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IMF Executive Board discusses making independent Evaluation Office operational

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Executive Directors welcomed the paper by the Evaluation Group of the Executive Board and considered that the proposals were an important step forward in making the IMF's independent Evaluation Office operational. The Executive Board will be reporting on the establishment of the Evaluation Office to the Board of Governors at the Prague Annual Meetings in September. Executive Directors expect the office to be operational before the spring 2001 meeting of the International Monetary and Financial Committee in Washington. They viewed the Evaluation Office as an important complement to the overall review and evaluation work undertaken in the IMF and believe that it will enable the institution to better absorb lessons for improvements in its future work.

Edited excerpts from IMF Managing Director Horst Köhler's concluding remarks follow. The full text and Press Release Nos. 00/27 and 00/49 and the background paper are available on the IMF's website (www.imf.org).

"A key consideration in the discussion was how to ensure that the work of the Evaluation Office would fully support the Executive Board's oversight role and contribute to transparency and the learning culture in the IMF. Various views were expressed on the nature of the evaluations to be undertaken and on the relation between the office's *(Please turn to the following page)*

IMF Institute seminar

Frankel challenges current consensus on need for pure fixed or floating exchange rate regimes

Jeffrey Frankel came to Washington to enlist IMF economists in his search for the "missing middle"—the wide center ground that fills the spectrum between the extremes of fixed and floating exchange rates. In a lively presentation at an IMF Institute seminar on August 7, Frankel reviewed current issues in research and policy on exchange rate regimes but chiefly focused on a conundrum. Why is it that while it is the post-Asian crisis fashion for economists and policymakers to advocate deserting intermediate exchange rate regimes, roughly half of all countries still inhabit this middle ground?

In an effort to unravel the mystery of the missing middle, the Harpel Chair professor of Harvard University's School of Government explored whether exchange rate regimes matter for the real economy, weighed the respective advantages of fixed versus floating rates, and examined new criteria for optimum currency areas.


Frankel: No single currency regime is right for all countries at all times.

Ultimately, Frankel argued, the real culprit is not intermediate exchange rate regimes but the notion that any single currency regime is right for all countries at all times.

Exchange rate goals

Drawing on the Princeton University Graham Lecture that he presented in April this year, Frankel noted that in the late 1990s, a view evolved that only a rigidly fixed exchange rate or a clean float would solve the problems that come with modern globalized financial markets. This hypothesis, Frankel observed, seems to be held as a corollary of the "impossible trinity," which posits that a country can pick only two goals from the tripartite menu of exchange rate stability,

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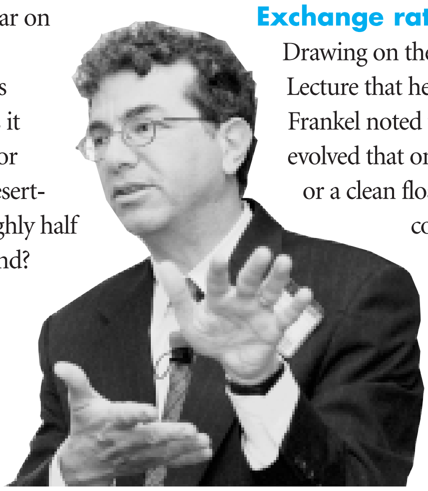

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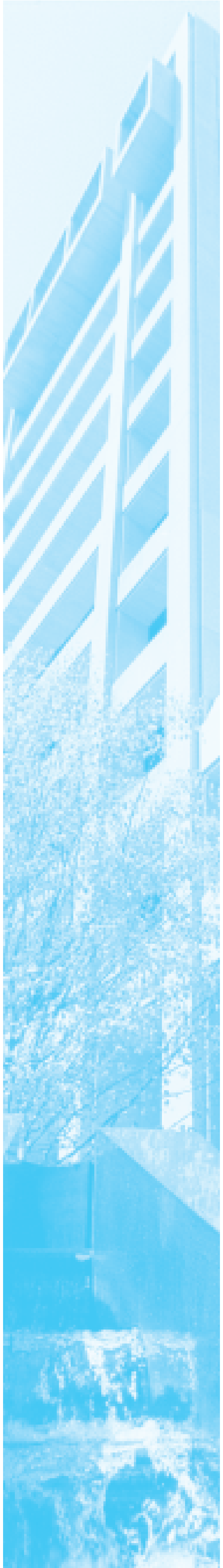
Evaluation Office to be part of IMF review process



(Continued from front page) work and the other review and evaluation work undertaken by the IMF. Directors considered that the office should primarily cover issues related to general policies and their implementation, comparative cross-country analyses, and completed country operations. At the same time, there is broad agreement that the office must avoid interfering with ongoing operational activities or micromanaging responsibilities in the institution. Policies and procedures under active discussion in the IMF and current IMF programs would not, therefore, be appropriate areas for the office's evaluation. As the office becomes fully operational and gains some initial experience, this issue will become clearer and will be reviewed again before final decisions on the Evaluation Office are made.

Independence of Evaluation Office

"There was broad consensus that the office should be independent from IMF management and staff and should operate at arm's length from the Board. This means that, once established by the Board, the office must be operationally independent. The office will be expected to report fully on individual evaluations to the Executive Board and to allow the Board, management, and staff an opportunity to comment on its assessments. The Board and management will be responsible for following up on the conclusions drawn by the Board from its consideration of the evaluation reports. In developing its work program and choosing evaluation topics, Directors expected that the Evaluation Office, while maintaining its independence, would seek the views of Executive Directors, management, staff, and interested parties outside the IMF. How the work program of the office will be given its final form is another operational issue to which Executive Directors will need to return.

"Directors discussed the merits and disadvantages of developing a full-scale charter for the Evaluation Office to guide its work. They concluded that, on balance, a fully elaborated charter risks imposing excessive rigidity on the office's work, especially at the outset. Accordingly, Directors agreed that the office should be guided by terms of reference, which should provide the safeguards on the office's independence that all Directors support, while not constraining the office's freedom of action unduly. The Board will establish such terms of reference in the period ahead.

Executive Board and Evaluation Office

"There was broad consensus that the whole Board should continue to be involved with the Evaluation Office. A number of Directors considered that, after the office becomes operational, the role of the Evaluation Group of Executive Directors may need to be reexamined.

"The budget of the Evaluation Office will be determined annually by the Board, without intermediation by IMF management or staff. Regarding the size of the office, Directors generally supported the recommendation that it be limited to no more than 11 individuals. There was broad agreement that the work of the office would be considerably enhanced by the fresh approach and perspective that individuals from outside the IMF would bring to bear. Accordingly, Directors suggested that external recruits and consultants should constitute a significant, if not the major, part of the office's staffing, thereby adding value to the institutional insight and experience that individuals drawn from the IMF staff would contribute. Executive Directors supported the selection of the Director of the Evaluation Office by the Executive Board, assisted as appropriate by an external search firm. Once appointed, the Director of the Evaluation Office should be free to choose high-caliber individuals to staff the office. Ultimately, of course, the office's success will be assured by the professionalism and integrity of the Director of the Evaluation Office and its staff.

