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# Review of Recent Crisis Programs

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Prepared by the Strategy, Policy and Review Department

In consultation with other departments

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***Scope***. This paper reviews the emerging market programs put in place in response to the current financial crisis. (A forthcoming paper will review the recent experience in low-income countries.) The report covers 15 Stand-By Arrangements (SBAs) approved by the IMF between September 2008 and early July 2009. The programs are concentrated in Europe and the CIS region (Armenia, Belarus, Bosnia & Herzegovina, Georgia, Hungary, Iceland, Latvia, Romania, Serbia, and Ukraine). Other cases covered are Pakistan, Mongolia, and the precautionary (i.e., nondisbursing) SBAs with Costa Rica, El Salvador, and Guatemala. Because the focus here is on the policies pursued under Fund-supported programs, the three countries (Mexico, Poland, and Colombia) that have access to Fund resources under the new Flexible Credit Line (FCL), which does not involve an economic program monitored by the Fund, are not the focus of this paper.

***Aim***. The goal is to bring a cross-country perspective, examine outcomes, and ask if policies and conditionality are properly tailored to individual country circumstances. While it is too soon to draw firm conclusions (this study does not obviate the need for country-by-country reviews of the type conducted by the Fund in the past), an early assessment is useful in providing real time feedback to country authorities, IMF staff, partner institutions, and policymakers elsewhere.

***Approach***. Throughout the paper, comparisons are made between the current set of program countries and (i) other current emerging market countries that have not needed Fund support; and (ii) a set of past capital account crisis cases, to see whether program policies and outcomes differ significantly from the general crisis response and from previous Fund involvement (see Figure 4 for methodological notes). Despite the heterogeneity of the program countries involved in this study, the empirical results are generally robust to the choice of countries. In particular, results do not change substantively when omitting the three Central American countries, Mongolia, and Pakistan, which were arguably less affected by the crisis than the Central and Eastern Europe (CEE) and CIS countries. The uncertain nature of 2009 projections, to which the analysis in this paper is anchored, suggests to treat with caution the empirical findings presented here.

***Data***. The analysis is based on data from the Fall 2009 World Economic Outlook. As such, there may be some discrepancies with information contained in recent IMF country reports.

***Consultations***. The paper benefited from discussions with stakeholders in program countries and elsewhere. Feedback was received from participants to a recent seminar in Brussels and from respondents to an independent opinion survey covering Iceland, Hungary, Romania, and Ukraine.

***Staff***. The paper was prepared by a team from SPR led by J. Roaf and comprising G. Adler, A. Amranand, B. Barkbu, P. Dohlman, M. Goretti, I. Halikias, B. Joshi, P. Kehayova, F. Salman, Y. Sun, under the supervision of L. Giorgianni, and with contributions from A. Kumar (EXR), M. Horton, A. Ivanova, and E. Sze (FAD), and D. McGettigan, C. Serra, and G. Tolosa (SPR).

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**CONTENTS** **PAGE**

Executive Summary ........ 3

I. Manifestation of Crisis in Emerging Markets ........ 5
- A. Onset of crisis in Emerging Markets ........ 5
- B. What led countries to request Fund support? ........ 8
- C. Recent developments in program countries ........ 11

II. Overall Program Design ........ 13
- A. Overall objectives and crisis response ........ 13
- B. Fund financing and burden sharing with other creditors ........ 14
- C. Financing versus adjustment ........ 16
- D. Program conditionality ........ 19
- E. Ownership and review progress ........ 20

III. Fiscal Policy ........ 22
- A. Fiscal policy in the crisis ........ 22
- B. Fiscal developments leading up to the crisis ........ 22
- C. Overall fiscal stance in program countries ........ 23
- D. Medium-term fiscal adjustment ........ 27
- E. Social spending ........ 29

IV. Monetary and Exchange Rate Policy ........ 29
- A. Approach and overview ........ 29
- B. Exchange rate policy ........ 30
- C. Monetary policy ........ 34

V. Financial Sector Policies ........ 35
- A. Incidence of financial sector crisis ........ 35
- B. Policy considerations ........ 36
- C. Policy measures and outcomes ........ 36

VI. Crisis Recovery and Exit from Fund Support ........ 40
- A. Early signs of stabilization ........ 41
- B. Recovery and risks to external sustainability ........ 42
- C. Exit from Fund support ........ 43

VII. Conclusions and Issues for Discussion ........ 43

Appendix I. Current nonconcessional arrangements ........ 45
Appendix II. Recent cases of direct budget support ........ 46

Boxes
1. Role of the Fund in Emerging Markets during the crisis ........ 6
2. Recent experience with the Flexible Credit Line ........ 7
3. Use of Fund resources for budgetary support ........ 15
4. Initial conditions and external adjustment ........ 18
5. Opinion research on the Fund's role in selected European program countries ........ 21
6. Measuring fiscal stance ........ 25
7. Hungary's fiscal structural reform agenda ........ 28
8. Maintaining Latvia's peg ........ 32
9. Financial sector problems in Iceland, Latvia, and Ukraine ........ 35
10. Bank Coordination Initiative (BCI) in CEE countries ........ 37
11. Financial sector measures in program countries ........ 38
12. Household and corporate debt restructuring ........ 39

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## EXECUTIVE SUMMARY

This study concludes that recent Fund-supported programs in emerging market countries are delivering the kind of policy response and financing needed to cushion the blow from the worst global crisis since the 1930s. While the crisis has had a profound effect on output and employment, especially in those countries starting with large external vulnerabilities, many of the severe disruptions attending previous crises—currency overshooting and bank runs—have so far been avoided. Internalizing lessons from the past, programs have responded to country conditions and adapted to worsening economic circumstances to attenuate contractionary forces. As a result, signs of stabilization are emerging in program countries, though there remain challenges to secure sustained recovery in a number of countries. The main points presented in the report are as follows:

Fund-supported programs have generally helped countries avoid worse outcomes (Section I). In particular, output losses in program countries—while large—have not been significantly worse than in comparator countries once controlling for pre-existing vulnerabilities, especially current account deficits and externally-financed credit booms. Compared to previous capital account crisis cases, the current programs have involved less compression of domestic demand.

The adjustment in external balances has mostly been less wrenching than in past crises, reflecting a mix of timely, higher, and more frontloaded financing and supportive macroeconomic policies, which have helped avoid the large currency overshooting seen in past crises (Section II). Initial program conditionality has been more focused than in the past, and compliance better thus far. This appears to be reflected in improved country "ownership" of programs, a conclusion supported by a recent opinion survey of the Fund's role in selected program countries. Going forward, it will be important to implement structural reforms that address underlying vulnerabilities.

The stance of fiscal policy in most cases has been accommodative and adjusted to evolving conditions (Section III). Deficits were allowed to rise in response to falling revenues and, in cases where domestic and external financing was lacking, this was facilitated by channeling Fund resources directly to the budget. In many instances, however, underlying concerns about debt sustainability and weak structural fiscal positions required limiting the full play of automatic stabilizers. Going forward, countries experiencing significant increases in debt burdens will need to redouble efforts to advance structural fiscal reforms if they are to secure fiscal sustainability. Fund-supported programs have emphasized social safety net spending, though measurement and comparison across time and countries is difficult; more attention to providing adequate and tailored support in this area is warranted.

Sharp spikes in interest and exchange rates have been avoided, minimizing the negative dynamics from balance sheet effects, particularly in countries where a high share of borrowing is in foreign currency (Section IV). As a result, the real exchange rate adjustment needed to support lower current account deficits can hopefully be achieved in a more gradual and less stressed environment.

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The general avoidance of banking crises in program countries thus far is remarkable, given that in many cases, especially in Central and Eastern Europe (CEE), banking systems entered the crisis after an externally-financed credit boom (Section V). Various factors—strengthened financial sector regulation in advance, the avoidance of currency and interest rate overshooting, and emergency program measures including liquidity provision and deposit insurance—have contributed to this result.

Looking ahead, significant challenges remain (Section VI). Despite early signs of stabilization, the exit from crisis and Fund programs may be prolonged: current account deficits still need to adjust in some cases, and the balance sheet problems of banks, companies, and households may yet intensify in the process. Countries like Latvia (where policies are limited by the choice of the currency regime), Iceland (where the crisis has resulted in a very heavy external debt burden), and Ukraine (which is still affected by financial and political fragility) face the greatest challenges going forward.

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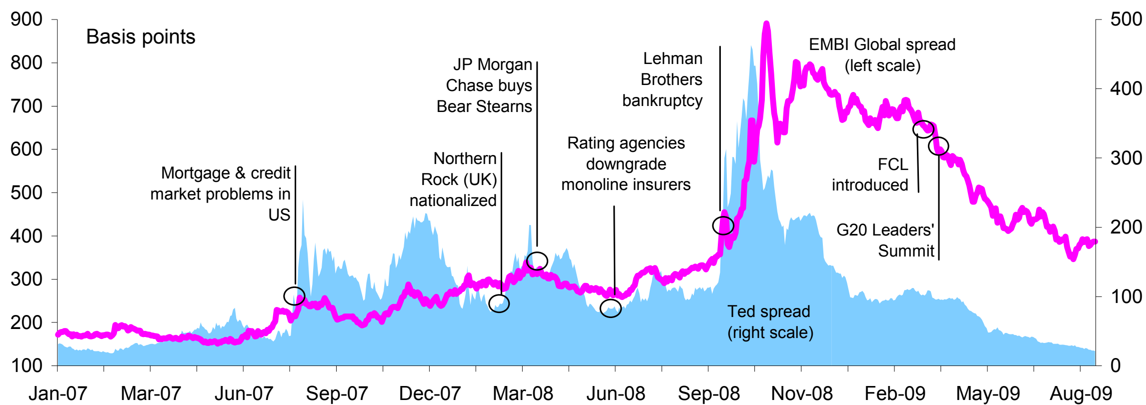
# I. Manifestation of Crisis in Emerging Markets

## A. Onset of crisis in Emerging Markets

1. **The deepest global financial crisis of the post-war era began in the advanced economies, and spread to emerging markets only with a lag**. Emerging markets became engulfed in the crisis when the extent of the damage to institutions in financial centers became apparent (Blanchard, 2009): until Lehman's bankruptcy in September 2008, emerging markets asset prices appeared to have decoupled from developments in advanced economies (Figure 1). The sudden loss of confidence and the rise in counterparty risk triggered by Lehman's bankruptcy led to a sudden "lock-up" in financial markets.

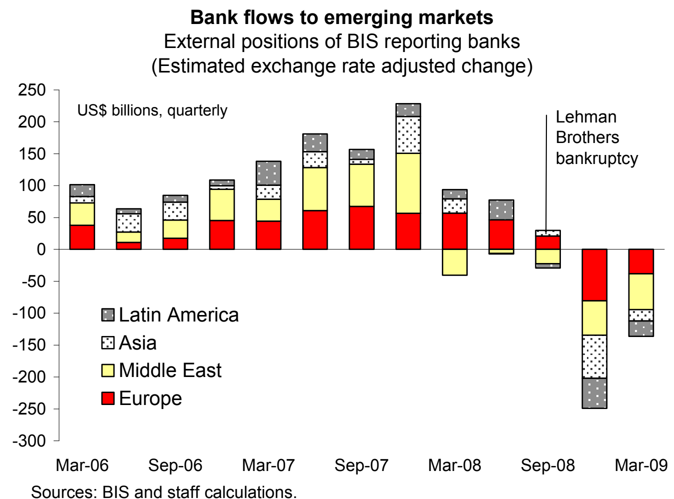
**Figure 1. Timeline of crisis in advanced and emerging economies**




Sources: CEIC, Markit, and staff calculations.

2. **The crisis was manifested in emerging markets as a sudden stop in capital inflows, with added strains from the collapse in global activity and commodity prices**. Central and Eastern European (CEE) countries and the CIS region, which had benefited from large-scale capital inflows during the global upturn, became the epicenter of the emerging market crisis when advanced country banks begun cutting back exposures. In the uncertain times in the aftermath of Lehman's bankruptcy, global industrial production declined over 20 percent and exports plummeted by over 40 percent causing a "recoupling" of emerging market countries with advanced economies. The precipitous fall of commodity prices during the second half of 2008 provided a further drag to commodity exporters.

**Bank flows to emerging markets**
External positions of BIS reporting banks
(Estimated exchange rate adjusted change)




Sources: BIS and staff calculations.

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3. **The global crisis has greatly increased the demand for Fund resources**. In response to the crisis, the Fund moved quickly to expand its lending capacity, increase the flexibility of its lending toolkit, and provide financing, with some $163 billion in commitments made to date (Box 1). Compared to past episodes, the current arrangements are notable for their size, severity of projected output contraction, and simultaneity (Figure 2).

