-10.2	4.2	4.5 to 5.0
Consumer prices (period average)	5.9	5.6	8.1	0.3	3.0
	(Percent of GDP [minus sign signifies a deficit])				
Central government balance***	1.9	-0.9	-2.4	-2.9	-3.0
Current account balance	-6.0	-7.9	-2.0	12.7	9.1
	(In billions of U.S. dollars)				
External debt	90.5	93.4	86.2	76.0	67.8

Sources: Thai authorities and IMF staff estimates.
*Estimate.
**Projection.
***Fiscal year, which runs from October 1 to September 30.

Box 2. Korea

Over the past several decades, Korea transformed itself into an advanced industrial economy. However, the financial system had been weakened by government interference in the economy and by close linkages between banks and conglomerates. Amid the Asian financial crisis, a loss of market confidence brought the country perilously close to depleting its foreign exchange reserves. On December 4, 1997 the IMF's Executive Board approved financing of up to SDR 15.5 billion or about US\$21 billion, over three years.

The objectives of Korea's crisis resolution strategy were, first and foremost, to restore confidence and stabilize financial markets, and second, to lay the foundation for the resumption of sustained recovery in the real economy. The program thus included a mix of macroeconomic policies and far-reaching structural reforms. In addition, Korea reached agreement with foreign banks in early 1998 to extend the maturity of short-term claims on its banks to avoid default.

At the outset of the program, Korea's macroeconomic policies focused on a temporary interest rate hike aimed at stabilizing the won and avoiding a depreciation-inflation spiral. This step helped restore financial stability by early 1998, and once the won was stabilized, macroeconomic policies quickly eased to provide stimulus to the economy. The authorities also adopted an expansionary fiscal stance early in the program to mitigate the impact of the inevitable recession. The government recognized that the smooth implementation of adjustment policies would require broad social consensus and it fashioned a Tripartite Accord involving labor, business, and the government. The authorities also strengthened the social safety net by expanding the unemployment insurance system and providing direct support through public works programs, temporary livelihood protection, and other social programs.

The structural reform agenda focused on liberalizing the capital account, restructuring the financial and corporate sectors, enhancing labor market flexibility, and improving data reporting. Korea's restructuring sought to restore stability to the financial system quickly through liquidity support, a time-bound blanket guarantee, and closures of nonviable institutions. The restructuring effort also aimed at resolving the problem of non-performing loans, recapitalizing banks, and strengthening the institutional framework by bringing prudential regulations and supervision in line with international best practices.

Corporate restructuring efforts initially concentrated on improving governance and competition policies. Subsequently, the focus shifted to financial and operational restructuring, with the goal of reducing debt levels and strengthening capital structure. Progress is being made in the out-of court workout agreements for a number of companies and also in court-supervised insolvencies within the framework of capital structure improvement plans reviewed by banks. In addition, progress is being made in meeting the pledges under these plans; equity issues, spin-offs, asset sales, and strategic alliances with foreign investors account for most of the improvement.

Korea is now recovering strongly and the policies adopted under the IMF-supported program have helped to successfully restore external stability, rebuild reserves, and initiate reform of the financial and corporate sectors. Korea has stopped drawing from the IMF; it also repaid part of the stand-by drawings nine months ahead of schedule. The challenge ahead is to avoid complacency and maintain the momentum of structural reforms.

Selected Economic Indicators

	1996	1997	1998	1999*	2000**
	(Percent change)				
Real GDP Growth	7.1	5.5	-6.7	10.7	8.0
Consumer prices (end of period)	4.9	6.6	4.0	1.4	1.8
	(Percent of GDP [minus sign signifies a deficit])				
Central government balance	0.0	-1.7	-4.4	-3.5	-3.0 ¹
Current account balance	-4.4	-1.7	12.7	6.1	2.0
	(In billions of US dollars)				
External debt	164.4	158.1	148.7	136.0	129.6
	(Percent of GDP)				
External debt	31.6	33.2	46.9	33.4	26.8

Sources: Korea authorities and IMF staff estimates

* Estimate.

** Projection.

¹For 2000, includes civil service pension fund.

Box 3. Indonesia

The floating of the Thai baht in July 1997 soon intensified pressures on the Indonesian rupiah. Structural weaknesses in Indonesia's financial sector and the large stock of short-term private sector external debt contributed to doubts about the government's ability to defend the currency peg. After a brief period of widening the intervention band, the rupiah was floated and, by early October, it had depreciated by 30 percent. On November 5, 1997, the authorities entered into a three year stand-by arrangement with the IMF for US\$ 10 billion, which was augmented by about US\$1.4 billion in July 1998. Large amounts were also pledged by other multilateral institutions (\$8 billion) and by bilateral donors (\$18 billion--the so-called "second line of defense"). Although the rupiah initially appreciated, market sentiment began to sour again in December 1997 - January 1998, after sixteen insolvent banks were closed by Bank Indonesia in November. There were also slippages in program implementation coupled with serious social and political upheaval, which culminated in the fall of President Suharto in May 1998. By end-July 1998, the rupiah had fallen by about 65 percent relative to end-1997. The loss of confidence sparked financial instability, and output collapsed, with a severe

impact on the poor.