"Executive Directors were in favor of the office being fully accountable to the Executive Board and expected the Director of the Evaluation Office to report regularly to the Executive Board. In addition, the International Monetary and Financial Committee would also expect to receive reports on the office's activities.

Publication

"Directors were of the view that, as a rule, Evaluation Office findings should be published, with appropriate safeguards for confidential material. Publication would be accompanied by comments on the evaluation from management and staff, and others where appropriate, along with the conclusions reached by the Board in considering the evaluation report. Publication would enhance the accountability and transparency of the evaluation process.

"With regard to next steps, the Evaluation Group will prepare a revised paper based on comments made during this discussion. This paper will be submitted to the Executive Board for approval shortly, possibly on a lapse-of-time basis. The revised paper will be posted on the IMF's website for public comments, along with these concluding remarks. Taking into account those comments, a final report on the Evaluation Office will be presented to the International Monetary and Financial Committee in Prague and will indicate that the Executive Board has taken the necessary decisions to make the office operational.

"Finally, these remarks reflect understandings that are still preliminary and will need to be revisited before the Board reaches final decisions on all aspects of the Evaluation Office." ■

Frankel favors range of exchange rate options

(Continued from front page) monetary independence, and financial market integration.

Frankel provided a new angle on the trinity, noting that, as international financial market integration becomes more of a given, countries' options seem to boil down to a single choice: exchange rate stability or monetary independence. But while a country cannot have complete exchange rate stability and complete monetary policy independence, it could—through a managed float—have some of both.

Frankel did not overlook the motivations that might prompt a country to abandon the "soft middle ground of flexible rates." Monetary union and pure floating are the two regimes invulnerable to speculative attack, and complicated intermediate regimes may be insufficiently transparent to global investors. Most of the intermediate regimes that have been tried have failed—"often spectacularly so," he conceded. Though formally pegged to the dollar when their crises hit, Mexico, Thailand, Indonesia, Korea, Russia, and Brazil were all following a variety of middle regimes.

Nonetheless, Frankel pointed out, neither pure floating (which is subject to large swings in exchange rates and speculative bubbles) nor currency unions (which can be broken by political upheavals) are the policymaker's nirvana. Indeed, one of the most interesting questions Frankel put on the table was, "Would any exchange rate regime have prevented the recent crises in emerging markets?"

Frankel offered both theoretical and empirical arguments against the current conventional wisdom that countries should retreat from intermediate regimes because they are intrinsically unsustainable. Such a view, he said, tends to overlook one of the economist's stocks in trade: that life involves trade-offs and, thus, corner solutions are often not optimal. Countries pick fixed exchange rates because they reduce transactions costs and exchange rate risks that might discourage trade and investment. They also fix their exchange rates to provide a credible nominal anchor for monetary policy. A floating exchange rate allows a country to pursue an independent monetary policy that accommodates negative real shocks without constricting demand.

Countries have to weigh the advantages of more exchange rate stability against those of more flexibility, and picking the optimal degree of flexibility would often seem to yield an inferior solution. Moreover, Frankel pointed out that the fixed versus floating debate is a vastly oversimplified dichotomy. There is a continuum of flexibility, so that you must travel from currency union to currency board just to arrive at a fixed exchange rate regime, and then must continue through pegs (adjustable, crawling, basket, and target zones) before reaching the free float. Based on the IMF classification of 185 economies in late 1999, 51 were independent floaters, 45 had abandoned national currencies, and 89 (48 percent of the total) had intermediate regimes.

The recent work of Guillermo Calvo and Carmen Reinhart of the University of Maryland is also germane, Frankel said. It is difficult to distinguish floaters from exchange rate targeters when you look at exchange rate stability and foreign reserve changes. Floaters should have less of both than the targeters, but this is not the empirical finding.

Optimum currency areas

Frankel used his research with Andrew Rose of the University of California at Berkeley on optimum currency areas to provide an elegant example of his proposition that the optimal exchange rate regime varies across countries and over time. Frankel and Rose found that among countries in currency unions, income correlation depends positively on trade integration. This suggests that a parameter assumed to be external to the choice of an optimum currency area— income correlation among potential members—is inherent to that choice and can change over time. Empirical results suggest that when a country adopts the currency of a neighboring state, the monetary union gradually promotes trade between the neighboring countries, which in turn has a positive effect on the correlation of their incomes. Thus, a currency union, by promoting trade among members, raises countries' cyclical correlation so that they may come to better satisfy the optimum currency area criteria ex post than they did ex ante; in other words, countries can "grow into" being good candidates for an optimum currency area.

In his view, Frankel concluded, there are good arguments to be made against the current conventional wisdom that would have countries limiting their exchange rate choices to the extreme ends of the exchange rate spectrum—that is, either firmly fixed or freely floating. ■

Lynn Aylward
IMF External Relations Department

Neither pure floating nor currency unions are the policymaker's nirvana.
—Frankel

Selected IMF rates

Week beginning	SDR interest rate	Rate of remuneration	Rate of charge
August 14	4.67	4.67	5.41
August 21	4.71	4.71	5.46

The SDR interest rate and the rate of remuneration are equal to a weighted average of interest rates on specified short-term domestic obligations in the money markets of the five countries whose currencies constitute the SDR valuation basket (as of May 1, 1999, the U.S. dollar was weighted 41.3 percent; euro (Germany), 19 percent; euro (France), 10.3 percent; Japanese yen, 17 percent; and U.K. pound, 12.4 percent). The rate of remuneration is the rate of return on members' remunerated reserve tranche positions. The rate of charge, a proportion (115.9 percent) of the SDR interest rate, is the cost of using the IMF's financial resources. All three rates are computed each Friday for the following week. The basic rates of remuneration and charge are further adjusted to reflect burden-sharing arrangements. For the latest rates, call (202) 623-7171 or check the IMF website (www.imf.org/external/np/tre/sdr/sdr.htm).

Data: IMF Treasurer's Department

A new economy

East Timor moves to establish foundations of sound macroeconomic management

In the year since the August 1999 referendum on its political future and the subsequent violence, East Timor—aided by significant official, bilateral, and multilateral resources—has sought to lay the foundations for a stable, functioning economy. This article, based on a forthcoming publication by Luis Valdivieso of the IMF's Asia and Pacific Department and others, examines East Timor's progress to date, the IMF's role, and the challenges ahead.