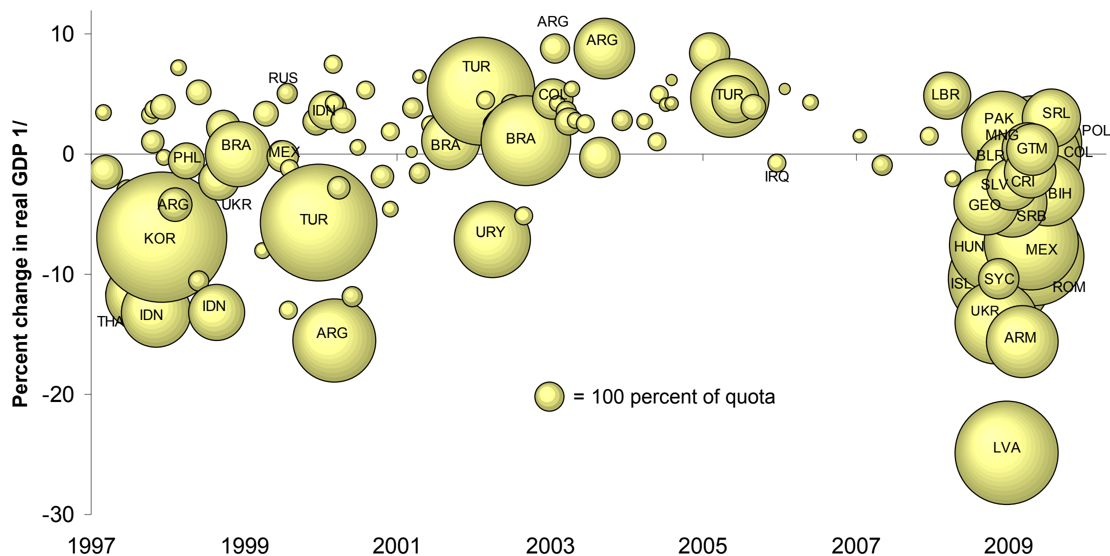
**Box 1. Role of the Fund in Emerging Markets during the crisis**

The Fund has increased its resources and overhauled its lending framework to assist countries facing external financing pressures in the current crisis.

***Resources***. Borrowed resources are to be increased by up to $500 billion, initially via bilateral borrowing agreements and note issuances, and eventually through the expansion of the New Arrangements to Borrow. A large allocation of Special Drawing Rights (SDRs) has also been implemented, injecting $250 billion of liquidity into the global economy, of which some $100 billion is available to developing and middle-income countries.

***Lending framework***. On March 24, 2009, the Fund established the *FCL*—a flexible credit line of 6 to 12 months' duration, with unlimited renewability and uncapped access—for countries with very strong fundamentals, policies, and track record of policy implementation, and not entailing traditional policy conditionality. The *conditionality framework* was modernized to ensure better tailoring of policy conditions to country circumstances (structural performance criteria were discontinued and structural policies are to be monitored in a holistic fashion in the context of program reviews). The *SBA* was made more flexible to provide countries with a high- and frontloaded-access precautionary instrument, and greater flexibility in the frequency of purchases was introduced. Moreover, *access limits* were doubled and the criteria for approving exceptional access arrangements were simplified and clarified.

**Figure 2: Access levels and growth declines in Fund arrangements**




Sources: WEO and staff calculations.
1/ Maximum cumulative decline in three years from program inception; projected changes for current programs.

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4. **This review covers 15 Fund-supported programs approved since September 2008** (Appendix I). Hungary, Iceland, Latvia, Pakistan, and Ukraine were among the first wave of countries to adopt Fund-supported programs in the immediate wake of the global crisis in late 2008, along with Georgia, which had turned to the Fund before being swept up by the crisis. In the early months of 2009, large, front-loaded programs were also approved for Armenia, Belarus, Mongolia, and Romania; and precautionary programs put in place for Costa Rica, El Salvador, Guatemala, and Serbia—the last quickly being augmented and made nonprecautionary. An arrangement for Bosnia & Herzegovina was approved in July. In addition, Mexico, Poland, and Colombia have availed themselves of the new FCL (Box 2).

**Box 2. Recent experience with the Flexible Credit Line**

The FCL arrangements with Mexico, Poland, and Colombia totaling around $82 billion treat access on a precautionary basis. Market reaction to arrangement approval was positive, with an immediate decline in spreads in all countries, likely owing to the role played by contingent financing in removing tail risks and creating room to undertake countercyclical policies.

- ***Mexico***. Access (1000 percent of quota, or around $49½ billion) was underpinned by the need to insulate the economy from potential tail risks from the global financial turbulence, given Mexico's relatively lower reserve coverage compared to other key emerging markets, its deep financial markets with large foreign investor positions, and large gross external financing needs. Markets' immediate reaction to the FCL announcement was positive, with CDS spreads narrowing by much more than those of Brazil or Chile. Fiscal policy is set to deliver a stimulus of up to 1½ percent of GDP in 2009, mostly financed by the oil fund and official financing. Likewise, monetary policy is being eased, with a cumulative 150 basis points reduction in interest rates since FCL approval.

  ***Poland***. Access (1000 percent of quota, or around $21½ billion) was determined on the basis of an adverse scenario with a decline in rollover rates and FDI inflows, and larger capital outflows. Following Poland's FCL announcement, the zloty reached a four-month high against the euro (though it has subsequently lost some ground), and CDS spreads narrowed. The government has been able to place international bonds to finance a revised budget entailing a fiscal stimulus of almost 2 percent of GDP in 2009. Moreover, monetary policy has started to accommodate the fiscal stimulus in view of declining inflation and reduced pressures on the zloty.

- ***Colombia***. Access (900 percent of quota, or around $11 billion) was based on an adverse external scenario with lower commodity prices, FDI, and debt rollover rates. Since the FCL announcement, CDS spreads have declined by more than in Chile. The government has been successful in securing external financing ($4.7 billion), including a $1 billion bond issuance days before the FCL announcement. Fiscal policy is set to provide a fiscal impulse in 2009 and 2010 of 0.2 percent and 0.9 percent of GDP, respectively. Policy rates have been cut by 150 basis points since the approval of the FCL arrangement.

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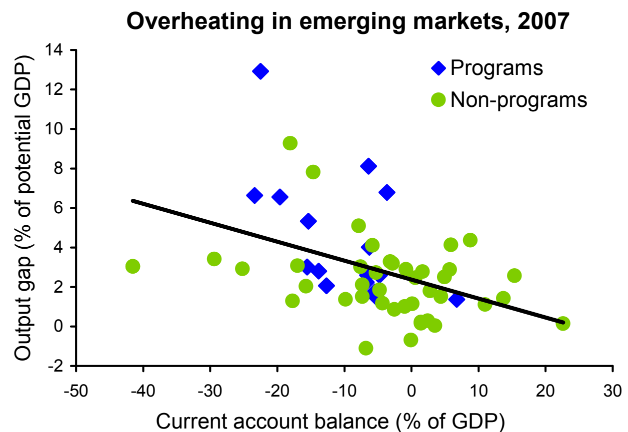
## B. What led countries to request Fund support?

5. **In the years leading up to the crisis, emerging market economies as a whole registered an impressive growth performance**. During 2003–07, their median growth rate was about 6 percent per year. The combination of high growth with stronger institutions and better policies in most cases resulted in notable drops in external and public debt ratios and the halving of government deficits to 1¼ percent of GDP by 2007.

6. **However, the boom carried the seeds of vulnerabilities**. Fast growth widened the median output gap—as measured in a consistent methodology adopted for the paper—to over 2½ percent of potential output by end–2007. With large capital inflows fuelling credit booms, most notably in the Baltics, many emerging market economies also entered this period with much overheated real estate markets. The wider overheating in the economy translated into appreciating currencies and widening current account deficits, with cross-country evidence indicating a statistically significant relationship between the output gap and the current account deficit. Furthermore, with an increasing proportion of this deficit financed by debt-creating (non-FDI) inflows, the external debt-to-GDP ratio of program countries declined little (or rose in some cases), in spite of high growth.

**Overheating in emerging markets, 2007**




Source: WEO and staff calculations.

7. **These vulnerabilities were widely recognized in advance by market and other analysts**. Within the Fund, the confidential internal staff Vulnerability Exercise for Emerging Market Economies (VEE), for example, highlighted weaknesses in sectoral fundamentals of many emerging market countries (and especially in the European emerging economies).[1] Figure 3 shows the sectoral distribution of vulnerabilities in the September 2007 exercise, a full year ahead of the crisis. Several factors stand out:

- All the new program cases were then seen as having a medium or high external vulnerability. As external vulnerabilities are those manifested in balance of payments pressures, it seems natural that these members may approach the Fund for assistance.

- In fact, all members requesting Fund-supported programs had vulnerabilities, in addition to the external sector, in another sector (fiscal or financial), while countries which were identified as having fiscal or financial vulnerabilities but not external

[1] The VEE was established in 2001 to inform staff's surveillance of emerging market countries. It examines several indicators against thresholds in the public, external, financial, and corporate sectors, reflecting country-specific judgments, to classify a country as having a "low," "medium," or "high" underlying vulnerability in each sector and overall.

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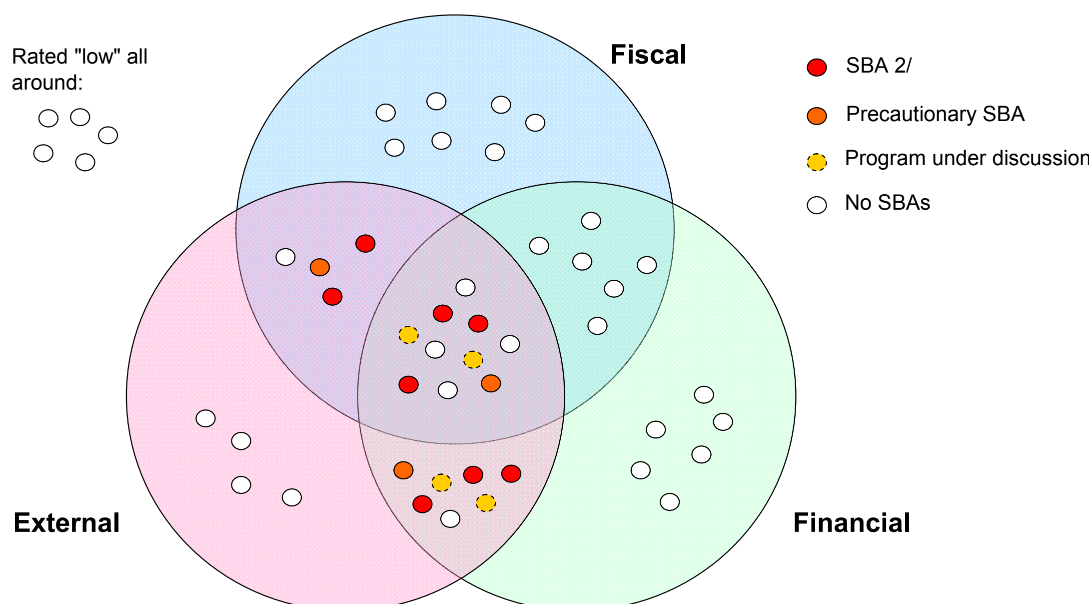
**Figure 3. Sectoral vulnerabilities in emerging markets as of September 2007 1/**




Notes:
1/ Countries within the circles were identified as having "medium" or "high" underlying vulnerabilities in the respective areas.
2/ The September 2007 VEE exercise covered a set of "traditional" emerging market countries, which did not include Armenia, Belarus, Georgia, Iceland, or Mongolia among the current program cases. Of course, vulnerabilities in these countries continued to be monitored as part of regular Fund surveillance. Since October 2008 the Fund's vulnerability and early warning exercise has been expanded to include some of these cases, as well as the advanced economies.

vulnerabilities have not approached the Fund for a program. These combination effects underscore how balance sheet weaknesses in one sector may get amplified by weaknesses in other sectors, making crisis more likely when the country is hit by shocks (as discussed in Ghosh et al., 2008).

8. **An examination of various macroeconomic variables also underscores the role of external imbalances in driving countries to turn to the Fund (Figure 4)**.

- *External imbalances* are statistically significant predictors of crisis: program countries have a 6 percentage points of GDP higher current account deficit than nonprogram countries in 2007. These deficits were also much higher than in previous crises. Differences in total external debt, however, are more subdued and not significant.
- *Reserves* relative to near-term financing needs also played a role, with reserve coverage in 2007 significantly lower in program countries than in those without programs, and comparable to those observed in previous capital account crises.
- *Credit growth* is higher in program countries relative to nonprogram cases (and to previous capital account crises), but variance also tends to be high. Credit booms help explain program participation when interacted with external imbalances.
- Other initial conditions (*GDP growth, inflation*, *the government balance,* and *public debt*) were not significantly different between program and nonprogram countries.