In August 1998, a strengthened reform agenda was reflected in a new extended arrangement with the Fund. To break inflation, the program was anchored in firm base money control. Food security --especially rice--was gradually restored through emergency imports, a strengthened distribution system, and temporary food subsidies. Banking sector reform accompanied by corporate restructuring, an effective bankruptcy system, deregulation and privatization, and improved governance were also at the core of the program. This policy framework delivered important results, including the virtual elimination of inflation, the stabilization of the rupiah, and a recovery in foreign exchange reserves. Interest rates were brought down dramatically, and rice prices stabilized. Improved market sentiment was reflected in the recovering stock market and in falling risk premia. Nevertheless, the overall progress did not reach a decisive stage under the program. There were lags in implementation of bank and corporate restructuring measures. Continued weakness in the governance of key institutions was exposed in the Bank Bali scandal and, along with other factors, led to the suspension of the IMF program in September 1999.

Against this background of fragile and incomplete accomplishments, the newly elected government negotiated a new three-year extended arrangement for about US\$ 5 billion with the IMF, which was approved by the Fund's Executive Board in February 2000. The macroeconomic framework seeks to restore an annual growth rate in the vicinity of 5 to 6 percent by 2002, with an annual inflation target of below 5 percent. The Financial Sector Policy Committee was established with the mandate to provide leadership and direction in banking and corporate restructuring. The key objective in bank restructuring efforts is to capitalize all the banks, including through the provision of public funds, to an 8 percent capital adequacy ratio by end-2001, as a precondition for replacing the comprehensive guarantee scheme with self-financed deposit insurance. Other objectives include: enhancing efforts to restructure state banks, ensuring better governance and supervision of the banking system and the Indonesia Bank Restructuring Agency (IBRA), deepening bond and equity markets, and reinforcing asset recovery efforts. The government has developed a new strategy to give fresh momentum to corporate restructuring and to anti-corruption measures in the judiciary.

Economic recovery is gathering pace while inflation remains subdued. GDP grew by 5.8 percent in the last quarter of 1999 relative to the same period of the previous year, enabling a small positive growth in calendar 1999. Consumption and de-stocking continue to be the main engines of the emerging recovery--a pattern shared by other Asian countries emerging from the crisis. Inflation has continued to be virtually flat since June 1999, and interest rates have been brought to pre-crisis levels.

Selected Economic Indicators

	1996	1997	1998	1999	2000**
	(Percent change)				
Real GDP Growth	8.2	1.9	-14.2	1.5 to 2.5	3 to 4
Consumer prices (period average)	5.7	12.9	64.7	-0.6	5.4
	(Percent of GDP [minus sign signifies a deficit])				
Central government balance	1.2	-1.1	-2.2	-3.3	-4.8
Current account balance	-3.4	-0.9	4.4	3.1	1.9
	(In billions of US dollars)				
External debt	127.4	135.0	149.9	147.6	149.1
	(Percent of GDP)				
External debt	54.5	163.1	129.0	91.0	86.9

Sources: Indonesian authorities and IMF staff estimates.

*Fiscal year, which runs from April 1 to March 31.

**Program, budget for April 1 to December 31.

Box 4. Malaysia and Philippines

The financial contagion that affected Asian countries from mid-1997 also hit Malaysia and the Philippines, but their experiences were somewhat different from other countries.

Malaysia's macroeconomic conditions were substantially stronger at the outset than those in the other crisis countries, particularly in the areas of external debt, inflation, and savings; the country also had a significant fiscal surplus. Its banking system and corporate sector were healthier than the other affected countries. The Philippines had embarked on a successful IMF-supported program of macroeconomic adjustment and structural reforms in the late 1980's and early 1990's, which seems to have enabled it to weather the crisis at a relatively lower cost in terms of output loss, unemployment and social dislocation. Crisis management after mid-1997 was sound, and the Philippines adapted its policies, including through the floating of the peso, tightening of monetary policy and strengthening of the banking system. It eventually relaxed its fiscal and monetary policies as stabilization took hold in mid-1998.

In both countries, however, the initial manifestations of the crisis were similar to those in Indonesia, Korea and Thailand, including a loss in investor confidence resulting in large capital outflows, a decline in reserves, stock market collapses and large currency depreciations. The policy responses were also similar initially. In particular, Malaysia responded with a tightening of monetary and fiscal conditions, and an emphasis on structural reforms, particularly in financial sector regulations and supervision and improvements in intermediation.

Malaysia imposed capital controls in September 1998, largely aimed at the offshore ringgit market in Singapore and short-term portfolio flows. The offshore market was believed by the authorities to constrain their ability to bring down interest rates rapidly. Controls took the form of requirements to bring the ringgit on-shore by end September, and a one-year holding period for repatriation of portfolio capital inflows. The latter controls were replaced in February 1999 with a system of graduated exit levies, and further relaxed in September 1999.

Malaysia's imposition of capital controls does not appear to have made a substantial difference, either positive or negative, to economic developments so far. The stabilization in the currencies of the region and the relative undervaluation of the ringgit resulting in a large balance of payments surplus have facilitated the implementation of these controls. Potentially negative impacts of controls may have been subdued, given that when they were imposed, most capital flight had already abated, and the acceleration of regional recovery, together with progress in financial and corporate restructuring and generally sound macroeconomic management in Malaysia helped buttress confidence.