Background

After more than four centuries of Portuguese rule, Indonesia annexed East Timor in 1975. In the mid-1990s, East Timor ranked among Indonesia's poorest provinces, with a per capita income of about $350. Its economy grew rapidly, however, driven by capital outlays on infrastructure funded largely by transfers from the Indonesian central budget. Real GDP growth averaged about 10 percent and inflation was in single digits.

Photo not available

East Timorese money changers offer their services in a Dili market. Inefficiencies and distortions have arisen from the use of multiple currencies.

Output growth collapsed with the onset of the Asian crisis in 1997. The decline was partially offset by growth in agriculture, the financial sector, public administration, defense, and public utilities. Per capita GDP reached $424 in 1998, and inflation increased to about 80 percent (see table, page 277).

In East Timor's small and rudimentary banking system, publicly owned banks were key players. Public finances depended heavily on transfers from Jakarta, with tax revenues amounting to only 6–8 percent of GDP (excluding revenues related to oil concessions), while expenditures represented 40–75 percent of GDP. The economy was quite open and heavily reliant on interisland trade. Exports averaged about 13 percent of GDP during 1995–98, while imports averaged about 36 percent of GDP.

After the referendum

Following an agreement among the United Nations, Indonesia, and Portugal, a referendum was held on August 30, 1999, on the future status of the territory. The referendum provided an overwhelming mandate for independence, but the outcome also triggered widespread violence that seriously disrupted East Timor's economy and institutional structure.

The destruction affected all sectors of the economy. Real GDP is estimated to have declined by almost 40 percent in 1999 and inflation increased sharply. The banking and payments system ceased functioning, and all transactions were conducted in cash—mostly in rupiah, although other currencies also started circulating. Public administration also stopped functioning, revenue collection came to a halt, and budgetary transfers from Jakarta ceased.

The disruption in production and transportation sparked a marked decline in trade. But perhaps most crucial for the economy, the massive displacement of people led to the loss of valuable human capital, particularly key civil servants and commercial bank officials.

In mid-September 1999, a multinational peacekeeping force arrived to restore security and facilitate humanitarian assistance provided by various UN agencies and other bilateral and nongovernmental organizations. In October, the People's Consultative Assembly of Indonesia revoked the annexation of East Timor and, subsequently, the UN Security Council issued a resolution establishing the UN Transitional Administration in East Timor (UNTAET) with broad responsibilities for administering the territory during its transition to independence.

At the request of the UN Secretary General, several official, bilateral, and multilateral agencies joined with the UN agencies and the East Timorese to assess reconstruction requirements, including external financing and technical assistance and training. The World Bank took the lead in assessing reconstruction needs and in designing the development program. IMF staff and experts focused on helping to develop a basic macroeconomic and institutional framework, with special emphasis on the immediate steps needed to ensure stability and create an enabling environment for economic recovery.

Macroeconomic framework

The IMF staff proposed a strategy centered on three essential components—the revival of the payments system, the development of a basic fiscal framework, and a comprehensive program of policy and technical advice. The most critical initial steps toward reviving the payments system were the choice of a legal tender and the establishment of a monetary authority that would design and enforce a basic regulatory framework for the operation of the foreign exchange market and the banking system.

Photo Credits: Denio Zara, Padraic Hughes, Pedro Márquez, and Michael Spilotro for the IMF, pages 273 and 279; Darren Whiteside for Reuters, page 276; and Jimin Lai for AFP, pages 282–83.

There was a consensus that conditions were not currently in place for the introduction of an East Timorese currency and that a single foreign currency would be needed to help eliminate the inefficiencies and distortions that had arisen from the ongoing use of multiple currencies. A Central Payments Office would be created to provide basic depository and payments services to the government and perform the treasury functions related to payments of stipends to civil servants.

The basic fiscal strategy featured two key elements: the establishment of a Central Fiscal Authority, which would be responsible for administering public finances as well as enforcing fiscal legislation and would ensure appropriate oversight, and the adoption of a budget underpinned by a fair, transparent, and efficient tax system that was easy to administer.

The UNTAET prepared the preliminary budget for 2000, in consultation with the IMF staff. The budget, presented to donors in Tokyo in December 1999, proposed the introduction of a 5 percent import duty, various excises, a 5 percent sales tax on commercial imports, a 5 percent service tax on selected services, and a 5 percent presumptive income tax on coffee exports.

Recent developments

The overall economic situation has improved considerably since September 1999. Real GDP is estimated to have grown at an annual rate of 15 percent in the first half of 2000, led by the reconstruction of public and residential buildings and the progressive restoration of commerce and some basic services. Prices are slowly beginning to stabilize, but unemployment remains high, particularly in urban areas. Humanitarian assistance continues to be a major source of income support for large segments of the population.

The implementation of the preliminary budget up to the end of June has been well below projections for that period. This has been primarily due to low levels of expenditures reflecting complex administrative procedures, delays in the receipt of external financing, and long-drawn-out planning stages for investment programs. Moreover, the composition of expenditures has deviated markedly from that originally envisaged. In particular, the wage bill was almost twice as large as originally projected, because public sector employment and the average monthly compensation were higher than assumed in the budget.

In the financial sector, two foreign institutions have started operations, mainly providing foreign exchange services. Progress has also been made in restoring the payments system, particularly budgetary payments. UNTAET, with the endorsement of the National Consultative Council, adopted the U.S. dollar as the legal tender in early January 2000. The use of the U.S. dollar has not been as widespread as expected, however, because of a scarcity of low-denomination notes, the absence of coins, and a lack of familiarity with the new legal tender. These problems are being addressed.

On the external front, foreign trade activity also appears to be picking up gradually. As regards external financing, generous assistance from the international community has supported East Timor's reconstruction effort. Donor pledges in Tokyo amounted to $523 million and have been sufficient to cover the special appeal for humanitarian aid ($150 million); a three-year, $147 million reconstruction program underwritten by a Trust Fund for East Timor; recurrent and capital expenditures for civil administration and law and order ($32 million); and a number of bilateral programs. All assistance has been voluntary and has taken the form of grants or donations to avoid external liabilities. Assistance has also been provided through the UNTAET budget, financed through assessed contributions from the UN member states.