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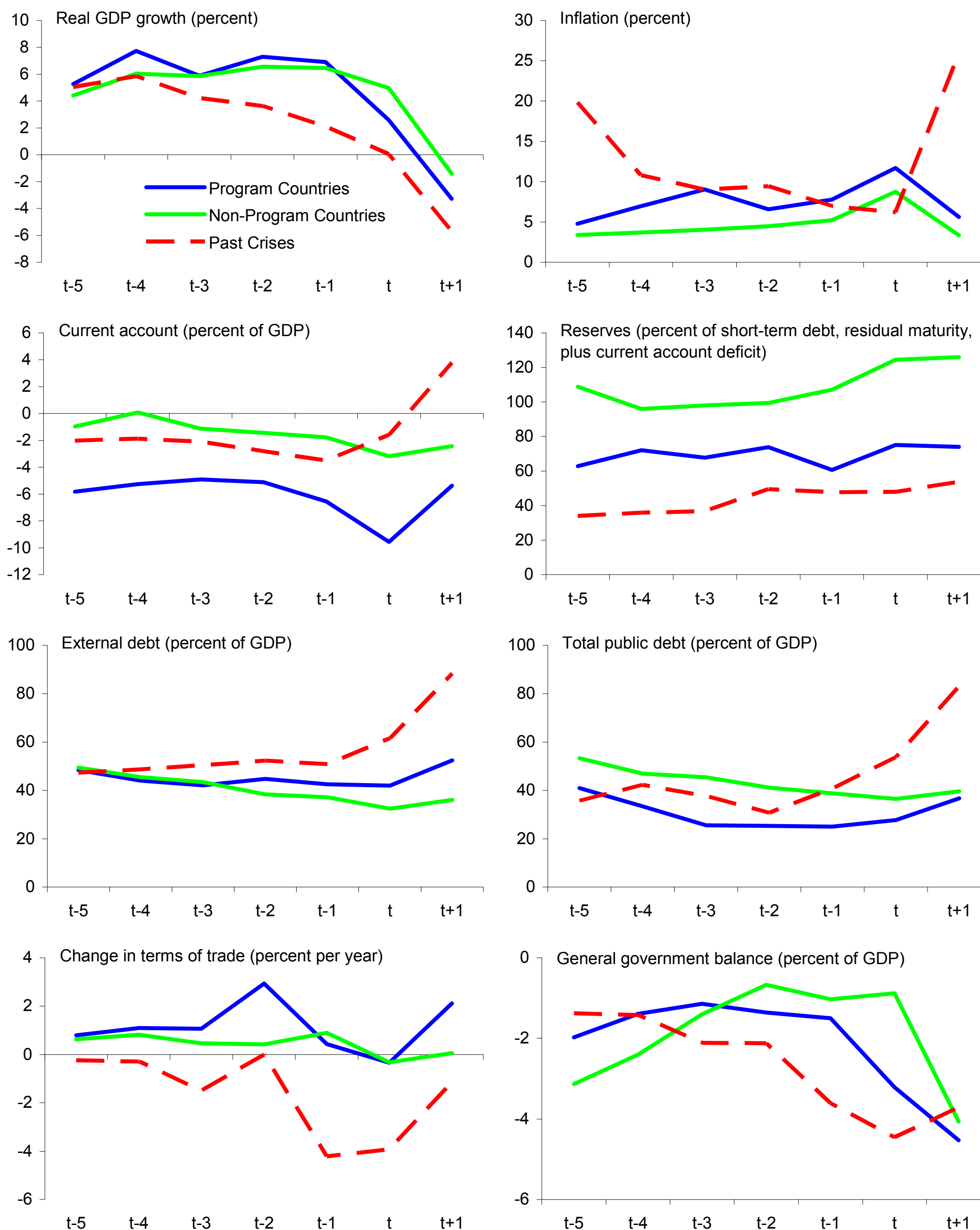
**Figure 4. Macroeconomic performance in emerging market countries**
(Medians for each category)




Sources: WEO and staff calculations

**Methodological notes for this and subsequent charts and analysis:**
- "t" refers to 2008 for current program and nonprogram categories, and the inception of the crisis for past cases
- Past capital account cases are Mexico (1994), Indonesia (1997), Korea (1997), Philippines (1997), Thailand (1997), Brazil (1998), Ecuador (1998), Russia (1998), Turkey (2000), Argentina (2001), and Uruguay (2001). Dates in parentheses are of crisis inception. Comparisons with past crises should be interpreted with caution, owing to differing external circumstances applying to different episodes.
- Current nonprogram cases are those shown in Figure 5; however, for some charts and analysis subsets are used for reasons of data availability.

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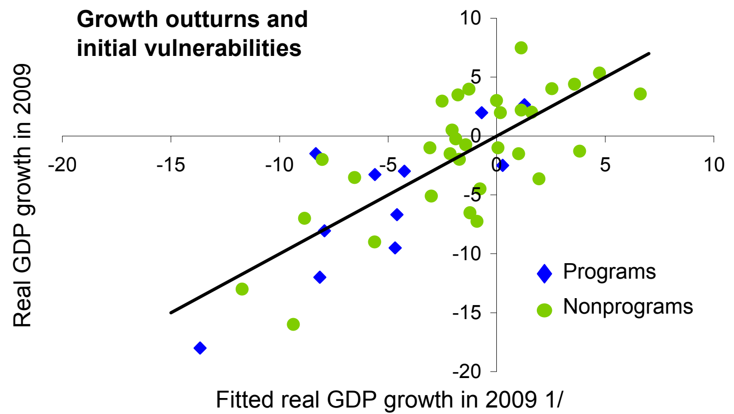
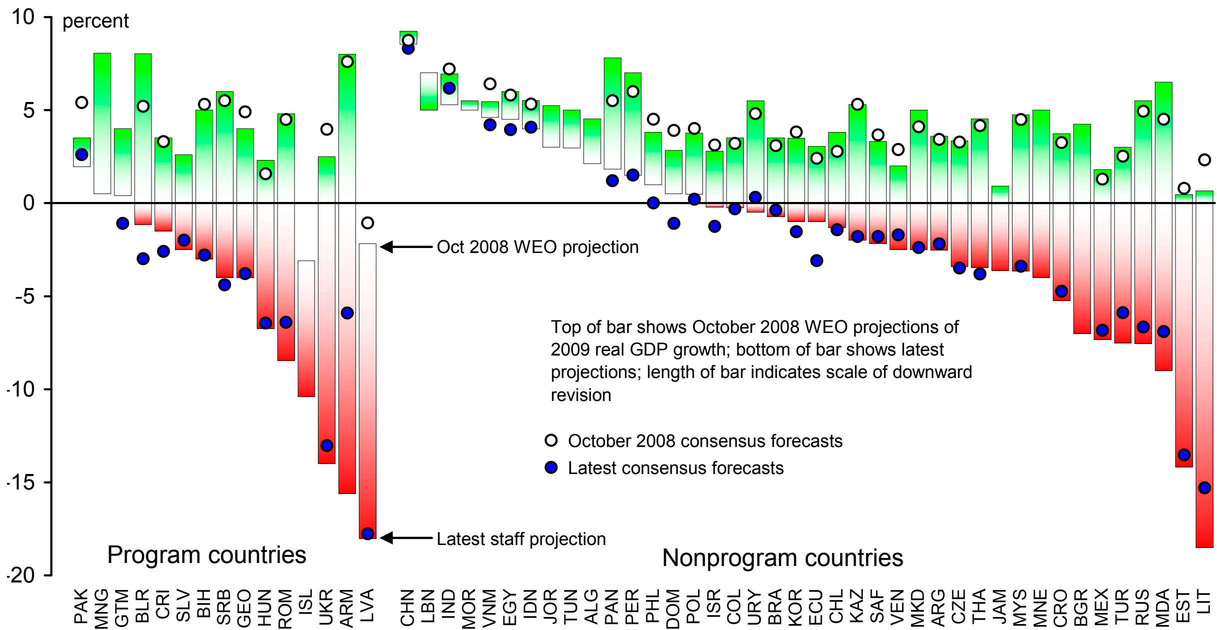
## C. Recent developments in program countries

9. **In both the depth of contractions and revisions to the outlook, CEE and CIS economies stand out**. As the realization of underlying vulnerabilities prompts members to turn to the Fund for financial support, lower growth in program countries should come as no surprise. While the projected average real growth decline for 2009 in countries with Fund-supported programs is around 5½ percent, with the comparable number for other emerging markets being about 1½ percent, this is driven mostly by CEE and CIS economies. Controlling for initial conditions—with worse external imbalances being critical—program participation is not associated with a worse growth outturn. In terms of downward revisions to growth (Figure 5), too, CEE and CIS countries are outliers—with average downward revisions between October 2008 and now of about 12 percentage points of GDP. Within the regions, there is no statistical difference in the revisions between program and nonprogram countries.




1/ The fitted regression on real GDP includes current account deficit, fiscal deficit, external debt, public debt, and reserves (all actuals, as of 2007).

**Figure 5. Revisions to 2009 growth projections: IMF staff and consensus**




Source: WEO, Consensus Economics, and staff projections.

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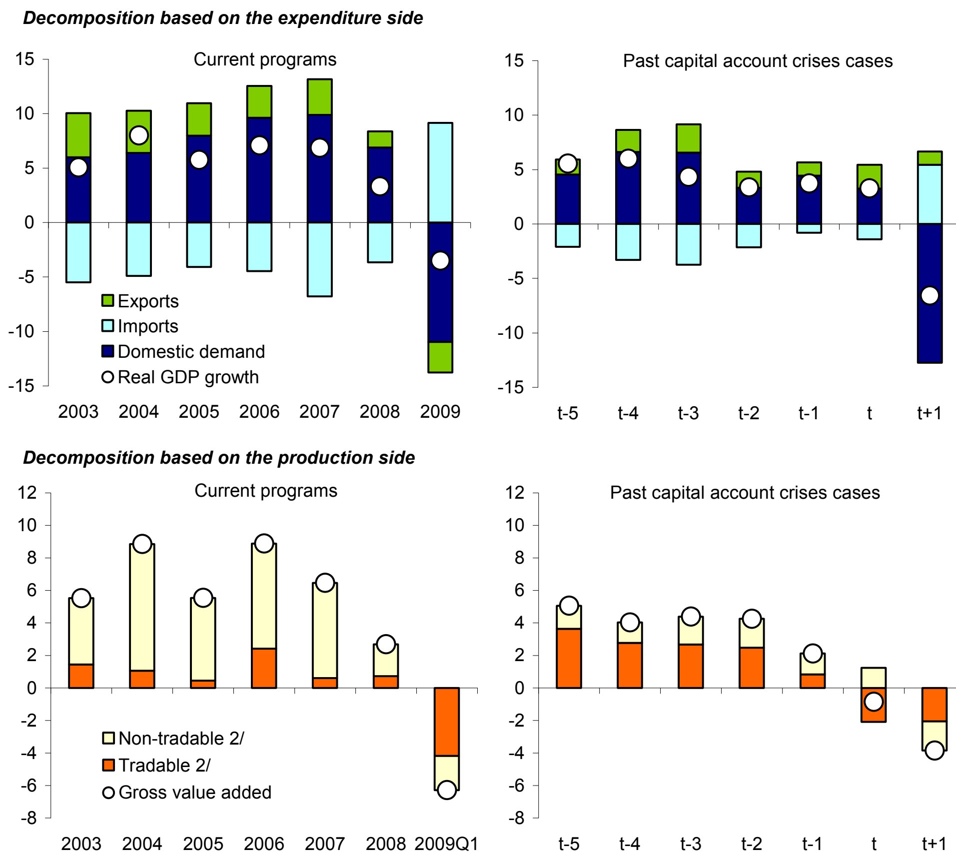
10. **The composition of the output declines in program countries in 2009 is markedly different from that observed in past crises (Figure 6)**. On the demand side, current programs have been characterized by sharp declines in domestic demand, although to a considerably lesser extent than past crisis cases. But, while in the past the sharp drop in domestic demand has been partly offset by improvements in exports, the turnaround in net exports in the current cases has been exclusively driven by a dramatic import compression: exports are also declining against the backdrop of very subdued global demand, adding to the effects of the sizable drop in domestic demand. On the supply side, preliminary data for the first quarter show the bursting of the pre-crisis boom in the nontradable sector, notably services and construction, which had contributed to overheated economies, loss of competitiveness, and a buildup of external imbalances in many current programs countries.

**Figure 6. Contributions to real GDP growth** 1/




Source: WEO, Haver.
1/ Medians within groups.
2/ Tradables comprise agriculture, manufacturing, and mining sectors; non-tradables comprise services and construction sectors.

11. **Given the global deflationary forces, most current Fund-supported programs face a benign inflation outlook**. For emerging markets as a whole, median inflation is estimated to decline five percentage points to 4½ percent in 2009. Among program cases, estimated median inflation for 2009 is a little higher, at around 7½ percent. This stands in stark contrast to the experience of past capital account crises, which were marked by a spike in inflation in the immediate aftermath of the crisis due to large currency depreciation.

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12. **The falls in output have prompted an important reconsideration of potential output during and after the boom years**. In retrospect, the years 2005–07 involved even more "froth" of excess growth above the economies' underlying potential than was recognized at the time. This has important implications for fiscal policy—with past apparently comfortable fiscal positions incorporating large cyclical elements masking more serious structural deficits—as well as the prospects for growth in the medium term as countries seek to exit from Fund support.

## II. Overall Program Design

### A. Overall objectives and crisis response

13. **Program objectives have been tailored to country-specific circumstances, with most focusing on mitigating external and financial sector pressures (Table 1)**. With countries generally facing large external imbalances, particularly in Eastern Europe, key objectives revolved around smoothing current account adjustments and mitigating liquidity pressures, while preserving market confidence by addressing underlying vulnerabilities over time. Avoiding systemic banking crises, which featured prominently in past crises, or restoring bank solvency where banking crises were underway, were also key program goals. Finally, where weak structural fiscal positions called for adjustment, excessive frontloading of measures that would have exacerbated the economic downturn was avoided, with market confidence secured via medium-term fiscal consolidation plans backed by structural reforms.

**Table 1. Initial stated program objectives**

| | Macro-economic stability/ adjustment | Crisis response/ preparedness | Adequate financing/ reserves, confidence in currency | Financial sector stability | Fiscal sustainability/ adjustment |
|---|---|---|---|---|---|
| Armenia | • | | • | • | |
| Belarus | • | | • | | |
| Bosnia | | | • | • | • |
| Costa Rica | • | | | | |
| El Salvador | | • | | • | • |
| Georgia | | | • | | |
| Guatemala | • | • | | | |
| Hungary | | | • | • | • |
| Iceland | | | • | • | • |
| Latvia | • | | • | • | |
| Mongolia | • | • | | | |
| Pakistan | • | | • | | • |
| Romania | • | | • | • | • |
| Serbia | • | • | | • | • |
| Ukraine | • | | | • | |

Sources: SBA request documents.