In the Philippines, recent macroeconomic developments have also been favorable. Recovery is well under way with real GDP growth of 3.25 percent in 1999, led by a rebound in agricultural production from a severe drought in 1998. Monetary policy is supportive of continued recovery, and interest rates are now below pre-crisis levels, while foreign exchange reserves have risen to the level of short-term debt (on a residual

maturity basis) as the current account surplus increased to almost 9 percent of GNP in 1999. Bank balance sheets are also being strengthened. The budget deficit had been allowed to increase to support recovery, but fiscal policy has shifted toward consolidation in 2000 given the need to reduce the relatively high level of public debt.

The authorities of Malaysia and the Philippines are now focussed on implementing structural reforms to address the vulnerabilities and provide the basis for sustained growth over the medium term. Much remains to be done to strengthen both countries' ability to withstand negative external developments and sustain the current economic and financial recovery, and the broad structural reform agenda remains a challenge for the respective authorities.

Table 1. Commitments and Disbursements of the International Community in Response to the Asian Crisis
(in billion of U.S. dollars)

	Commitments				Disbursements (as of 5/30/00)		
	IMF	Multilateral ¹	Bilateral	Total	IMF	Other ⁴	Total
Indonesia ²	15.0	10.0	24.7	49.7	11.6	10.3	21.9
Korea ³	21.1	14.2	23.1	58.4	19.8	10.6	30.4
Thailand	4.0	2.7	10.5	17.2	3.4	10.9	14.3
Total	40.1	26.9	58.3	125.3	34.8	31.8	66.6

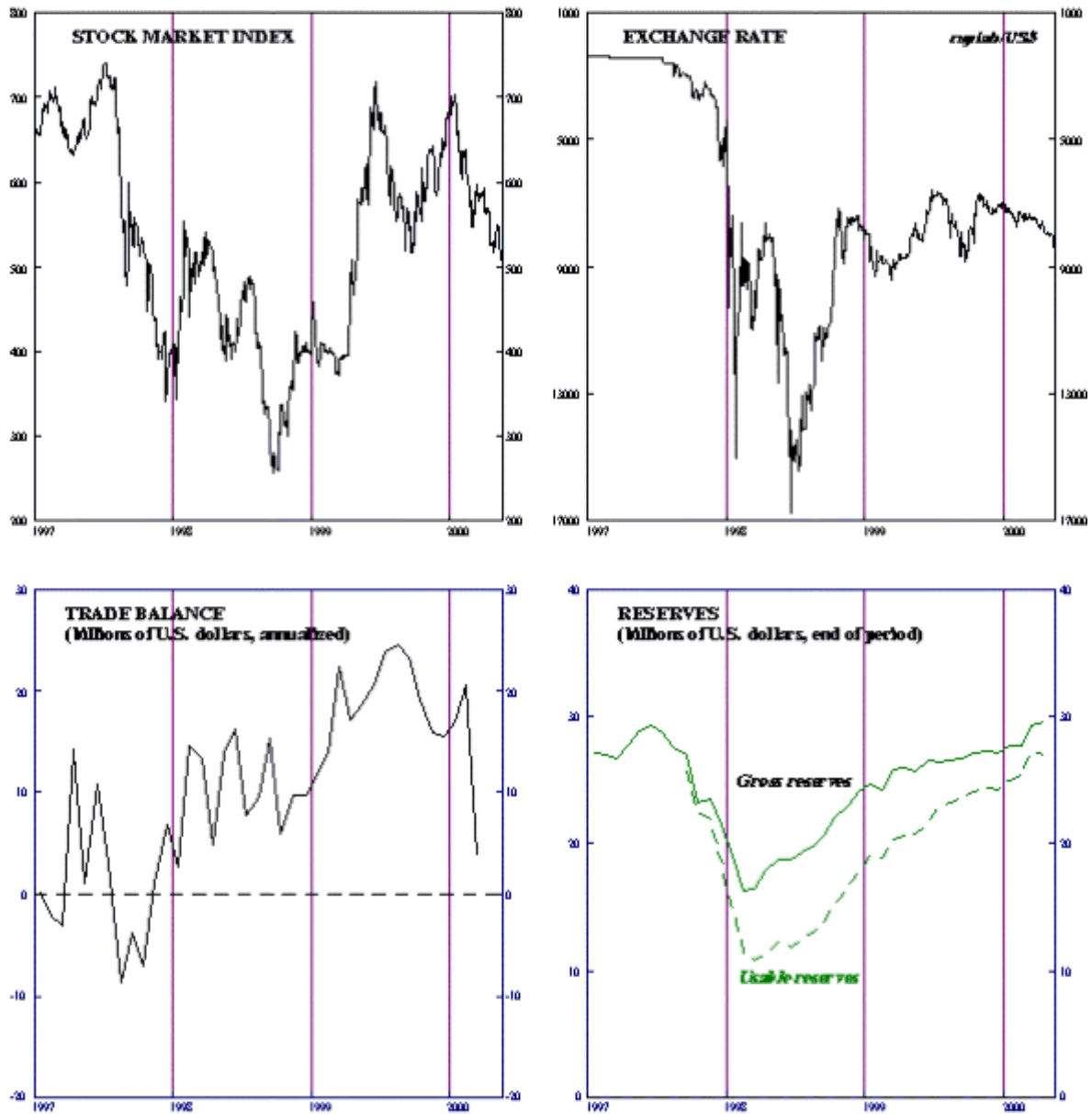
¹World Bank and ADB

²Includes augmentations since July 1998

³Korea has repaid US\$ 13 billion of the financing provided by the IMF as of end-May 2000.