On the institutional front, the two key economic institutions—the Central Fiscal Authority and the Central Payments Office—are close to becoming operational. The IMF's Fiscal Affairs, Legal, and Monetary

Key economic indicators

	1995	1996	1997	1998	1999 Est.	2000 Proj.	2001 Proj.
GDP per capita (U.S. dollars)[1]	374	429	442	424	304	...	...
				(percent change)			
Real GDP growth	9	11	4	–2	– 38	15	15
Inflation rate [2]	8	5	10	80	140	20	3
				(percent of GDP)			
Consumption	83.4	79.9	71.0	74.6	91.9	104.2	112.7
Investment	40.8	44.3	52.9	47.0	28.1	33.4	46.7
Domestic saving	16.6	20.1	29.0	25.4	8.1	–4.2	–12.7
External saving	–24.2	–24.2	–23.9	–21.6	–20.1	–37.6	–59.4
				(million U.S. dollars)			
Merchandise exports	37	44	52	55	46	49	63
Merchandise imports[3]	112	132	142	135	82	118	192

Fiscal year[4]	1995/96	1996/97	1997/98	1998/99	1999/2000 Budget[5]	Jan.–Jun. 2000 Prel. Budget	Jan.–Jun. 2000 Est.	2000/01
				(percent of GDP)				
Fiscal balances								
Revenues	...	...	8.1	8.2	6.0	3.2	1.1	5.9
Recurrent expenditures	...	...	13.0	14.6	13.0	7.4	5.0	15.1
Capital expenditures	...	...	61.8	22.5	29.5	21.0	6.9	44.6
Overall balance (deficit)	...	...	–66.7	–28.8	–36.5	–25.2	–10.8	–53.8

[1]GDP in U.S. dollars was calculated using 1996 as the base year and assuming purchasing power parity.
[2]CPI, Dili, based on rupiah prices, except for projected 2001 figure, which is CPI, Dili, based on U.S. dollar prices.
[3]Includes imports through foreign aid; excludes projected imports by UNTAET and Office of Coordination of Humanitarian Affairs in 1999, 2000, and 2001.
[4]The fiscal year under Indonesia was from April 1 to March 31. There are no data on the execution of the 1999/2000 budget. The preliminary budget of UNTAET was prepared for calendar year 2000. Fiscal year 2000/01 is from July 1 to June 30.
[5]Original Indonesian provincial budget for East Timor

Data: Indonesian authorities and IMF staff estimates and Exchange Affairs Departments have provided extensive technical assistance, including identifying suitable expatriate staff for key positions.

One of the most important institutional developments has been the creation of a decision-making structure, which includes the establishment of the National Consultative Council and, more recently, the shift from a transitional administration to a transitional government in which East Timorese would assume executive positions. The IMF's Asia and Pacific Department has provided continued policy advice to UNTAET, including helping to form a consensus at the National Consultative Council on key economic policy issues.

Outlook for the near term

Real GDP is projected to grow by at least 15 percent a year during 2001–02, led by agriculture, commerce, basic services, and construction. As supply constraints are relaxed and the U.S. dollar becomes more widely used, inflation in East Timor should start converging to that of its major trading partners.

The fiscal deficit for 2000/01 is projected at $155 million, with domestic revenues covering only 10 percent of expenditures. The deficit is projected to remain above $100 million in the following two years, with fiscal revenue more than doubling in the outer years to cover about 80 percent of expenditures. The projected increase in revenues, however, would require an additional tax effort and a broadening of the tax base. Setting an appropriate wage policy for the civil service would also be a critical policy challenge in the fiscal area.

Financing of the deficit will continue to rely fully on external grants. A donors' meeting in late June helped to confirm the availability of funds for the reconstruction and development program funded through the Trust Fund for East Timor and provided strong indications that the funding of recurrent and capital expenditures for civil administration would be made available.

In the financial sector, urgent steps need to be taken to reestablish the banking function by enacting key prudential regulations and establishing a system of supervision of financial institutions. Finally, there will be a continued, albeit declining, need for external financial assistance as well as for further technical assistance and training for a number of years.

Challenges ahead

Despite the progress achieved so far, the tasks ahead remain monumental. As the reconstruction effort gains momentum with generous external financial support, sound economic management will be critical in preserving macroeconomic stability and providing reasonable assurances to all parties involved, including donors, that the resources made available to East Timor are being effectively used and properly accounted for.

Active participation of the East Timorese in all stages of the process—including the design, implementation, monitoring, and, if required, reformulation of objectives and policy priorities—is critical to the success of the reconstruction effort and would consolidate gains already made. ■

Luis Valdivieso
IMF Asia and Pacific Department

Copies of *East Timor: Establishing the Foundations of Sound Macroeconomic Management*, by Luis M. Valdivieso, Toshihide Endo, Luis V. Mendonça, Shamsuddin Tareq, Alejandro López-Mejía are available for $18.00 each from IMF Publication Services, Box X2000, IMF, Washington, DC 20431 U.S.A. Telephone: (202) 623-7430; fax: (202) 623-7201; e-mail: publications@imf.org.

Available on the web (www.imf.org)

Press Releases

00/48: IMF Executive Board Establishes Code of Conduct, August 16

00/49: IMF Executive Board Discusses Independent Evaluation Office, August 18 (see page 273)

00/50: IMF Executive Board Grants Waiver on Noncomplying Disbursement to Ghana, August 22

News Briefs

00/70: IMF Management Welcomes Progress in Ecuador's Debt Restructuring, August 17

00/71: IMF Completes Second Review of Ghana Under PRGF-Supported Program and Approves in Principle $35.1 Million Disbursement, August 22

00/72: IMF Completed Final Review of Korea Program, August 23

Public Information Notices (PINs)

00/60: Czech Republic, August 9

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Letters of Intent and Memorandums of Economic and Financial Policies (date posted)

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Michael Mussa, IMF Economic Counselor and Director of Research, *Factors Driving Global Economic Integration*, August 22

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IMF's Financial Resources and Liquidity Position, 1998 to July 2000, August 11

IMF Financial Activities, August 11

Draft *Guidelines for Public Debt Management*, August 15

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Schedule of Public Engagements of IMF Management, August 18

McKinnon says long-term peg could help reduce incidence of crises for emerging markets

Does a country's exchange rate regime affect moral hazard in capital markets or address the problem of international overborrowing? Is there merit in resurrecting the de facto "East Asian dollar standard" that operated for more than a decade before the crises of 1997–98? Ronald I. McKinnon of Stanford University addressed these issues at an IMF Institute seminar on August 14.

Overborrowing syndrome

The financial crises suffered by emerging markets in the 1990s, beginning with Mexico in 1994, were often precipitated by large capital inflows to finance ambitious stabilization and reform programs. Financial liberalization, which was in many cases a part of these programs, had enabled domestic banks to borrow heavily in international capital markets and had resulted in massive, often excessive, inflows of foreign capital. This phenomenon, which McKinnon called "the overborrowing syndrome," became a source of macroeconomic imbalances that ultimately proved unsustainable. In McKinnon's view, overborrowing is a moral hazard issue rather than, for example, a matter of "getting the exchange rate right."

Because of their systemic importance to the domestic economy, banks expect to be bailed out when they run into trouble. Near certainty of official bailout further increases the magnitude of overborrowing and leaves the economy more vulnerable to speculative attack and more exposed to the real economic consequences of such an attack.