14. **As the crisis tightened financing constraints, it became essential to shift the focus of policies and Fund resources toward the budget**. As programs were designed amid an unusual degree of global economic uncertainty, when initial growth assumptions proved too optimistic, program policies were adapted. The forcing event was the harsh contraction in global economic activity, which quickly translated into sharply falling revenues in most countries, while widening financing needs were made acute by the drying up of funding

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opportunities. With weak external demand constraining export-led recoveries (a key driver in past crises) and the credit channel operating weakly on account of disrupted credit markets, programs shifted their focus—debt sustainability considerations permitting—to fiscal policy as the main countercyclical instrument supported by a more direct use of Fund resources for budget financing (Box 3).

15. **The Fund was able to mobilize very quickly financial support to countries hit by the financial turbulence of late 2008**. By activating fast-track procedures under the Emergency Financing Mechanism, the Fund was able to field missions within days and approve exceptional access arrangements within 3½–6 weeks of initial indication of interest by authorities in Hungary, Iceland, Latvia, Pakistan, and Ukraine, despite the challenging task of reaching understandings on difficult policy measures in a short period of time. The mechanism was also used for Georgia's and Armenia's recent SBA augmentations.

### B. Fund financing and burden sharing with other creditors

16. **Almost all arrangements entailed exceptional access—beyond the usual limits—to Fund resources, with frontloaded disbursements**. Widespread recourse to exceptional access (in 14 of 15 SBAs) reflects the severity of the global crisis and the large financing gaps. While there is much variability, access in current programs (with a median of 7 percent of GDP) has been higher than in past capital account crises (4 percent of GDP), although similar in terms of the share of gross financing needs (reflecting much larger needs this time around), and slightly lower in terms of members' quotas (Figure 7). The degree of frontloading has been higher than previous crises, despite larger initial reserve buffers, consistent with recent research findings on the role of financing in mitigating crisis effects.

17. **Financing packages have included support from other official creditors, enabling risk sharing**. Of $133 billion in aggregate financing packages, the Fund has committed $75 billion, the EU $21 billion (with especially large contributions to Latvia, 42 percent of the total financing package; Hungary, 33 percent; and Romania, 25 percent), the World Bank $11 billion, and other bilateral creditors some $26 billion. In the last group, European member states with close ties to crisis countries have pledged sizable contributions (reaching 31 percent in Latvia and 80 percent in Iceland, including loans tied to the repayment of deposit insurance liabilities), although, in other cases, burden-sharing with official creditors has been much more limited. While there is significant variation—from 21 percent in Iceland to 84 percent in Serbia—on average, the Fund's share of financing packages (56 percent) is considerably higher than in past crises (40 percent). (See Appendix I for financing details.)

18. **Private sector involvement has also been sought in a number of European programs both informally and through the Bank Coordination Initiative**. The latter is a platform involving host governments, national supervisory authorities, banks, and official agencies, and responds to the need for coordination in a highly integrated European financial system (Box 10). Through this initiative—adopted so far in Bosnia & Herzegovina, Hungary, Romania, and Serbia—European parent banks agree to maintain exposure and, if necessary, recapitalize subsidiaries, thus mitigating concerns about the potential effects of deleveraging.

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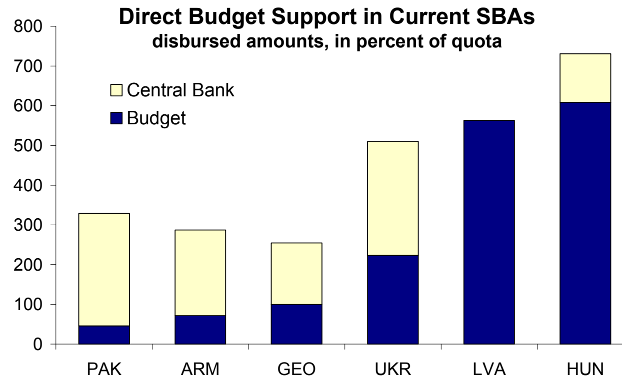
**Box 3. Use of Fund resources for budgetary financing**

**The current crisis has called for flexible fiscal responses where warranted by debt sustainability considerations**. In a global deleveraging environment and with increased country emphasis on (de jure) central bank independence, funding such fiscal accommodation has in some cases required directly tapping official resources.



Source: Staff estimates.

***Legal basis*. The Fund's legal framework allows using Fund resources for direct budget support**. This requires, as prescribed in the Articles, that (i) the member country has an actual balance of payments (BoP) need when making a purchase (requiring either an above-the-line BoP deficit *or* inadequate reserves); and (ii) there are adequate safeguards by virtue of policies that address the BoP problem and ensure timely repayments to the Fund. From an economic perspective, BoP needs often coincide with fiscal needs. As seen in this and past crises (Russia (1993), Argentina (2000), and Turkey (2001) when the Fund provided direct budget support), countries generally face external financing gaps together with fiscal financing pressures from collapsing revenues (Appendix II).

***Economic rationale*. Fund financing enables implementation of a countercyclical policy mix that avoids excessive external adjustment**. The customary role of central banks in making Fund purchases is closely related to their ability to distribute balance of payments support to the economy. However, there could be situations when liquidity does not find its way to where the need is the greatest (say, the government), because of either restrictions on the central bank's ability to on-lend resources (as would be the case when central banks are independent or in monetary unions, currency boards, and fully dollarized economies) or because of impaired market access by sectors of the economy. In such cases, it would be appropriate to channel Fund resources directly to the government, when restoring domestic and external stability in the context of a balance of payments crisis calls for a larger fiscal deficit than could be financed from external or domestic sources.

***Risks to the Fund*. Use of Fund resources for budgetary purposes carries risks**. First, repurchases could become subject to budgetary appropriation processes and government's ability to either generate a budget surplus or borrow from other sources. Second, fiscal policy could become unduly reliant on Fund resources to finance what may be permanent expenditures. Third, there are risks related to the potential misuse of Fund resources, as the main focus of the current Safeguards Assessments framework remains on central banks.

**These concerns could be mitigated in different ways**. The Fund could, for instance, require that (i) the government builds up minimum levels of cash deposits through overborrowing; (ii) institutional arrangements be put in place to clarify the respective responsibility of the central bank and treasury to service the liability to the Fund; (iii) the members' SDR accounts be used as a quasi-escrow account; and (iv) borrowing from the Fund and its subsequent use is reported in the accounts of the central bank. Ultimately, well-designed and fully-owned programs provide the strongest safeguard of exit from and appropriate use of Fund resources.

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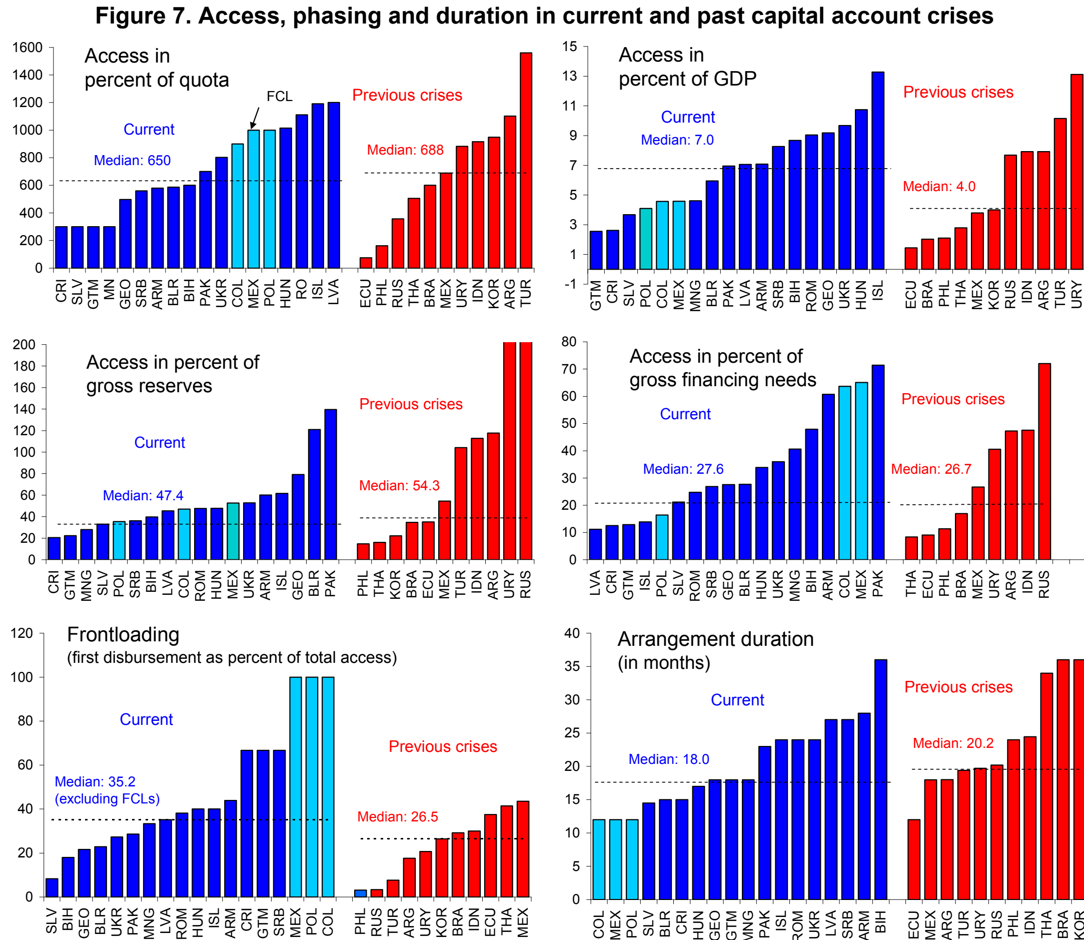
**Figure 7. Access, phasing and duration in current and past capital account crises**




Source: WEO and staff estimates.

## C. Financing versus adjustment

19. **The appropriate mix of external financing and macroeconomic adjustment is a key design issue in IMF-supported programs**. In general, the greater the financing, the smaller the required short-run correction in the current account and vice versa (although this is not a simple dollar for dollar relationship, since capital account flows react endogenously to the strength of policies and financing). For the current program countries, lack of timely access to official financing would have forced even more painful and disorderly demand contractions. At the same time, access to official financing should reflect, not only short-run demand management considerations, but also a medium-term perspective on external viability. This perspective is particularly relevant for the current program countries, which entered the crisis with very large current account deficits and are now experiencing sharp increases in external indebtedness that will need to be unwound through adjustment efforts.

20. **Mirroring larger than expected economic contractions, current accounts are projected to adjust markedly in 2009, and by more than initially programmed**. Initial program design aimed for more gradual adjustment. In the event, imports fell more than expected (and by a similar amount to previous crises), in line with domestic demand trends.

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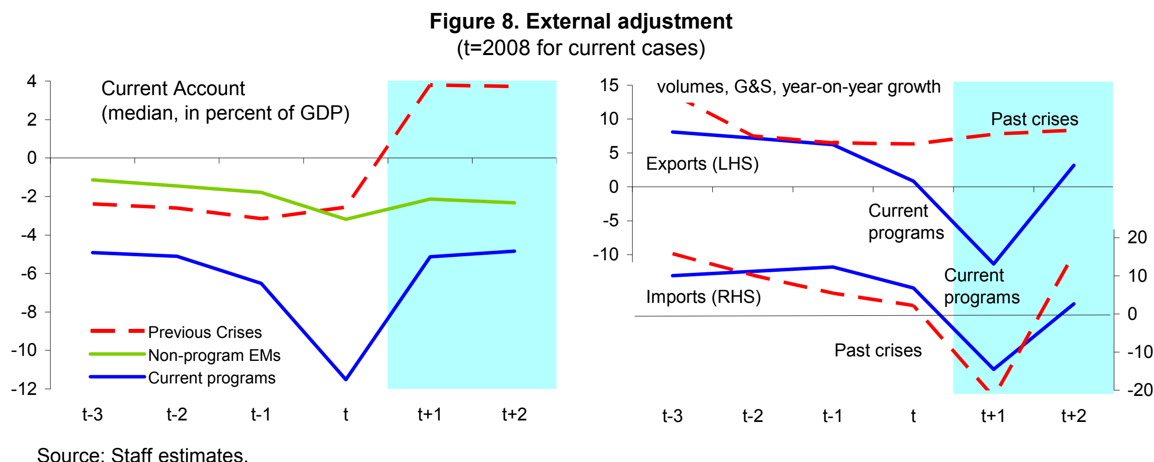
This led to a sharp turnaround in current accounts, despite larger-than-expected falls in exports—in sharp contrast to previous cases, which featured continuing strong export growth. Latest forecasts show median current account adjustments for 2009 of some 6 percentage points of GDP, although adjustments in some countries (Iceland and Latvia) are projected to be much larger (Figure 8).

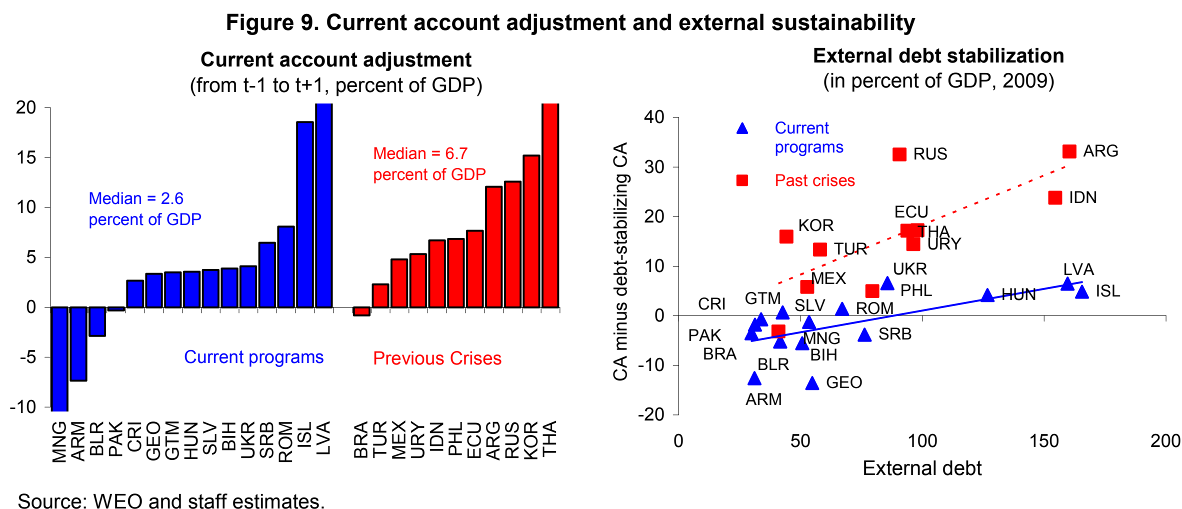
**Figure 8. External adjustment**
(t=2008 for current cases)




Source: Staff estimates.