⁴Combined multilateral and bilateral disbursements

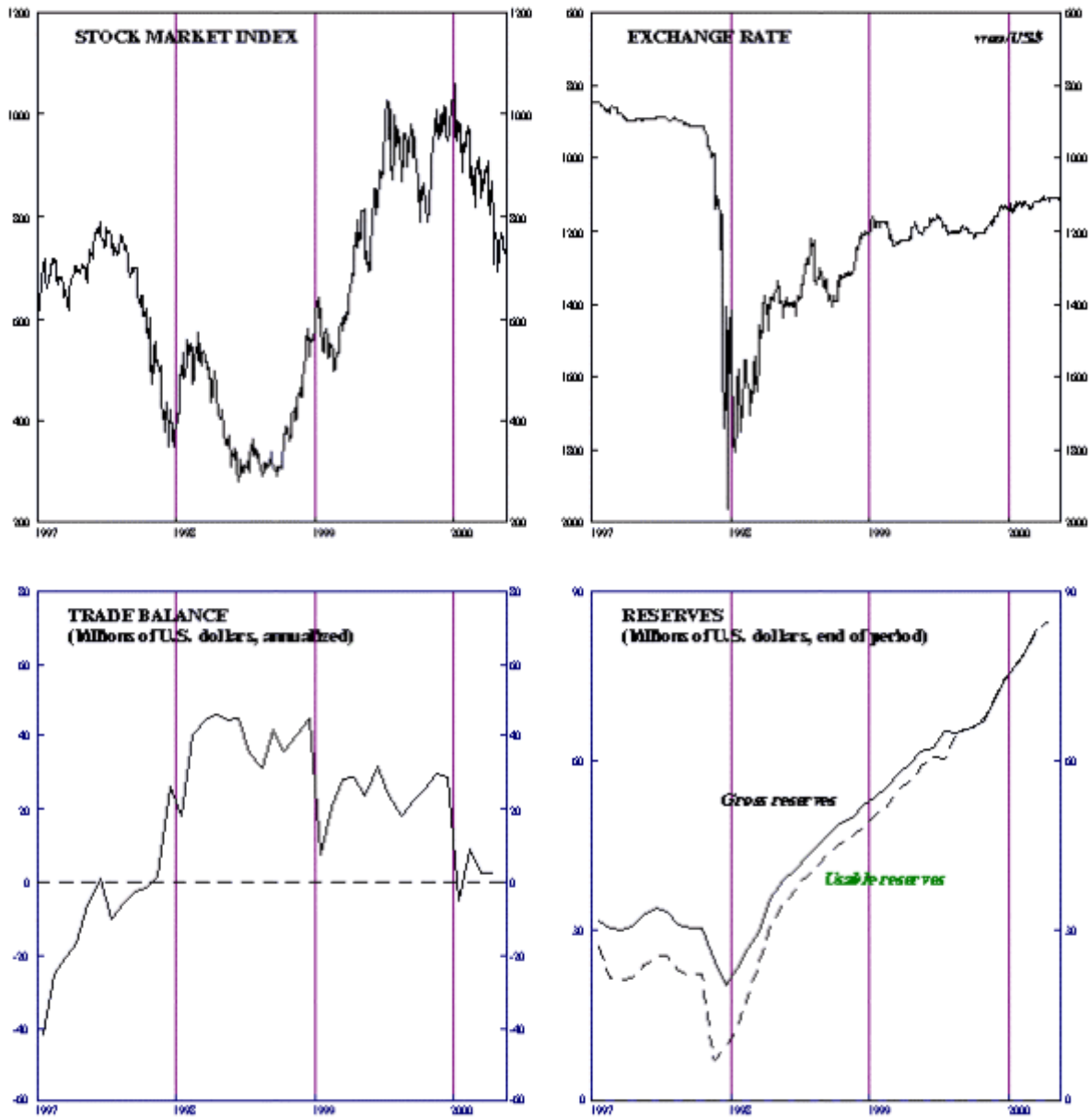
**CHART I
INDONESIA
SELECTED ECONOMIC INDICATORS, 1997-2000**