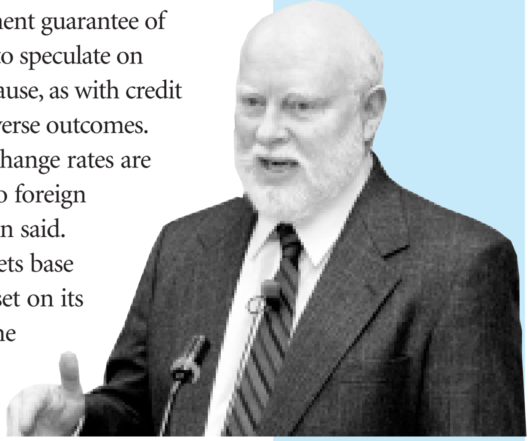
Modeling the overborrowing syndrome, McKinnon posited the hypothetical situation of a small open economy whose banks enjoy a government guarantee. The government embarks on a credible program of economic reform designed to eliminate distortions and make the economy more productive—for example, by lifting restrictions on foreign and domestic trade. To achieve this, a certain level of investment in the new technology is needed. However, the magnitude of the productivity rise depends on the overall macroeconomic success of the reform program.

In assessing investment risks in the reforming economy, banks may discount the risk of unfavorable outcomes and be more willing to borrow, secure in the knowledge that official bailout provisions will keep their depositors from deserting the ship. Because of the moral hazard in domestic lending, the quantity borrowed internationally is too high, which leads to an excessive expansion of credit. Only an unusually good macro outcome can then prevent a financial crisis.

Foreign exchange markets

Evidence from recent emerging market crises—especially in East Asia—suggests that banks also took excessive risks in the foreign exchange markets, McKinnon noted. Banks enjoying a government guarantee of their liabilities have an incentive to speculate on exchange rate developments, because, as with credit risks, they are protected from adverse outcomes.

Nominal developments in exchange rates are uncertain and introduce risk into foreign exchange transactions, McKinnon said. Investors in foreign currency assets base their demand for a particular asset on its riskiness, which is captured by the currency risk premium. Interest rates and price levels are typically more volatile in emerging markets than in industrial countries. Because wealth holders demand more compensation for holding emerging market assets, the interest rates on assets denominated in emerging market currencies have to be higher to maintain international portfolio balance.



McKinnon: Banks may discount the risk of unfavorable outcomes and be more willing to borrow, secure in the knowledge that official bailout provisions will keep their depositors from deserting the ship.

To reduce the risk, investors engage in hedge transactions—that is, they take other positions that reduce risk, usually at the expense of maximum reward. Thus, unhedged transactions cost less than hedged ones, because the risk is higher.

In many, if not most, emerging market countries, the regulatory and supervisory institutions are too weak to impose and enforce 100 percent hedging requirements on domestic banks. Consequently, banks with moral hazard have an incentive to borrow unhedged in foreign exchange markets at a lower interest rate, transferring the resulting foreign exchange risk to the government through the implicit government guarantee.

McKinnon termed the difference between the cost of capital for hedged borrowers and unhedged borrowers the "margin of temptation." This margin is reflected in the "super risk premium," which has two components: the currency risk premium and the part of the interest differential between domestic and foreign currency arising from the small probability of a large, sudden devaluation whose timing is unpredictable.

When they borrow unhedged foreign currency, domestic banks with deposit insurance and other government guarantees ignore the downside bankruptcy risks implied by such large devaluations. They also ignore ongoing volatility in the exchange rate. A bank exploiting a government guarantee by borrowing unhedged in the international capital market will charge a lower lending rate than a domestic bank borrowing in

No exchange rate regime, no mater how well chosen, can obviate the need for prudential regulation of domestic banks against undue risk taking.

—McKinnon

foreign currency but fully hedging its foreign exchange exposure.

This highlights a regulatory dilemma, McKinnon said. If the super risk premium is high and the ability of the regulatory authorities to enforce hedging rules is imperfect, there will be large differences in the perceived cost of capital to different financial agents and firms in the domestic market. Those that the authorities succeed in policing will face a much higher cost of capital than those that gamble and borrow unhedged. A declining market share could undermine the resolve of well-behaved banks to hedge their foreign exchange positions and lead to a breakdown in the domestic regulatory system, McKinnon cautioned.

Good "fix" versus free float

The current consensus in the academic literature, which has been endorsed by the IMF and other international organizations, McKinnon said, is that more flexible exchange rate arrangements are needed. With flexible exchange rates, this argument contends, the risks of accepting short-term deposits are clear. However, as McKinnon noted, while floating may reduce the super risk premium, it does not necessarily reduce the currency risk premium. Therefore, a free floating regime may not reduce moral hazard or the margin of temptation for unhedged borrowing by banks.

Of course, it is necessary to distinguish between a "bad" fix—one that is obviously unsustainable because of, say, ongoing fiscal deficits and correspondingly high domestic interest rates that create a huge margin of temptation—and a credible, "good" fix. A good fix, McKinnon argued, may be preferable to floating, because it can reduce the likelihood of a sharp devaluation and may also better stabilize the domestic economy while limiting moral hazard in the banking system. However, no exchange rate regime, no matter how well chosen, can obviate the need for prudential regulation of domestic banks against undue risk taking, McKinnon asserted.

East Asia dollar standard

As an example of a good fix that, at least on the surface, appeared to have failed, McKinnon described the experience of the East Asian economies that for more than a decade before the crises of 1997–98 pegged to the U.S. dollar. The crisis economies of Indonesia, Korea, Malaysia, the Philippines, and Thailand, as well as the noncrisis economies of Hong Kong SAR, China, and Taiwan Province of China, organized their domestic monetary policies to keep their dollar exchange rates remarkably stable. Besides insulating each other from beggar-my-neighbor devaluations, these informal dollar pegs successfully anchored domestic price levels during their remarkably rapid economic growth from the 1980s through 1996.

With the benefit of hindsight, however, McKinnon said, we can see that this unofficial "East Asian dollar standard" was incomplete. First, the authorities failed to properly regulate the financial system—including the central bank in some cases—against undue risk taking, including short-term foreign exchange exposure. Overborrowing was thus primarily a regulatory problem compounded by unnatural interest disparities and was not due to exchange rate mismanagement per se. Whether the countries were on fixed or floating exchange rates, McKinnon said, the margin of temptation to overborrow by banks with moral hazard would still be there.

Long-term parity

The absence of a formal exchange rate anchor as part of the monetary strategy of a country whose currency is under attack will leave international investors in the dark about where the exchange rate will end up in the aftermath of a crisis. Under the nineteenth-century gold standard, a country whose currency was attacked allowed its exchange rate to float until the dust settled, at which point it was expected that the parity with gold would be reestablished. This understanding lessened market uncertainty about the future behavior of an individual currency.