21. **However, the degree of adjustment taking place in 2009 is still much less than in past cases and not extreme when set against pre-existing external imbalances**. On average, current account adjustments in 2009 are projected mainly to unwind the deterioration observed in 2005–07, and accentuated in 2008, when an already evident slowdown in exports combined with still buoyant imports and worsening terms of trade. Thus, the adjustments between 2005–07 and 2009–10 are indeed much smaller than in previous crisis cases. Furthermore, most programs envisage current accounts balances to remain below debt-stabilizing levels in 2009, allowing countries to further accumulate external debt to smooth the adjustment over the medium term (Figure 9). Programs that envisage adjustment beyond debt-stabilizing levels (Hungary, Iceland, Latvia, and Ukraine) aim at bringing down high initial debt levels. This contrasts markedly with previous capital account crises, which displayed current account balances significantly above debt-stabilizing levels even for countries with relatively low external debt levels.

**Figure 9. Current account adjustment and external sustainability**




Source: WEO and staff estimates.

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22. **In addition, current programs have not entailed systematically greater external adjustment than nonprogram emerging market countries**. Cross-country regressions suggest that changes in current account positions observed in a large sample of emerging market countries can be largely explained by the initial external position, with a program dummy showing as statistically insignificant (Box 4).

**Box 4. Initial conditions and external adjustment**

A simple statistical relationship is estimated to quantify the role of initial external positions in driving the degree of adjustment in emerging market economies. The change in the current account from 2007 to 2009 for a sample of program and nonprogram emerging market countries is regressed against the initial external debt and current account levels and a program dummy.

The results show that initial conditions explain a significant share of the cross-country variance, with higher external debt and deficits associated with larger adjustments. Importantly, current programs do not show larger adjustments than nonprogram emerging markets. Dummies for pegged exchange rates or commodity exporters are also insignificant.

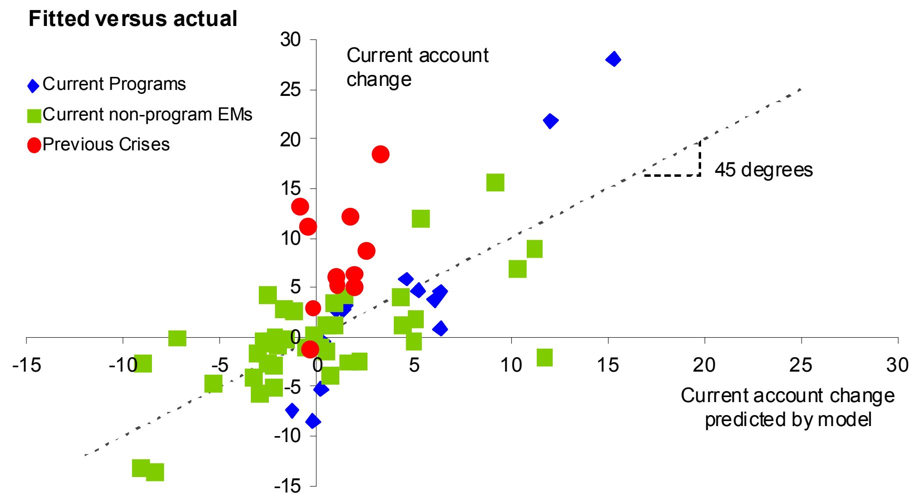
Among the program countries, only Iceland and Latvia show adjustments significantly above those predicted by the model, possibly reflecting omitted variables or nonlinear relations for these highly indebted countries. Conversely, Armenia, Mongolia, Belarus, and Georgia stand out as adjusting less than their comparators.

Dependent Variable: Change in current account (from t-1 to t+1)

| | *Coeff.* | *S.E.* | *t Stat* | *P-value* |
|---|---|---|---|---|
| Intercept | -3.83 | 1.18 | -3.25 | 0.00 |
| External debt average (t-1, t) | 0.06 | 0.02 | 2.74 | 0.01 |
| Current account t-1 | -0.43 | 0.09 | -4.56 | 0.00 |
| Program dummy | 0.52 | 1.52 | 0.34 | 0.73 |

| | |
|---|---|
| Multiple R | 0.75 |
| R Square | 0.57 |
| Ad. R Square | 0.54 |
| Standard Error | 4.70 |
| Observations | 55 |

**Fitted versus actual**




Source: WEO and staff estimates.

23. **Nor does a lack of official financing appear to be forcing greater adjustment**. Many programs envisage relatively low current account corrections despite projecting low or

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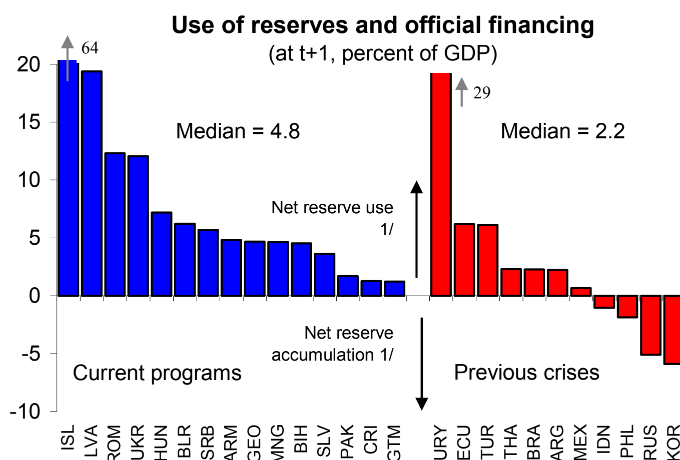
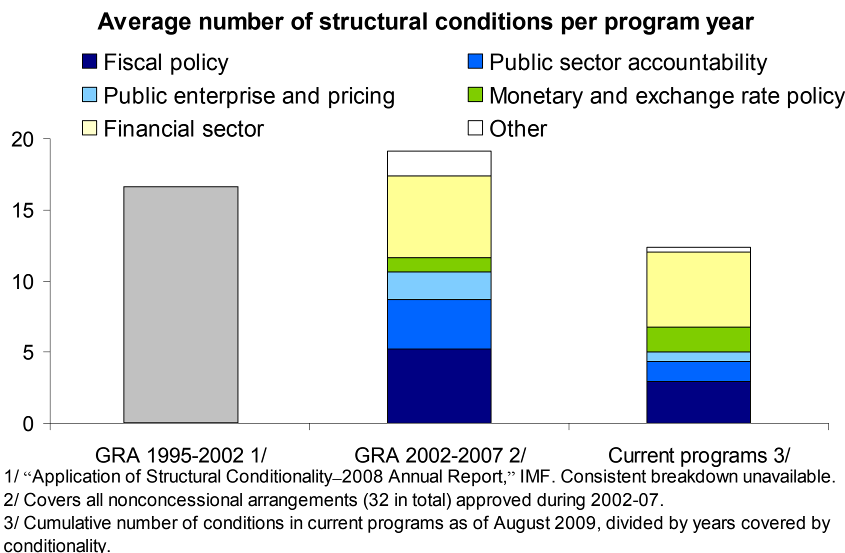


Source: WEO and staff estimates.
1/ Defined as net official financing plus decumulation of gross international reserves. Includes 2009 general and special SDR allocation.

negative private capital flows, as use of reserves and official financing are allowed to smoothen adjustment. This pattern is particularly pronounced in the cases of Iceland, Latvia, Romania, and Ukraine, which are facing large private capital outflows or large current account deficits. These results contrast with previous crises, many of which involved net reserve accumulation in the first program year, as large current account surpluses more than offset reversals in private capital flows.

## D. Program conditionality

24. **IMF financing is generally tied to policy conditions to ensure predictable access to financing, buttress policy credibility, and reduce repayment risks**. Conditionality includes quantitative targets (performance criteria) on key policy variables (fiscal balance, international reserves, monetary aggregates). Structural policy measures (benchmarks) complement quantitative policy targets in ensuring that program objectives are attained.



1/ "Application of Structural Conditionality–2008 Annual Report," IMF. Consistent breakdown unavailable.
2/ Covers all nonconcessional arrangements (32 in total) approved during 2002-07.
3/ Cumulative number of conditions in current programs as of August 2009, divided by years covered by conditionality.

25. **Current SBAs carry fewer structural conditions than previous arrangements**. Conditionality in past programs did not always focus on macro-critical policies, which had the effect of deterring countries from approaching the IMF early on, amplifying crisis effects. Consistent with the spirit of recent conditionality reforms, current arrangements have fewer structural conditions than earlier nonconcessional arrangements.[2]

[2] Structural conditions in the text figure and Figure 10 include prior actions, performance criteria, and structural benchmarks. The 2002–07 averages in the text figure are computed as the cumulative number of structural conditions by August 2009 divided by length of arrangements. As structural conditions in current arrangements (continued)

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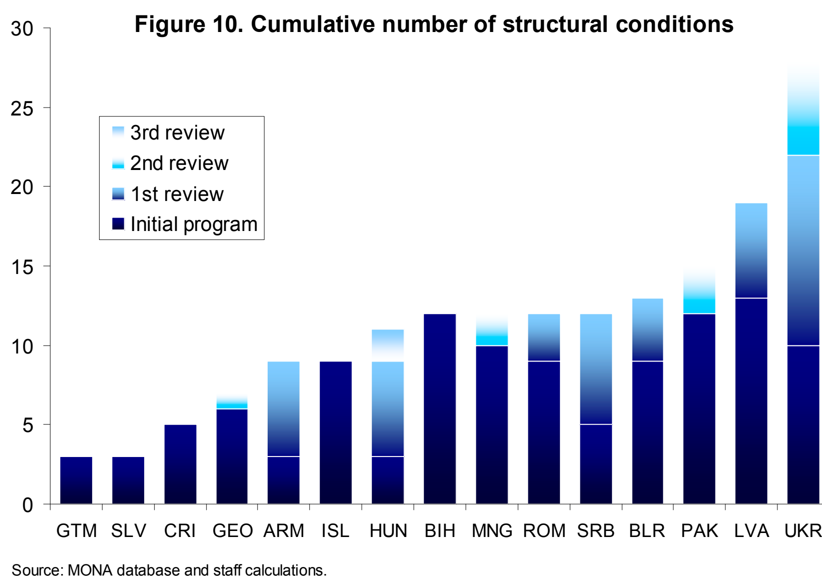
At the same time, there has been a marked increase in the share of financial sector conditions, and a very sharp fall in measures outside the key areas of Fund competency. Differences across countries are, however, considerable, reflecting heterogeneous starting conditions and the need to tailor the structural reform agenda to each country's problems.

26. **However structural conditions typically rise over time as crises deepen and vulnerabilities shift—so it remains to be seen if the recent parsimony holds**. Although still lower overall than in recent programs, conditionality has increased with program reviews (Figure 10). For Hungary and Ukraine, the initial programs were negotiated under time pressure, with the presumption that they would be modified as the crisis evolved. Also, in the case of Ukraine, the added structural conditions (with large reliance on prior actions) were needed to provide assurances of program implementation as political fragmentation raised questions about program ownership. For Armenia and Serbia, economic conditions deteriorated more than expected at the outset, requiring program policy adjustments.

**Figure 10. Cumulative number of structural conditions**




Source: MONA database and staff calculations.

## E. Ownership and review progress

27. **Generally, timely completion of program reviews suggests good country ownership of programs** (Figure 11). As of end–August, quantitative and structural conditions have largely been met—albeit with some delays—in most cases. Among the 19 program reviews so far (including those taking place in September), only six have requested waivers for missed quantitative performance criteria, and only for a small proportion of indicators. A recent opinion survey of the Fund's role in selected program countries also supports the perception of improved country ownership, among other findings (Box 5).

have not yet been specified for the full 12 months, averages were corrected by the number of days from program approval to the last date for which conditionality was specified, divided by 365. Numbers are adjusted where the same structural condition appears at two test dates to avoid double-counting.