Sources: National Authorities, CEIC, and WEF/INFLINE

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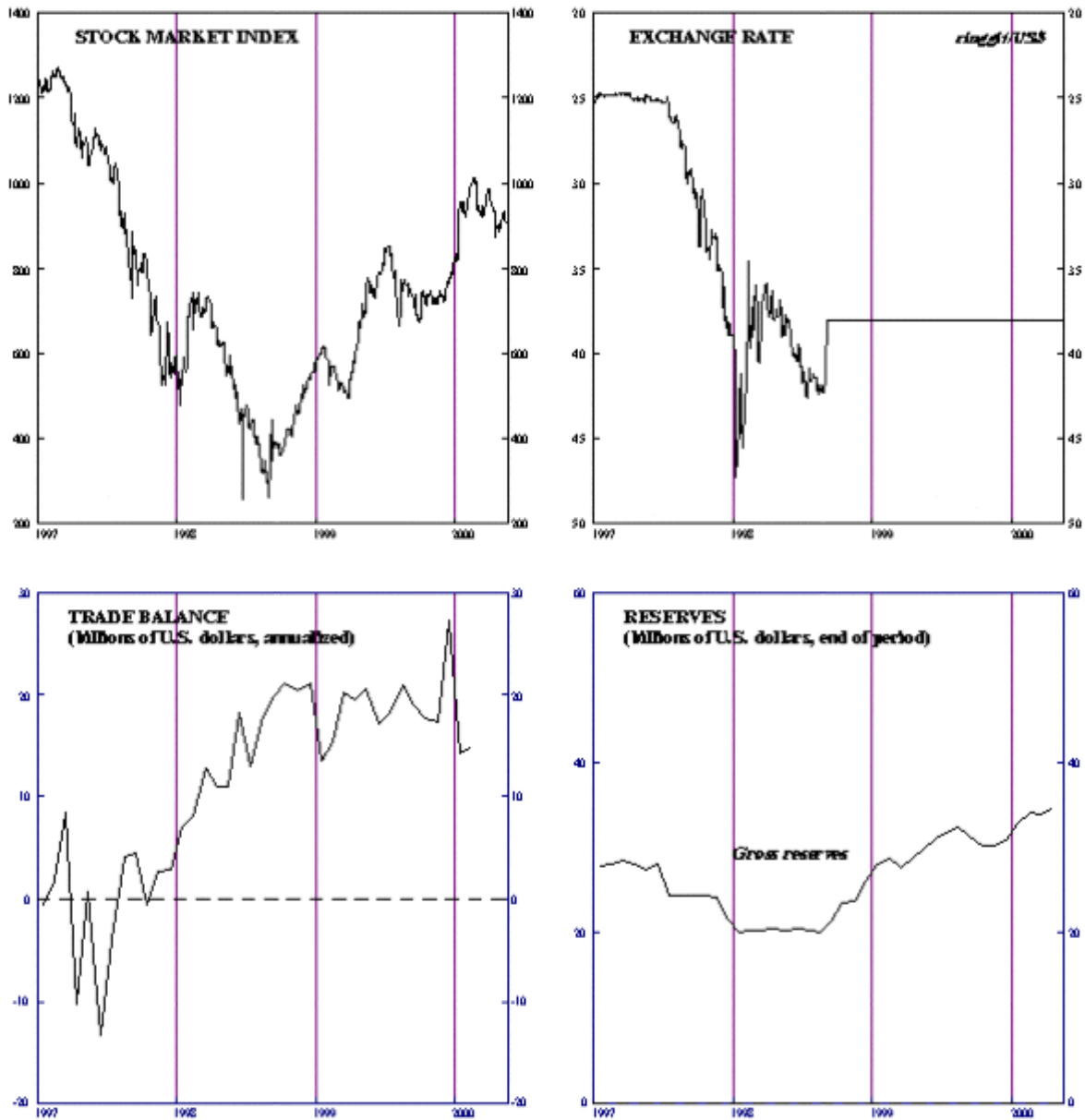
CHART II
KOREA
SELECTED ECONOMIC INDICATORS, 1997-2000