With the exception of Hong Kong SAR, none of the East Asian debtor countries had formally declared a dollar parity, McKinnon said. Because of the short-term structure of finance, each was vulnerable to speculative attack on its currency, but none had a long-run exchange rate strategy in place to mitigate the worst consequences of such an attack. Thus, with the forced suspension of these dollar pegs in the 1997–98 crisis, there was no traditional dollar parity to which the government was bound to return.

Formalizing the standard

The good record of fiscal balance in the East Asian economies suggests that a longer-term commitment to maintain their dollar exchange rates could be credible,

Members' use of IMF credit
(million SDRs)

	During July 2000	January–July 2000	January–July 1999
General Resources Account	236.94	2,204.03	7,369.19
Stand-By Arrangements	221.72	1,542.71	5,470.50
SRF	0	0	3,636.09
EFF	15.22	661.32	1,232.07
CFF	0	0	666.62
PRGF	73.45	221.92	502.25
Total	310.39	2,425.95	7,871.44

SRF = Supplemental Reserve Facility
EFF = Extended Fund Facility
CFF = Compensatory Financing Facility
PRGF = Poverty Reduction and Growth Facility
Figures may not add to totals shown owing to rounding.

Data: IMF Treasurer's Department

McKinnon observed. Thus, to secure a common monetary anchor, the advantages of returning to virtually stable dollar exchange rates in Asia greatly outweigh the disadvantages; and, in effect, most of the East Asian five have quietly, if unofficially, returned to dollar pegging.

McKinnon concluded by suggesting some modifications to the existing informal system that would make this common monetary standard more robust and efficient.

- Prohibit net foreign exchange exposure by banks or other financial institutions with short-term assets or liabilities.
- Move from informal dollar pegging to official dollar parities and treat these parities as long-term obligations to which governments in the region are committed after any crisis.
- Make other institutional changes to lengthen the term structure of domestic finance by encouraging the development of bond and mortgage markets. ■

Stand-By, EFF, and PRGF Arrangements as of July 31

Member	Date of arrangement	Expiration date	Amount approved	Undrawn balance
			(million SDRs)	
Stand-By Arrangements				
Argentina	March 10, 2000	March 9, 2003	5,398.61	5,398.61
Bosnia and Herzegovina	May 29, 1998	March 31, 2001	94.42	30.15
Brazil[1]	December 2, 1998	December 1, 2001	10,419.84	2,550.69
Ecuador	April 19, 2000	April 18, 2001	226.73	141.73
Estonia	March 1, 2000	August 31, 2001	29.34	29.34
Korea[1]	December 4, 1997	December 3, 2000	15,500.00	1,087.50
Lithuania	March 8, 2000	June 7, 2001	61.80	61.80
Latvia	December 10, 1999	April 9, 2001	33.00	33.00
Mexico	July 7, 1999	November 30, 2000	3,103.00	1,163.50
Panama	June 30, 2000	March 29, 2002	64.00	64.00
Philippines	April 1, 1998	December 31, 2000	1,020.79	475.13
Papua New Guinea	March 29, 2000	May 28, 2001	85.54	75.54
Romania	August 5, 1999	February 28, 2001	400.00	260.25
Russian Federation	July 28, 1999	December 27, 2000	3,300.00	2,828.57
Turkey	December 22, 1999	December 21, 2002	2,892.00	2,226.84
Uruguay	May 31, 2000	March 31, 2002	150.00	150.00
Zimbabwe	August 2, 1999	October 1, 2000	141.36	116.62
Total			**42,920.43**	**16,693.27**
EFF Arrangements				
Bulgaria	September 25, 1998	September 24, 2001	627.62	209.22
Colombia	December 20, 1999	December 19, 2002	1,957.00	1,957.00
Indonesia	February 4, 2000	December 31, 2002	3,638.00	3,096.50
Jordan	April 15, 1999	April 14, 2002	127.88	91.34
Kazakhstan	December 13, 1999	December 12, 2002	329.10	329.10
Pakistan	October 20, 1997	October 19, 2000	454.92	341.18
Peru	June 24, 1999	May 31, 2002	383.00	383.00
Ukraine	September 4, 1998	September 3, 2001	1,919.95	1,207.80
Yemen	October 29, 1997	March 1, 2001	105.90	65.90
Total			**9,543.37**	**7,681.04**
PRGF Arrangements				
Albania	May 13, 1998	May 12, 2001	45.04	9.41
Benin	July 17, 2000	July 16, 2003	27.00	20.20
Burkina Faso	September 10, 1999	September 9, 2002	39.12	27.94
Bolivia	September 18, 1998	September 17, 2001	100.96	56.10
Cambodia	October 22, 1999	October 21, 2002	58.50	50.14
Cameroon	August 20, 1997	August 19, 2000	162.12	18.02
Central African Rep.	July 20, 1998	July 19, 2001	49.44	32.96
Chad	January 7, 2000	January 7, 2003	36.40	26.00
Côte d'Ivoire	March 17, 1998	March 16, 2001	285.84	161.98
Djibouti	October 18, 1999	October 17, 2002	19.08	13.63
Gambia, The	June 29, 1998	June 28, 2001	20.61	10.31
Ghana	May 3, 1999	May 2, 2002	155.00	110.70
Guinea	January 13, 1997	January 12, 2001	70.80	15.73
Guyana	July 15, 1998	July 14, 2001	53.76	35.84
Honduras	March 26, 1999	March 25, 2002	156.75	64.60
Kyrgyz Republic	June 26, 1998	June 25, 2001	73.38	38.23
Mali	August 6, 1999	August 5, 2002	46.65	39.90
Mauritania	July 21, 1999	July 20, 2002	42.49	30.35
Mozambique	June 28, 1999	June 27, 2002	87.20	42.00
Nicaragua	March 18, 1998	March 17, 2001	148.96	53.82
Pakistan	October 20, 1997	October 19, 2000	682.38	417.01
Rwanda	June 24, 1998	June 23, 2001	71.40	38.08
Senegal	April 20, 1998	April 19, 2001	107.01	42.80
São Tomé and Príncipe	April 28, 2000	April 28, 2003	6.66	5.71
Tajikistan	June 24, 1998	June 23, 2001	100.30	40.02
Tanzania	March 31, 2000	March 30, 2003	135.00	115.00
Uganda	November 10, 1997	November 9, 2000	100.43	17.85
Yemen	October 29, 1997	October 28, 2000	264.75	114.75
Zambia	March 25, 1999	March 24, 2002	254.45	244.45
Total			**3,401.48**	**1,893.53**
Grand total			**55,865.28**	**26,267.84**

[1]Includes amounts under Supplemental Reserve Facility
EFF = Extended Fund Facility.
PRGF = Poverty Reduction and Growth Facility.
Figures may not add to totals owing to rounding.

Data: IMF Treasurer's Department

Members drawing on the IMF "purchase" other members' currencies, or SDRs, with an equivalent amount of their currency.