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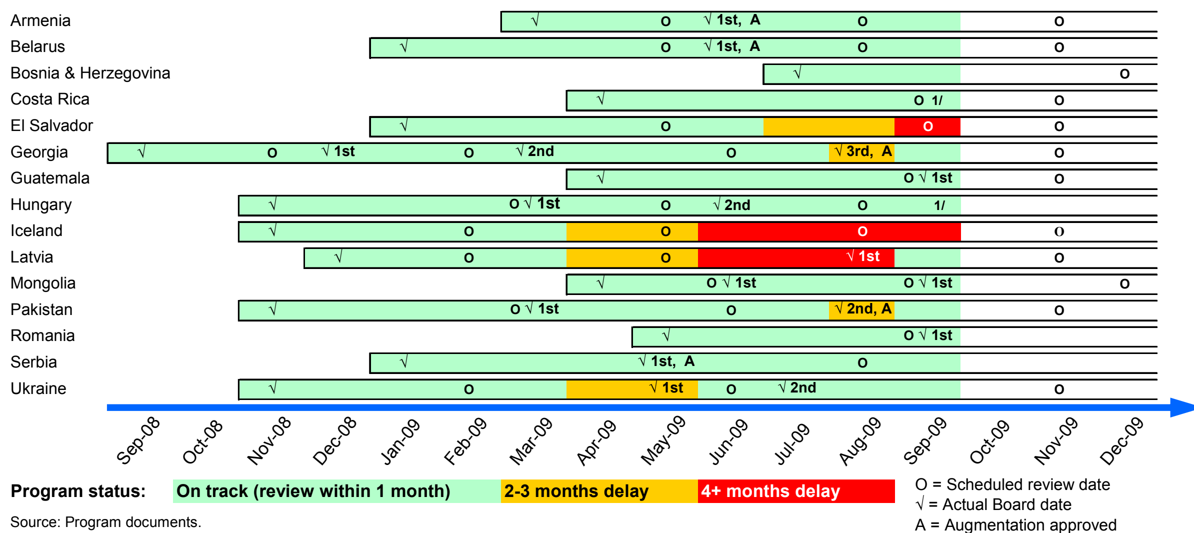
**Figure 11. Program approval and review timelines**




Source: Program documents.
1/ Review scheduled for Board consideration in September.

**Box 5. Opinion research on the Fund's role in selected European program countries**

An independent opinion research surveyed 88 opinion-makers (media, private sector, civil society, and trade union representatives, academics, parliamentarians, government, and central bank officials) in Iceland, Hungary, Romania, and Ukraine on the role of the Fund in dealing with the crisis. It credited the Fund with quick and decisive actions that helped avert an even worse crisis. The findings also provided insights into potential program and reputational risks, as well as the urgent need for improved outreach and communications to ensure broader support for the Fund's role. The main themes were:

***The Fund's "core competencies."*** There was a clear perception of the Fund as a leading global player and voice in the financial crisis, attributed in large measure to its core competencies: financial resources; technical knowledge, expertise, and experience; and global reputation.

***A "changing Fund."*** The Fund was perceived as more collaborative, transparent, flexible, and responsive to specific circumstances and needs than in the past.

***Pessimism about government "effectiveness."*** A perception of governments as lacking sufficient capacity and commitment to implement the necessary reforms characterizes the challenging and risky political country environments in which the Fund is operating.

***Call for an even stronger Fund role***. A number of respondents suggested the need for the Fund to push more assertively for implementation of reform (in contrast to past criticism of the Fund taking on too much of an "enforcer" role).

***Social protection***. Many respondents believed that it was critical for the Fund to continue to advocate for reform that helps to ensure a safety net for the poor now, and in the future."

***Importance of more strategic communications***. The research pointed to the role of better communications, expanding Fund outreach beyond a narrow "circle of elites," and explaining better the *why, what,* and *how* of Fund advice and actions, to ensure institutional effectiveness.

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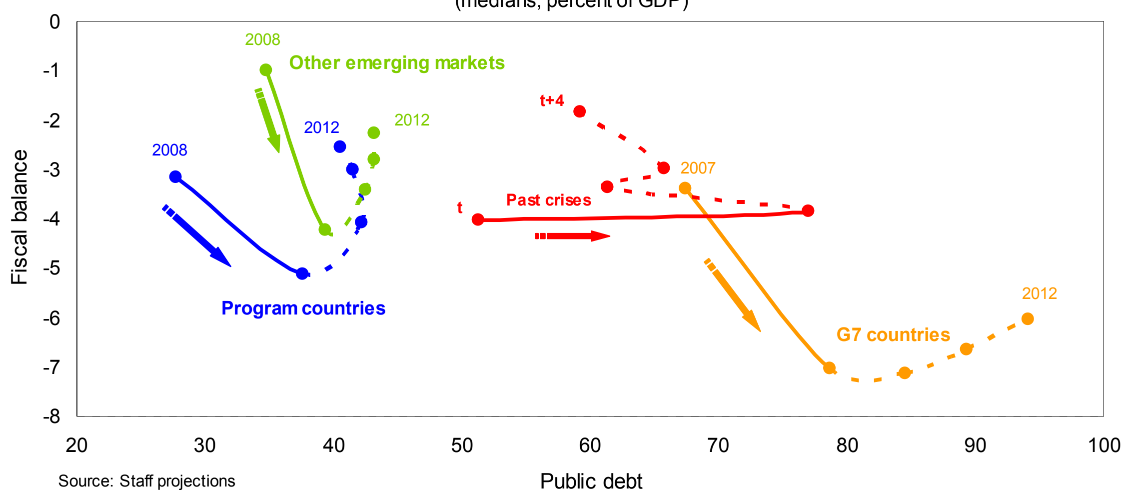
28. **However, three programs suffered delays of over three months in completing reviews**. In Iceland, completion of the first review has been delayed by the collapse of the government in February, which complicated achieving consensus for key fiscal and bank reforms, and by difficulties in securing external financing assurances. Similarly, in Latvia, difficult negotiations on fiscal targets against the backdrop of a dramatic economic contraction and a government changeover led to a long delay in completing the first review. In El Salvador, political transition hindered the completion of the first review, while deteriorating economic conditions have shifted the authorities' interest toward a new SBA. More generally, political instability has affected program implementation in many cases, with fragile government coalitions or changes in government since the crisis in many cases.

## III. FISCAL POLICY

### A. Fiscal policy in the crisis

29. **The question of the appropriate fiscal stance has been central in the recent programs**. Faced with severe recession and limitations to monetary policy effectiveness, fiscal policy in program countries has, broadly speaking, sought to cushion the effect of the cycle in the short run, while ensuring sustainable long-run fiscal positions backed by structural reforms. But the tight constraints facing all emerging market countries (including curtailed financing, debt intolerance, and institutional factors such as EU-wide policy strictures) have prevented the massive increases in deficits and debt taking place in the largest industrialized economies (Figure 12). And a revised view of potential output has tempered the scope for accommodation in some cases.

**Figure 12. Fiscal deficits and debt in advanced and emerging market economies**
(medians, percent of GDP)




### B. Fiscal developments leading up to the crisis

30. **Ahead of the crisis, the fiscal position of many emerging market countries strengthened, but the improvement was flattered by above-trend growth (Figure 13)**. Debt in the program country group remained lower than in nonprogram and past crisis countries, and fiscal deficits were modest. However, most current program countries were

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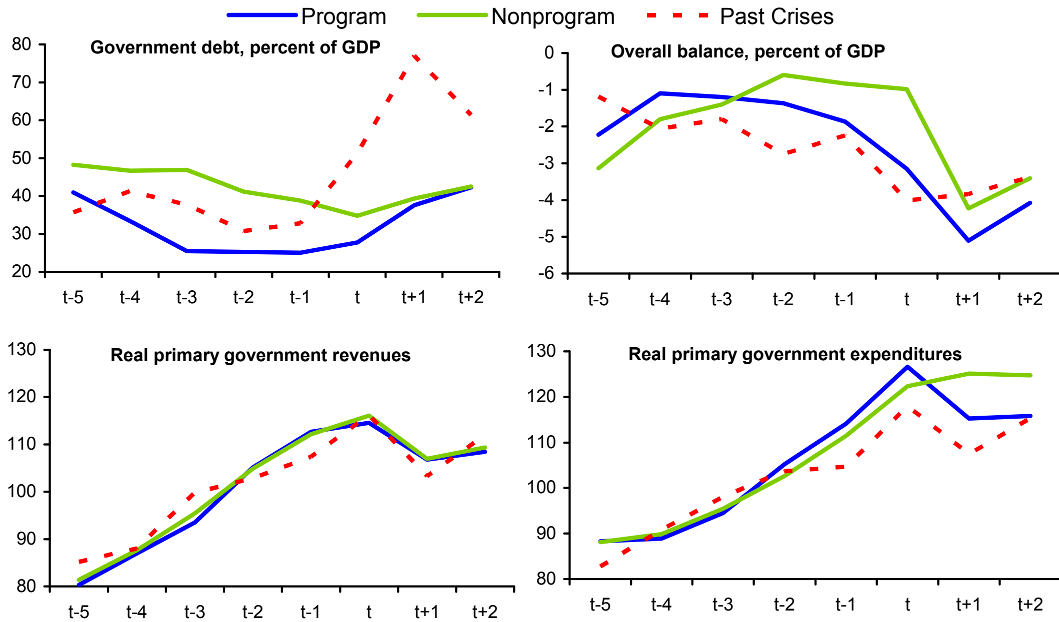
Figure 13. Fiscal indicators in program, nonprogram and past crisis countries
(medians)



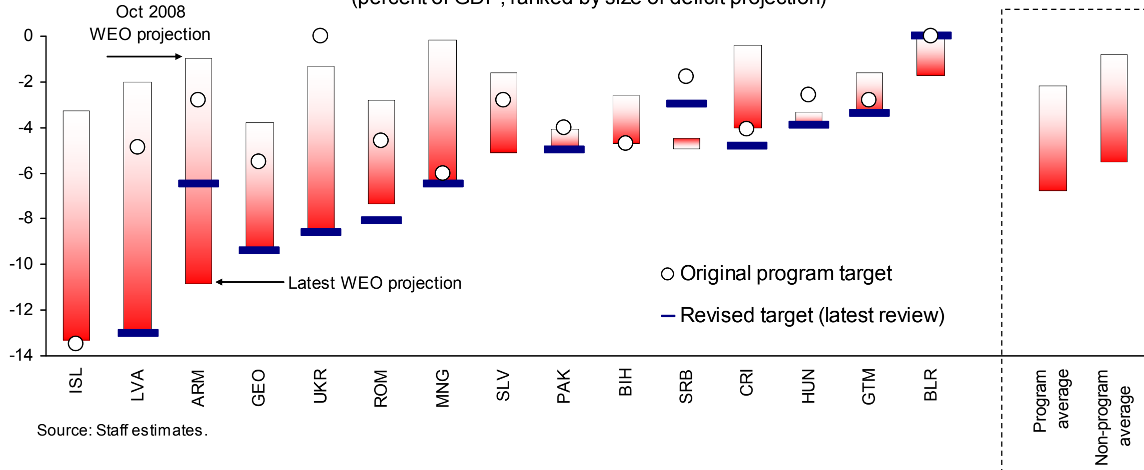

Source: Staff projections.
1/ t = 2008 for current cases. Real primary revenues and expenditures are computed using the GDP deflator, and are shown as the change from the average level for t-4 to t-1.

running pro-cyclical policies, with exceptionally—and unsustainably—high revenue growth setting off even faster increases in primary spending. Thus, generally benign developments in headline fiscal deficits masked a steady deterioration in the structural fiscal position.

## C. Overall fiscal stance in program countries

31. **Fiscal policy has adapted to deteriorating conditions, with most programs now showing net fiscal accommodation—i.e., rising overall or primary deficits (Figure 14)**. Repeated downward revisions to growth projections have resulted in increasingly negative output gaps in all program countries in 2009. In response, fiscal deficits for 2009 have been revised upwards and now range between zero and 13 percent of GDP.

Figure 14. Revisions to overall fiscal balance projections (and program targets) for 2009
(percent of GDP, ranked by size of deficit projection)




Source: Staff estimates.

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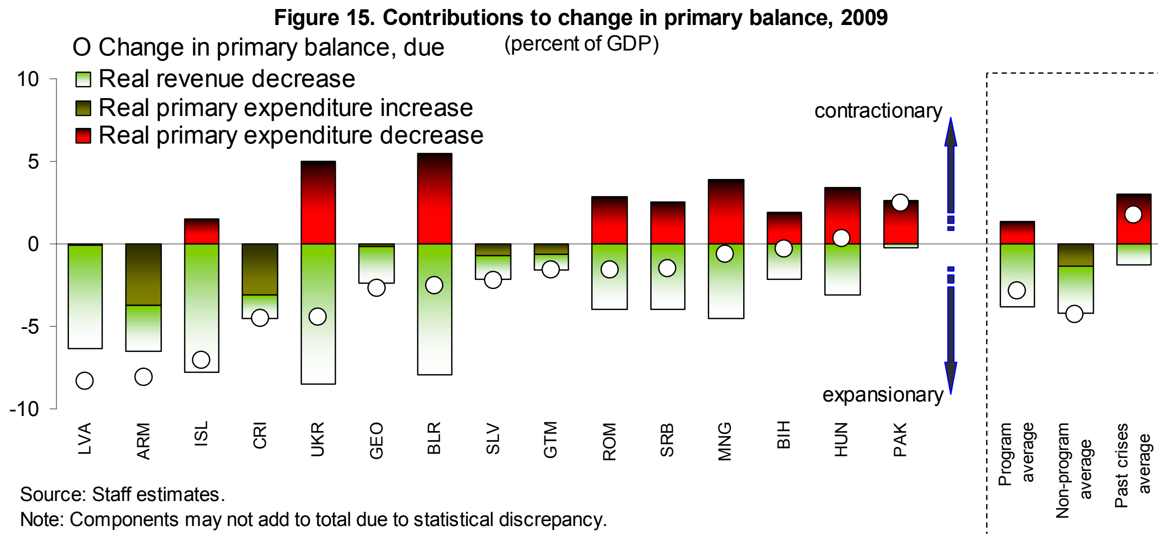
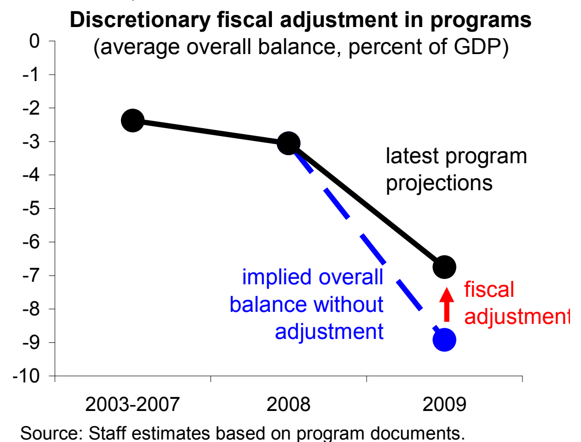
32. **Real revenues are projected to fall sharply, and by more than in past crises (Figure 15)**. Revenues are falling faster than GDP in most program and nonprogram countries. These declines can be only partly explained by tax policy changes, with net tax reductions limited to Armenia, Belarus, and Georgia, and small net tax increases in Bosnia & Herzegovina, Iceland, Latvia, Pakistan, and Romania. Other, more significant, sources of revenue weakness include falling imports, declining asset prices, and weak tax compliance.