Sources: National Authorities, CEIC, and WEF/INILINE

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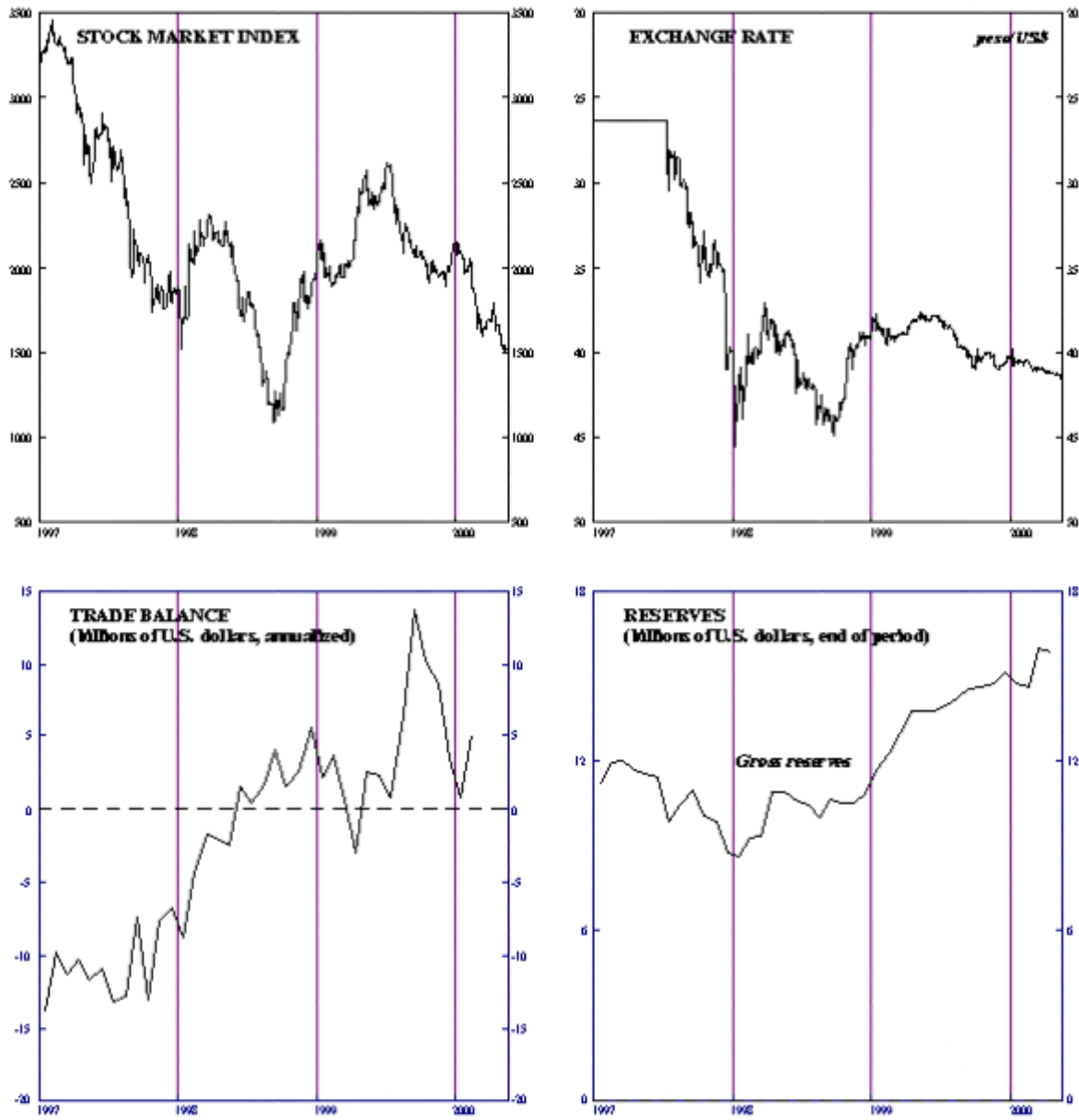
**CHART III
MALAYSIA
SELECTED ECONOMIC INDICATORS, 1997-2000**



Sources: National Authorities, CEIC, and WEF/INLIVE

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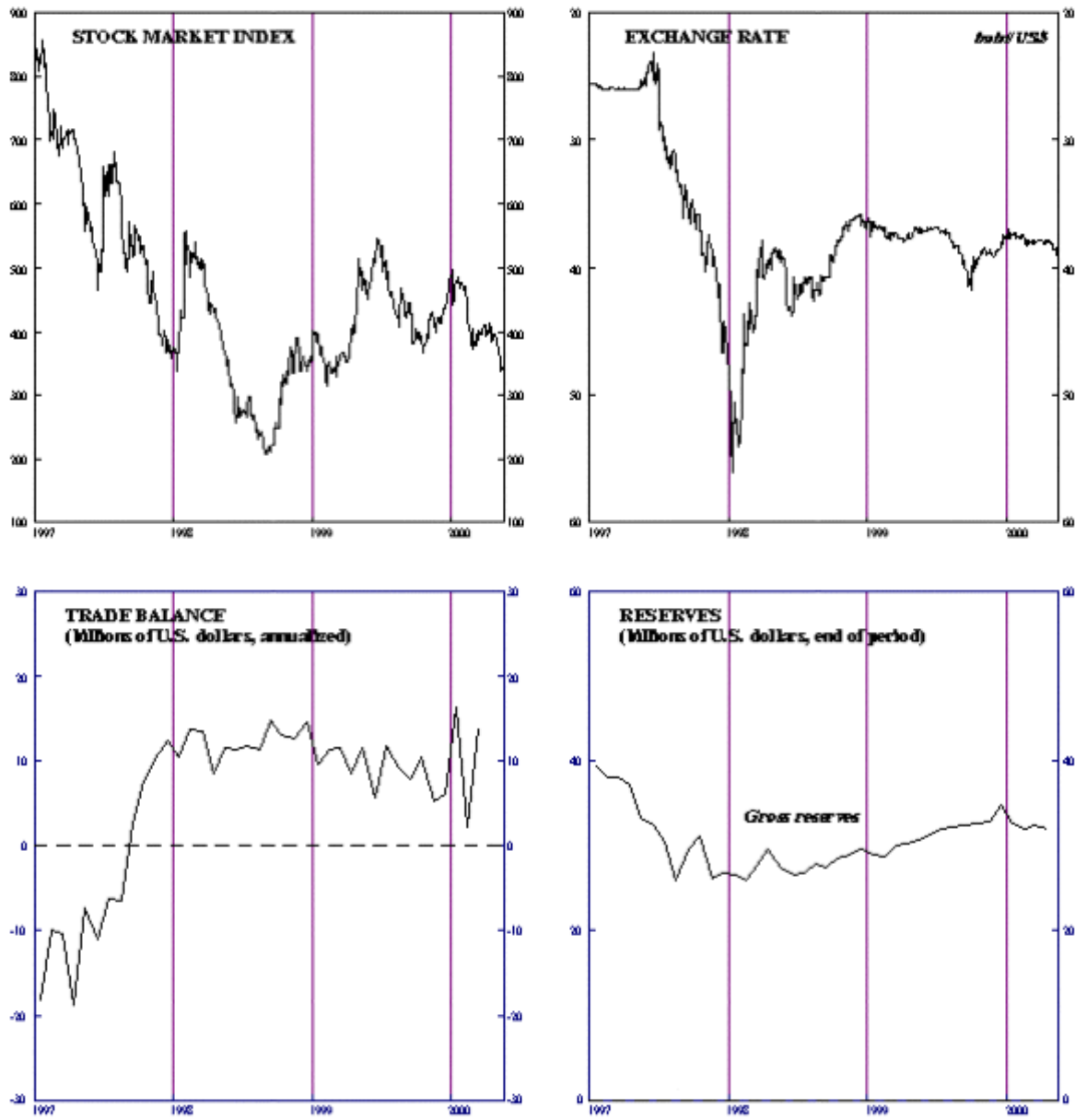
**CHART IV
PHILIPPINES
SELECTED ECONOMIC INDICATORS, 1997-2000**