Signs of reduced vulnerability

Malaysia fashions own path to recovery, looks to strengthen growth

Malaysia is showing signs of rapid recovery and reduced vulnerability. Since mid-1999, the country's output growth has been among the strongest of the Asian crisis economies, led by buoyant world demand for electronics and supported by accommodating macroeconomic policies. This recovery has become more broad-based in recent months, with domestic consumption picking up and private investment beginning to recoup. Inflation remains subdued, and international reserves are at a comfortable level. In response to better economic performance and a gradual easing of the capital controls imposed during the crisis, market confidence in Malaysia has begun to strengthen and portfolio inflows have resumed.

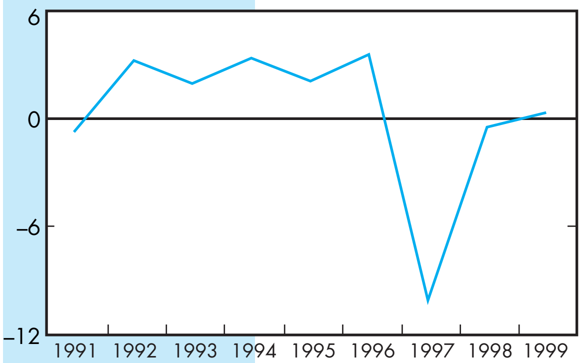
This article looks at Malaysia's evolution into an emerging market economy, its distinctive handling of the Asian crisis (notably the use of selective capital controls and a pegged exchange rate), and the challenges it now faces.

Transition to emerging market economy

Malaysia's rapid growth from 1970 to the mid-1990s reflected a dramatic shift from agriculture and mining to a growing reliance on manufacturing. By the early 1980s, however, growth was accompanied by substantially increased budget deficits and an unsustainable public debt.

Malaysia: net portfolio investment

billion dollars



Data: Malaysian authorities

The Malaysian authorities took steps to reduce the federal government deficit and lower the public debt, while more open trade and payments systems helped rapidly expand Malaysia's export base. Diversification, coupled with deregulation and liberalization of its financial system, helped transform Malaysia into a middle-income emerging market by the end of the decade and allowed it to improve living standards and income distribution.

In the early 1990s, Malaysia's macroeconomic performance was very strong. Real output growth averaged 8½ percent a year; unemployment dipped below 3 percent; prices and the exchange rate remained stable; and international reserves were robust. But there were also signs of stress, as exports decelerated and large current account deficits developed.

Vulnerabilities emerge

With the benefit of hindsight, it is clear that Malaysia's accelerated economic growth also gave rise to vulnerabilities that exposed it to the crisis.

- Excessive investment produced a number of uneconomical capital-intensive projects and created substantial unused capacities. Deteriorating investment quality led to lower productivity and declining corporate earnings. Also, close government involvement in the privatized infrastructure projects created potential public sector liabilities and the perception of reduced transparency and weak corporate governance.
- Fast economic growth, a stable exchange rate, and relatively low external indebtedness induced large private capital flows, fueling excessive investment in real estate and equity markets that raised their prices beyond underlying values. Relatively easy access to bank credit encouraged further speculative investment, and the ensuing fast credit growth weakened the quality of bank assets.
- A high level of stock market capitalization combined with substantial corporate short-term bank financing left the corporate sector vulnerable to declines in asset prices and increases in interest rates, with adverse repercussions for the financial system.
- Malaysia's dependence on electronic and electrical exports made it more susceptible to boom-bust cycles in the global electronic markets, while the real appreciation of the ringgit reduced the country's external competitiveness. Rapidly expanded imports resulted in large current account deficits financed in part by portfolio flows, which increased Malaysia's vulnerability to sudden reversals in market sentiment.
- Fiscal tightening and monetary sterilization allowed Malaysia to avoid a substantial nominal appreciation of the exchange rate despite the large capital inflows. But the ringgit's predictability encouraged further foreign borrowing and discouraged the development of hedging instruments, leaving the banking and corporate sectors exposed to currency risks.
- An active offshore ringgit market that faced relatively few restrictions rendered the currency more open to speculative attacks once it became apparent that the currency was overvalued.
- Despite Malaysia's relatively strong banking culture and well-developed accounting and prudential supervision systems, the capacity of financial institutions to manage risks did not keep pace with global technological advances and financial innovation.

Generally speaking, however, Malaysia entered the crisis with a better fiscal position, a stronger financial sector, a lower short-term external exposure, and higher usable international reserves than other Asian crisis countries. These features, indicative of the country's overall financial discipline and prudential regulations on external borrowing, mitigated weakening market confidence early in the crisis and reinforced stabilization efforts that were key to managing the crisis later on.

Onset of the crisis

From early 1997 through the period following the eruption of the crisis midyear, as these vulnerabilities were recognized, confidence in Malaysia, along with the rest of the region, increasingly diminished. Large portfolio outflows took place (see chart, page 282), and equity and property values declined significantly.

The ringgit came under significant pressure. Currency traders took short positions offshore in anticipation of a large devaluation. As a result, offshore ringgit interest rates increased significantly relative to domestic rates, which intensified outflows of ringgit funds offshore. These flows exacerbated banks' liquidity problems and overall financial distress, and heightened pressure on domestic interest rates.

The Malaysian corporate sector experienced significant wealth loss as a result of sharp falls in the value of real estate and stocks used as bank collateral. Corporate incomes and cash flows also declined, leaving corporations unable to service their debt. Cross-shareholding—which permitted companies to build up higher debt than was obvious on individual balance sheets—exacerbated the financial difficulties.

Managing the crisis

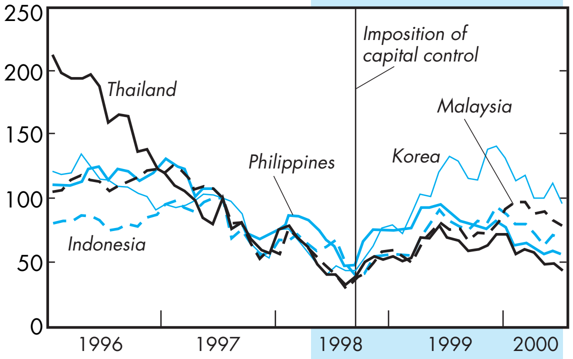
Similar to the other crisis countries, Malaysia initially tightened monetary policy to help anchor market sentiment and restore confidence in the financial system. The authorities temporarily hiked interest rates in mid-1997, while the 1998 budget was revised early that year to an expansionary position. This policy stance was expected to sustain the economic adjustment process needed to correct external imbalances. The contagion effects of the crisis and the associated economic contraction, however, were far worse than anticipated. The fiscal policy proved insufficiently expansionary, and growth rates slowed and then turned sharply negative in early 1998.