33. **Program countries show larger real spending cuts than nonprogram countries**. This reduction in spending is smaller than that seen in past crises, and follows much larger pre-crisis expansions (including in wages, pensions, and subsidies). Only Armenia and the three Central American countries are expected to expand spending in real terms in 2009.

34. **Automatic stabilizers have been allowed to come into play, but not fully as authorities in most programs took measures to contain the widening of headline deficits**. Figure 16 shows the increase in fiscal deficits that would be required to allow automatic stabilizers work unimpeded. Automatic stabilizers are larger on average in program countries than in nonprogram or past crisis cases (as explained in Box 6, automatic stabilizers tend to be underestimated in cases of "negative tax buoyancy," when revenues decline faster than GDP—a key feature of this crisis). Relative to the size of the estimated automatic stabilizers, however, the degree of actual fiscal accommodation in most program countries is being limited. As a result, withdrawals of fiscal impulse can be seen in a number of cases (Hungary, Pakistan, Ukraine, Romania, and Bosnia & Herzegovina show the largest withdrawals). Nevertheless, on the whole, the average fiscal impulse in the current programs is less restrictive than in past crisis cases, although it is tighter than in current nonprogram cases.

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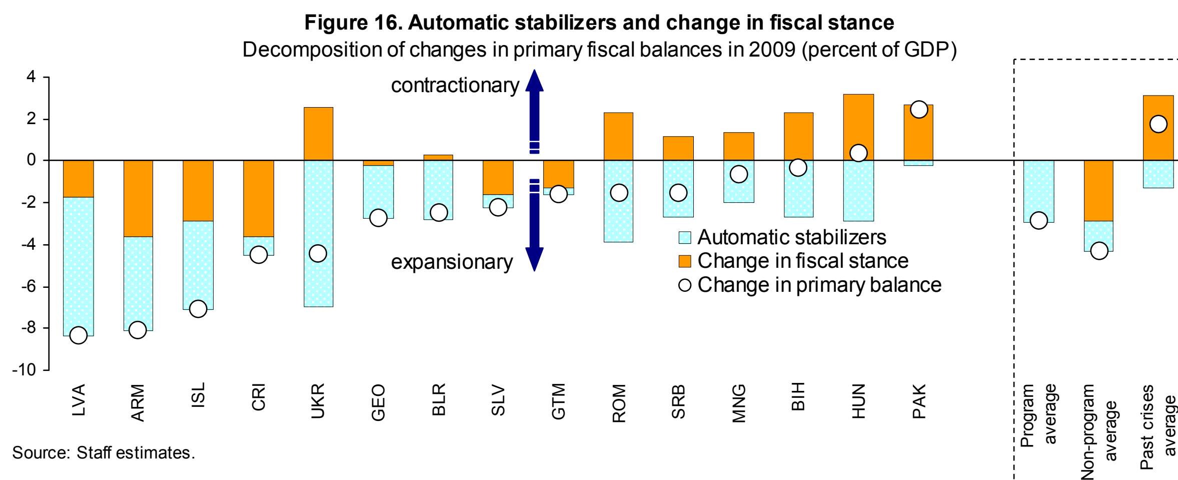


**Figure 16. Automatic stabilizers and change in fiscal stance**

Decomposition of changes in primary fiscal balances in 2009 (percent of GDP)

Source: Staff estimates.

## Box 6. Measuring fiscal stance

The simplest measure of the degree to which fiscal policy is providing an expansionary or contractionary influence on the economy is the change in the overall fiscal balance. This has appeal in its simplicity and its correspondence with standard economic relationships and identities. Where the bulk of interest payments accrue to nonresidents, a better measure of the impact of fiscal policy on aggregate demand is the change in the primary balance. These measures, however, do not provide information on whether the change in the fiscal position is the cause or the effect of the changes in economic activity. That is, they do not convey information on whether the change in the stance is due to the effects of the cycle or to discretionary policy action.

An alternative measure used here is based on the decomposition of the change in the fiscal balance into cyclical (automatic stabilizer) and discretionary (fiscal impulse) components. The methodology defines as cyclically-neutral a policy that allows revenue to evolve in line with actual output, and expenditure to evolve in line with potential output. A deficit increase greater (less) than the automatic stabilizer implies an expansionary (contractionary) stance or a fiscal impulse (withdrawal of stimulus), represented as a negative (positive) value in the charts.

There are caveats also to this measure. First, the assumption of unitary revenue elasticity to GDP implies that tax buoyancy effects are attributed to discretionary action. Second, the expansionary effect of fiscal policy would tend to be underestimated for countries with large automatic stabilizers (e.g., because of generous unemployment benefits). Third, any cyclical decomposition around a crisis is necessarily tentative, due to the difficulty of pinning down potential output growth. This study relies on a uniform methodology for estimating potential output based on averages of several filtering techniques, and so may differ from output gap estimates in program documents. A uniform methodology and set of assumptions may thus distort country-level findings—e.g., Latvia's actual revenue decline is sharper than suggested by a unit elasticity, and its overall stance may therefore be more contractionary than estimated.

Finally, there is a well-founded economic literature on "expansionary fiscal contractions" whereby positive confidence effects outweigh the negative direct effects on demand from fiscal tightening, when fiscal positions are unsustainable, or lack credibility. But given the external origins of the crisis and the scale of the downturn, it seems unlikely that such effects are relevant in most current cases.

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35. **Much of the resistance to full play of automatic stabilizers can be explained by initial conditions**. A cross-section regression of 55 program and nonprogram emerging market countries suggests that fiscal policy is less expansionary in countries with higher initial debt levels and lower starting cyclically-adjusted primary balances. Importantly, current programs do not show larger adjustments than nonprogram countries (an SBA dummy in the regression was insignificant).

**Regression of fiscal impulse on initial conditions, 2009**

Dependent Variable: Fiscal Impulse

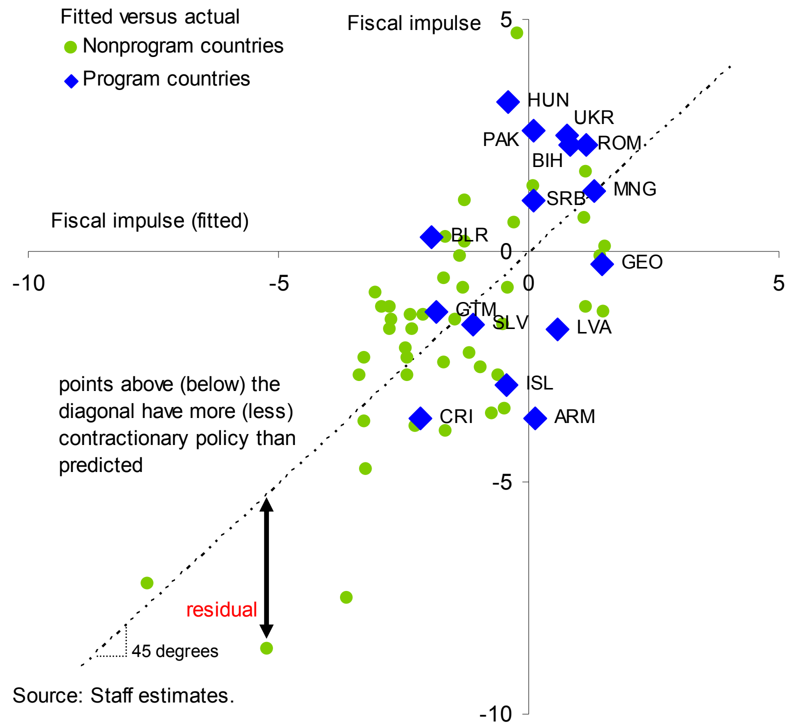
| | *Coeff.* | *Robust S.E.* | *t Stat* | *P-value* |
|---|---|---|---|---|
| *Cycl. Adjusted Prim Bal/GDP t-1* | -0.48 | 0.06 | -7.39 | 0.00 |
| *Public Debt/GDP t-2* | 0.03 | 0.01 | 2.30 | 0.03 |
| *Intercept* | -2.71 | 0.61 | -4.44 | 0.00 |
| *Adj-R2* | 0.46 | | | |
| *Observations* | 56 | | | |

Source: Staff estimates.

36. **There are, however, outliers reflecting important country-specific factors**:

**Initial conditions and variation across program countries**

(based on cross-section regression, 2009)




Source: Staff estimates.

- Iceland and Latvia exhibit larger deficit increases than predicted by the model, but these are explained by much larger (nondiscretionary) revenue declines than the assumed unitary elasticity to GDP growth would imply. Therefore, these cases do not involve discretionary policy loosening. Similarly Georgia and Armenia are accommodating an unexpected large revenue loss to prevent a deeper economic downturn (as indicated below, these countries also show the largest projected medium-term fiscal adjustments, backed by structural reforms).

- In the case of Costa Rica, credibility effects owing to past prudence (not captured in the regression) has created space for pursuing countercyclical policies, including by considerably expanding social safety nets.

- The unexplained element of Pakistan's discretionary fiscal tightening can be reconciled with relatively weak policy credibility, as well as the automatic reversal of

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the large fiscal deterioration suffered in the run-up to the crisis as generous energy and food subsidies have fallen with the collapse in commodity prices.

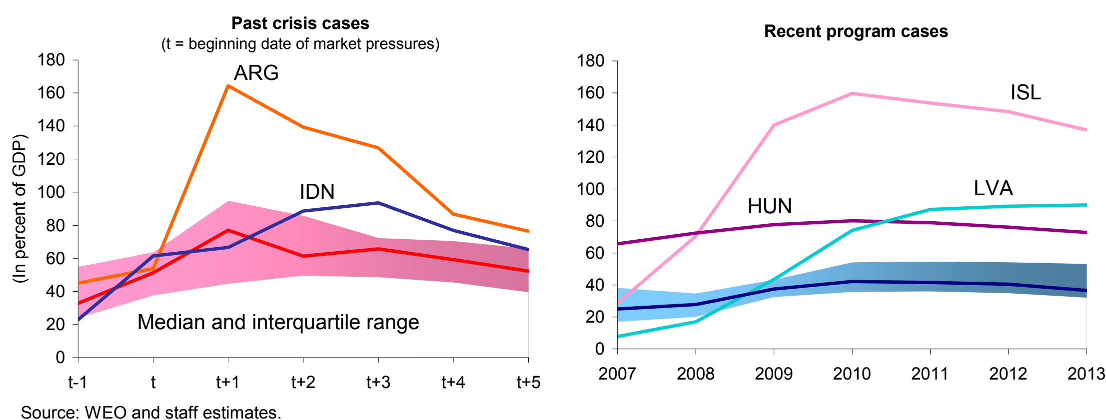
- The unexplained component of fiscal tightening in Belarus can be attributed to the authorities' preference for a balanced budget (instead of a looser fiscal stance, combined with tighter credit policies) as the best means to maintaining confidence. Similarly, in Hungary, discretionary loosening was limited by the need to preserve policy credibility with financial markets given the high debt ratio, the existence of large automatic stabilizers on the spending side, and EU-related constraints.

- In Ukraine, a smaller than predicted fiscal expansion was motivated, inter alia, by financing constraints and the deterioration in the finances of a state gas company in the face of a sudden increase in its import prices.

## D. Medium-term fiscal adjustment

37. **Most countries are expected to face significant fiscal challenges in the coming years**. A few program countries entered the crisis with weak fiscal positions, reflecting large entitlement programs, rapid public wage growth, and narrow tax bases, which the recent crisis has amplified. Even those countries that entered the crisis from stronger fiscal positions than in past episodes will experience large increases in public debt from widening deficits in the downturn, bank restructuring costs, and adverse macro conditions (lower growth, higher interest rates, and weaker exchange rates). Even so, most program countries are projected to preserve public debt ratios comfortably below 50 percent of GDP in outer years—though such outcomes are very sensitive to assumptions about potential output, interest and exchange rates (Figure 17). Latvia, Hungary and Iceland, however, stand out as countries with significant debt sustainability problems.

**Figure 17. Public debt dynamics**




Source: WEO and staff estimates.