Sources: National Authorities, CEIC, and WEA/INILINE

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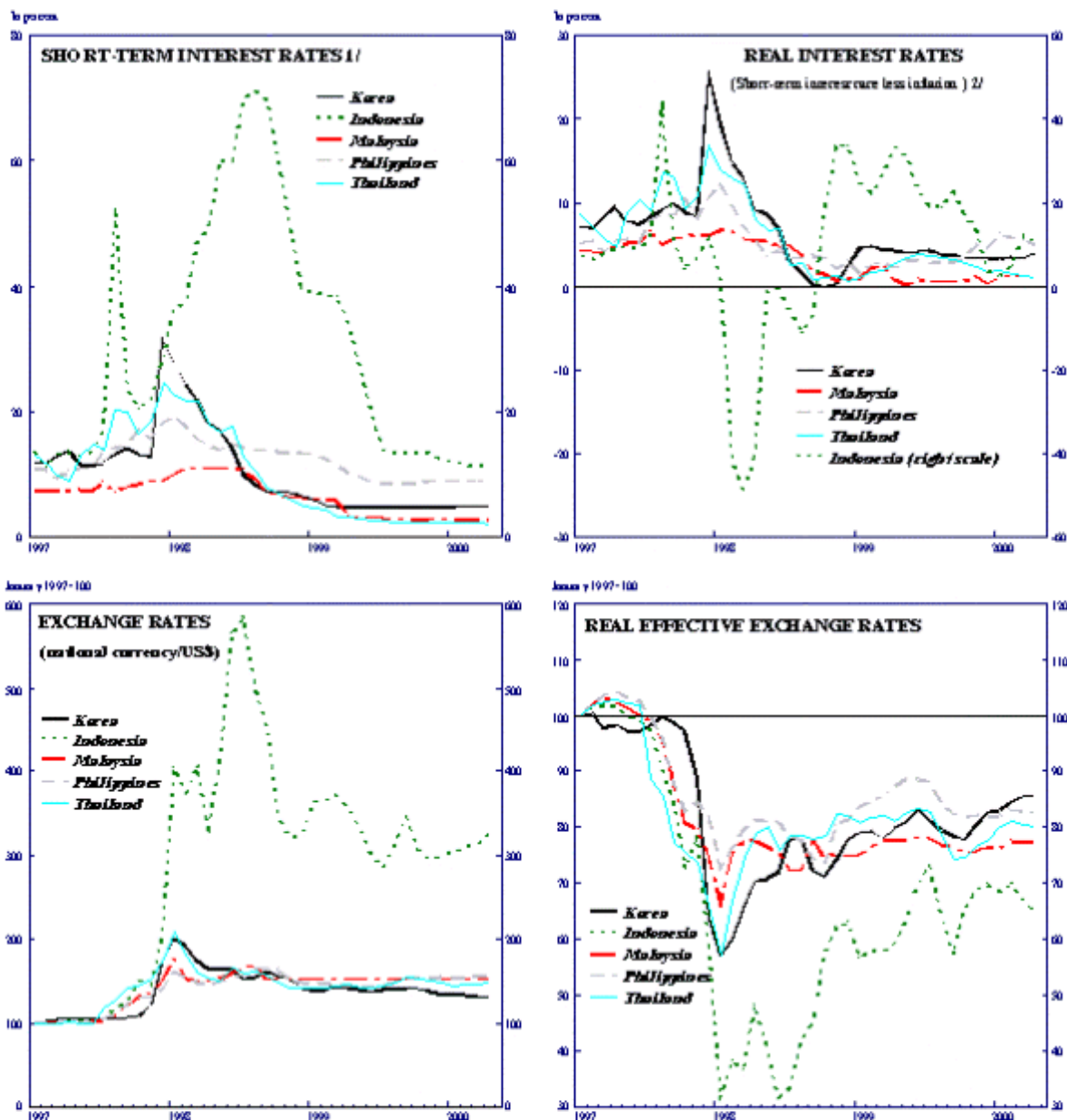
**CHART V
THAILAND
SELECTED ECONOMIC INDICATORS, 1997-2000**