An abrupt fall in domestic demand shifted the external current account to a significant surplus but also led to a further deterioration of the financial sector. The level of nonperforming loans rose, deposits slowed, and financial institutions saw earnings and capital decline. Market confidence faltered amid adverse regional developments and uncertainties. Capital outflows persisted, leading to a self-fulfilling vicious cycle of financial panic, and anticipation of a further devaluation heightened. By the summer of 1998, the stock market fell to its lowest level in recent history (see chart, this page).

In September 1998, the Malaysian government launched a policy package designed to insulate monetary policy from external volatility. The authorities pegged the ringgit to the U.S. dollar and imposed exchange and capital controls. The controls prohibited offshore trading of the ringgit and restricted the repatriation of portfolio investment. The portfolio restrictions were set to be temporary and focused on selected transactions; payments for current account transactions and foreign direct investment flows were not affected. These measures permitted greater monetary independence and facilitated the subsequent lowering of interest rates, and complemented a May 1998 fiscal stimulus package that stepped up capital spending. However, by the time the September policies were introduced, some measure of stability had already returned to the regional financial markets, and currency movements had become less volatile.

Asian crisis countries: stock market index

July 1997=100



Data: Bloomberg and WEFA/INTLINE

Malaysia's exchange and capital controls reflected a significant departure from the policy mix adopted by the other crisis countries, and international market responses were initially negative. Rating agencies downgraded the country's credit ratings and removed Malaysia from major benchmark international investment indices. As a consequence, Malaysia's risk premium in international markets increased markedly (see chart, page 284).

Malaysian policymakers and businesses, however, viewed the exchange rate peg and the controls as a means of gaining some predictability at a time of intense financial volatility. The initial impact on the domestic market was broadly positive, with stock market prices increasing immediately after the controls were imposed, reflecting both inflows of funds unable to leave the country and renewed interest by both domestic and foreign investors as the regional situation began to stabilize.

Impact of crisis measures

Improved market sentiment and economic recovery in Malaysia shortly after the introduction of controls resembled the pattern in other Asian crisis countries, and it is difficult to isolate the impact of Malaysia's approach to the crisis from regional developments that have also permitted other countries to pursue monetary easing and structural reforms. The controls have been effectively implemented, yet they have had limited identifiable impact on portfolio flows. This could be because by the time the measures were introduced, substantial portfolio

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capital had left the country and the external environment had already improved. Also, the subsequently undervalued ringgit reduced incentives for capital outflows. The elimination of the offshore ringgit market did, however, help quell speculation against the currency.

Subsequent easing of the controls also moderated their negative impact. In early 1999, the one-year holding period on the repatriation of portfolio capital was replaced with a graduated system of exit levies. The levy system was then further eased so that only profit remittances on portfolio capital brought in after mid-February 1999 remained subject to a flat levy. Market participants welcomed these moves. Although net outflows occurred during February–October 1999, the amount was smaller than anticipated. Relatively large inflows followed as sovereign spreads narrowed and investors repositioned themselves in anticipation of Malaysia's reinclusion in key benchmark investment indices.

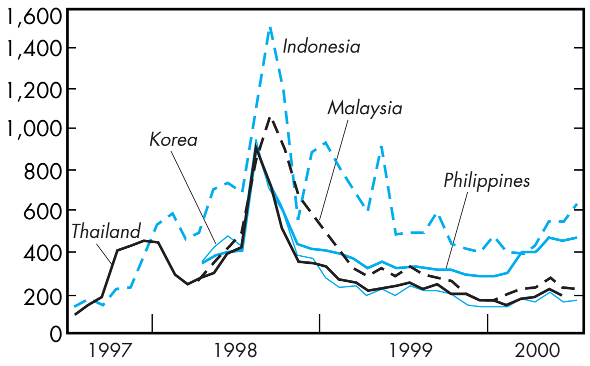
The policies could have lingering and indirect effects, however. The ringgit peg and control measures have reduced activity in the onshore foreign exchange market, dampened trading in futures and options, and discouraged hedging activities. Foreign direct investors now face higher administrative costs associated with additional verification and approval procedures and perceive investment policy regimes as unpredictable. All these factors may increase Malaysia's country risk, but it is too early to assess whether there will be longer-term adverse effects on investors' outlook or on the development of the domestic financial market, including the advancement of robust risk-management practices.

The Malaysian authorities believed capital controls were needed to avert an imminent financial panic. The pegged exchange rate permitted domestic businesses to make plans with less uncertainty, and low interest rates gave some breathing space, allowing the authorities to focus on structural reforms. Beginning in mid-1998, Malaysia sped up efforts to improve banking sector balance sheets. It created an asset-management agency to acquire and maximize the recovery value of nonperforming loans, a recapitalization agency to bring the capital of financial institutions up to adequate levels, and a committee to help restructure large corporate loans. A comprehensive bank merger program subsequently focused on the development of a core of resilient and dynamic domestic banking institutions able to compete in a more globalized environment.

In parallel, the authorities assigned high priority to strengthening prudential regulation and supervision in line with international best practice, highlighting capital adequacy and asset quality. Notable progress has been made toward the introduction of consolidated and risk-based supervision, complemented by the use of formalized risk-management practices by banking institutions. Malaysia has also taken steps to strengthen corporate governance and disclosure standards.

Asian crisis countries: sovereign bond spreads

basis points, end of period



Data: Bloomberg and Deutsche Bank, *Emerging Market Weekly*

Better economic conditions and restructuring efforts have contributed to the improved financial performance of the banking and corporate sectors. Well-coordinated undertakings to remove nonperforming loans and raise capital have contributed to better financial sector performance. Strong external demand, higher asset prices, reduced interest rates, and debt restructuring have helped upgrade corporate balance sheets. Restructuring of operations and management has also accompanied debt restructuring, but the effects of this will take time to be felt.

Challenges ahead

Malaysia's economy is recovering rapidly, and it will be important to sustain the recovery while keeping inflation under control. Over the near term, macroeconomic policies will have to maintain a judicious balance between the need to sustain domestic demand and a fast-closing output gap. Restructuring efforts will also have to continue. Over the medium term, Malaysia aims to return to high, sustainable growth through productivity gains. To achieve this, it will have to maintain macroeconomic stability while facilitating efficient resource allocation and encouraging investors to take a long-term view of Malaysia. Internally consistent macroeconomic policies combined with an appropriate regulatory framework are key. Such policies will improve risk management and allow for an orderly exit from the remaining capital controls and development of more resilient and competitive financial and corporate sectors. Accelerated corporate reforms will raise productivity and help contain potential contingent liabilities of the government.

The government is mapping a long-term strategy to transform Malaysia into an economy whose high-skilled sectors are based on information, communications, and technology. A crucial issue will be advancing this transformation through deregulation and encouragement of a competitive environment. ■

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