Sources: National Authorities, CEIC, and WEF/INLIVE

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CHART VI
SELECTED ASIAN COUNTRIES
INTEREST RATE AND EXCHANGE RATE DEVELOPMENTS



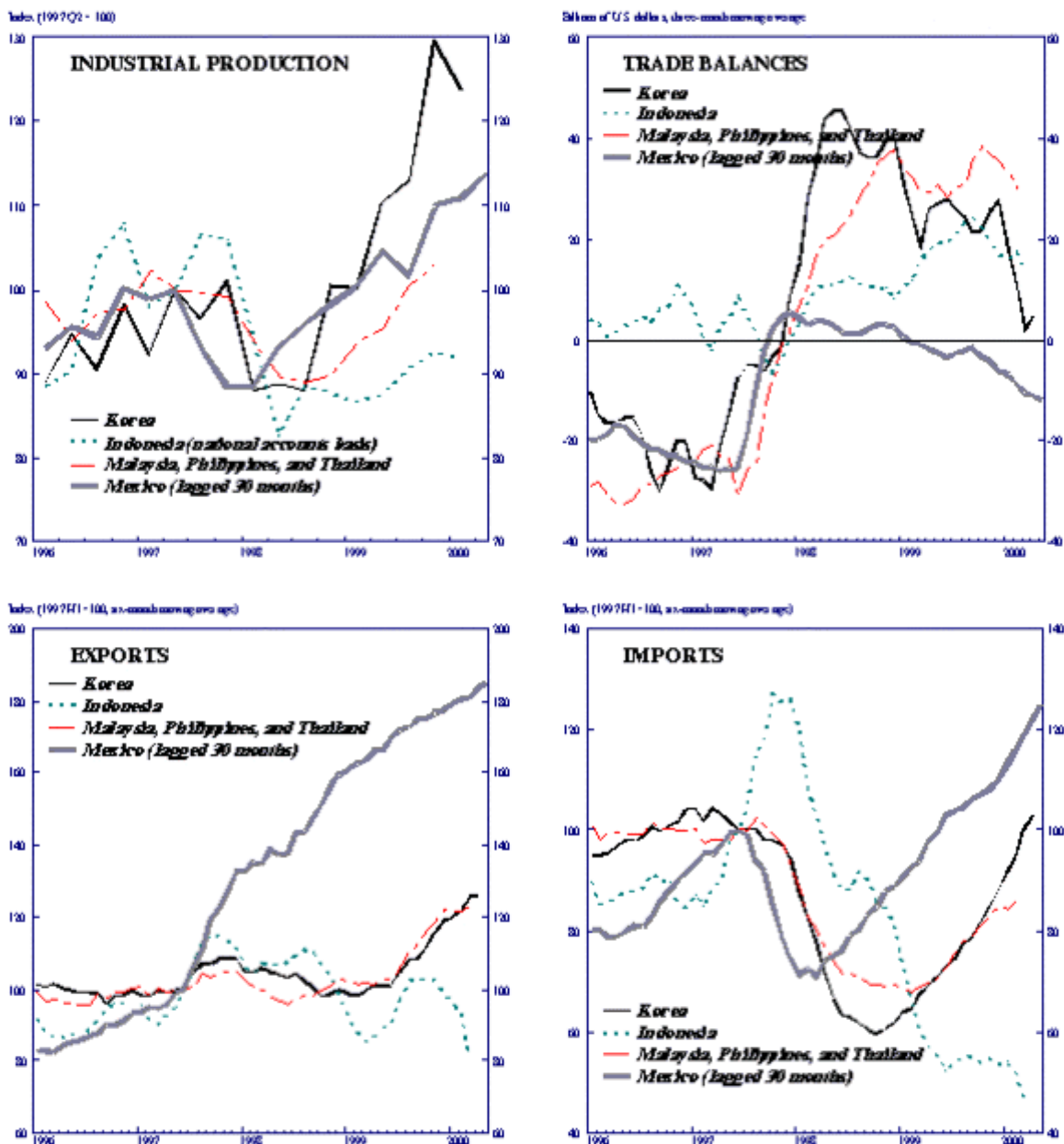
Sources: IFS, IFS, Bloomberg, WETR, and staff estimates.

1/ End of period. Korea: Overnight call rate; Indonesia: One month interbank rate; Malaysia: One month interbank rate; Philippines: 91-day Treasury Bill Rate; Thailand: One month repurchase rate.

2/ Year-over-year CPI inflation except in the case of Indonesia, where three-month moving averages of annualized monthly inflation.

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**CHART VII
ASIAN AND TEQUILA CRISES I¹**



Sources: National Authorities; WEA²; and CEIC.

1/ The 'tequila' crisis was marked by the decision to let the Mexican peso float in late December 1994.

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¹The origins of the crisis are discussed more fully in the IMF "World Economic Outlook" of December 1997.

²See Timothy Lane and others, "IMF-Supported Programs in Indonesia, Korea, and Thailand: A Preliminary Assessment," 1999, IMF Occasional Paper 178.

³See Carl-Johan Lindgren and others, "Financial Sector Crisis and Restructuring: Lessons from Asia," 1999, IMF Occasional Paper 188.