38. **Programs envisage the unwinding of near-term fiscal accommodation through medium-term fiscal adjustment plans backed by structural reforms (Figure 18)**. Reflecting heterogeneity in initial fiscal positions, program projections show generally larger medium-term fiscal adjustments in countries with heavier debt burdens. Many programs

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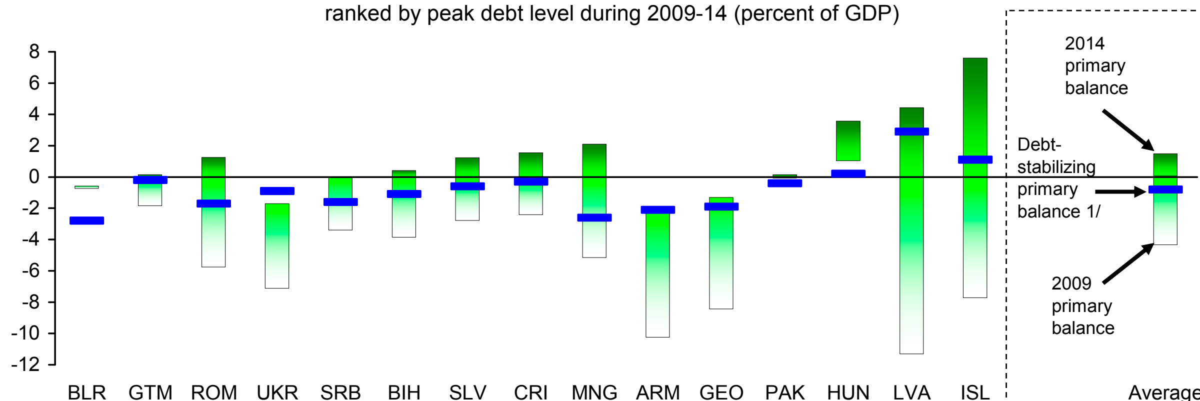
project fiscal adjustments somewhat beyond debt-stabilizing levels, reflecting the priority of reducing, rather than stabilizing, public debt—with the degree of "over-adjustment" also generally greater for those countries with the heaviest debt burdens. This adjustment is generally buttressed by fiscal structural reforms (see Section II.D and Box 7).

**Figure 18. Primary balance adjustments and debt-stabilizing levels in program countries**
ranked by peak debt level during 2009-14 (percent of GDP)




Source: Staff projections.
1/ Primary balance that stabilizes debt ratio using 2014 program projections for debt ratios, growth, interest and exchange rates.

**Box 7. Hungary's fiscal structural reform agenda**

In Hungary, important structural reforms are being undertaken under the program to strengthen fiscal sustainability, while allowing a temporary increase in the fiscal deficit in 2009-10. The government has recently reformed the pension system, social transfers and subsidies to increase the affordability of Hungary's expansive entitlement programs and achieve permanent reductions in spending. A tax reform, which shifts the tax burden from labor to consumption and wealth, has also been implemented. The combination of spending and tax reforms also aims at boosting labor participation and potential growth. Institutional reforms aiming at anchoring the formulation and credibility of the medium-term fiscal framework feature prominently in the program. These include the adoption of a fiscal responsibility law establishing (i) numerical constraints on debt and deficits, (ii) procedural rules aimed at containing expenditure growth, and (iii) a fiscal council to provide independent scrutiny of budget preparation and execution.

## E. Social spending

39. **Commitments to sustain or expand social safety nets to protect and shield the poor have been made by authorities in all program countries** (Table 2).[3] Authorities planned a mix of policies to preserve and/or expand protection of poorer households, including conditional cash transfer programs, housing utility allowances, labor-intensive infrastructure projects, and unemployment insurance. Pakistan has made stronger social safety nets a key priority

[3] See http://www.imf.org/external/np/exr/facts/protect.htm for further details of social protection measures in Fund-supported programs.

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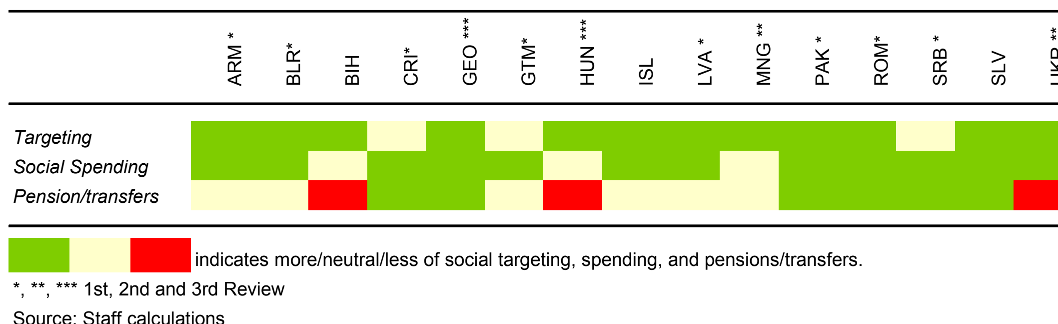
(cash transfer programs were augmented) backed by program conditionality to strengthen targeting. In Costa Rica, the authorities are using "fiscal space" to increase spending on education and labor-intensive infrastructure projects, and to expand conditional cash transfer programs and noncontributory pensions (totaling 1 percent of GDP).

**Table 2. Social safety nets and spending on pensions and transfers**



| | ARM * | BLR* | BIH | CRI* | GEO *** | GTM* | HUN *** | ISL | LVA * | MNG ** | PAK * | ROM* | SRB * | SLV | UKR ** |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| *Targeting* | more | more | more | neutral | more | neutral | more | more | more | more | more | more | neutral | more | more |
| *Social Spending* | more | more | neutral | more | more | more | neutral | more | more | neutral | more | more | more | more | more |
| *Pension/transfers* | neutral | neutral | less | more | more | neutral | less | neutral | neutral | neutral | more | more | more | more | less |

[green/yellow/red] indicates more/neutral/less of social targeting, spending, and pensions/transfers.

*, **, *** 1st, 2nd and 3rd Review

Source: Staff calculations

40. **Over time, however, fiscal constraints have pushed some countries to change their strategy from higher expenditure to better targeting**. Bosnia & Herzegovina, Hungary and Mongolia have shifted from higher spending in favor of better targeting.

41. **The need to put fiscal positions on a sound long-term footing is also driving selected wage restraint and cuts in transfers and pensions**. In some cases, these measures partly unwind the rapid wage and entitlement growth of the pre-crisis period. In Latvia, wage cuts in the public sector are being undertaken after years of very rapid growth to help restore competitiveness and secure public debt sustainability. Bosnia & Herzegovina—a peg like Latvia—is taking a similar approach. Cuts in a generous system of entitlements were also necessary in Hungary to address fiscal sustainability concerns. In Ukraine, after years of rapid increases in pensions, downward adjustments are expected to take place (minimum pensions will be safeguarded) to help place the pension system on a sound footing and facilitate medium-term fiscal adjustment.

## IV. Monetary and Exchange Rate Policy

### A. Approach and overview

42. **During a crisis, monetary and exchange rate policies have to trade off a number of objectives: inflation, external adjustment, and financial stability**. Monetary tightening may be required to stem a run on the currency or prevent exchange rate overshooting—though adjustment may be unavoidable when the currency is out of line with fundamentals. Exchange rate and interest rate exposures in balance sheets need to be taken into account in considering the combination of monetary tightening and exchange rate adjustment, with capital controls a potential further tool in particular circumstances.

43. **The fact of only modest levels of interest rates, currency depreciation, and inflation in this crisis stand in stark contrast to past experience**. In most cases, low, if not negative, pre-crisis real interest rates combined with rising risk premia, required nominal

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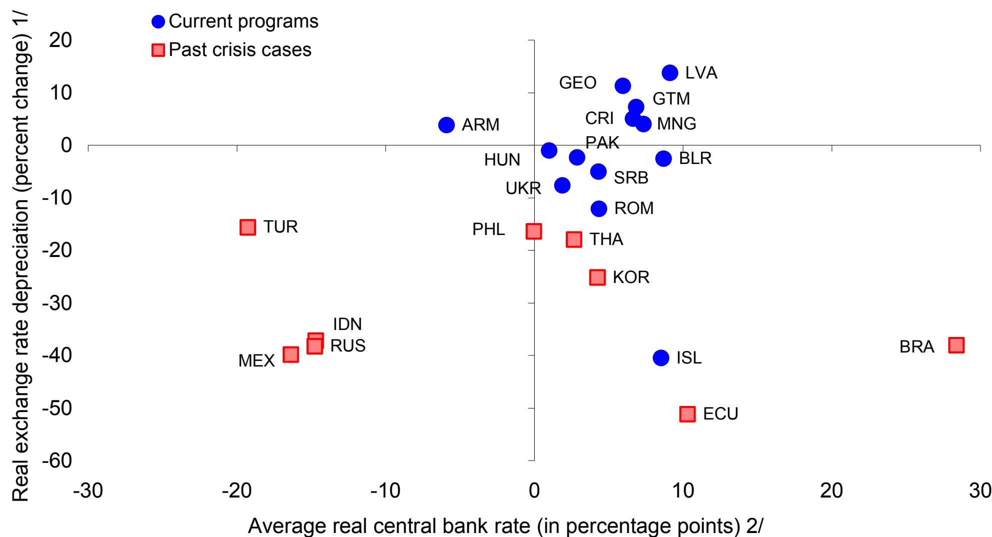
policy rate hikes to preserve market confidence, but these increases were relatively modest compared to past episodes. As falling food and fuel prices reduced inflation pressure, such rate hikes, were typically sufficient to anchor medium-term inflation expectations and prevent the large currency overshooting that created havoc in previous crises (Figure 19). This outcome likely owes also to a number of supportive factors: (i) timely and frontloaded financing packages and larger initial reserve buffers removing tail risk scenarios; (ii) sharp reductions in advanced country interest rates; (iii) a variety of approaches to exchange rate policy, with greater emphasis on country ownership of currency regimes; (iv) better than expected bank rollover rates; and, possibly, (v) a reduced capacity for speculative attacks on currencies among hedge funds and other investors, given their own parlous conditions. As noted below, there were some exceptions to these patterns, notably the case of Iceland, which required capital controls to deal with a free-falling currency and large deposit outflows.

**Figure 19. Post-crisis real interest rates and real exchange rate changes**




Source: IMF, International Finance Statistics, Information Notice System; and staff estimates.
1/ Change from October 2007 to July 2009 for current programs, and for past crises, from 12 months before crisis to 12 months after crisis. A decrease means depreciation.
2/ Average real central bank policy rates (for current programs) and discount rates (for past crisis cases) for latest three months (t+7 to t+9 for past crises). "t" is the beginning of crisis for past crises, and October 2008 for current programs.

## B. Exchange rate policy

44. **The Fund has sought to respect the authorities' choice of exchange rate regime, while ensuring their consistency with macro policies**. In the context of an adjustment program, the regime choice needs to provide credibility to the adjustment strategy. And, even when warranted by the need to unwind large currency misalignments, changes in regime are often controversial, not least because of the intrinsic difficulty in weighing their costs and benefits, as made clear by the Latvia case (Box 8). Only the Belarus and Ukraine programs involved a change in the *de jure* exchange rate regime toward greater flexibility (Figure 20 shows bilateral exchange rate developments through the crisis using an illustrative—and necessarily somewhat arbitrary—characterization of countries' *de facto* exchange regimes).

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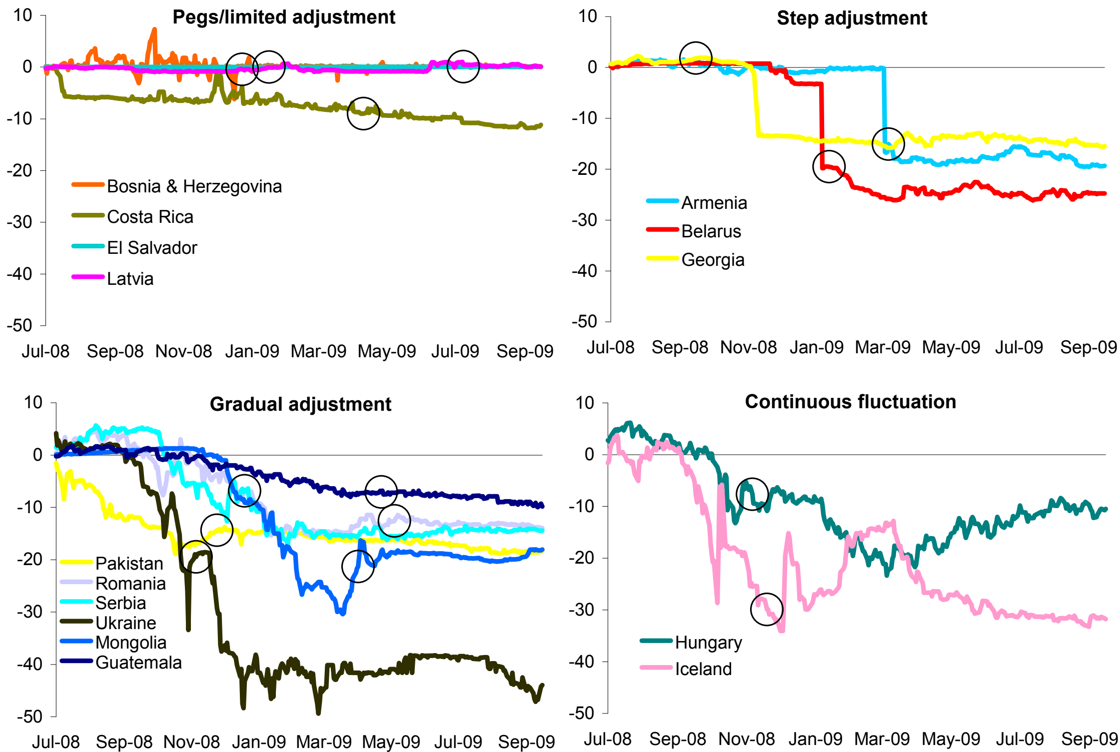
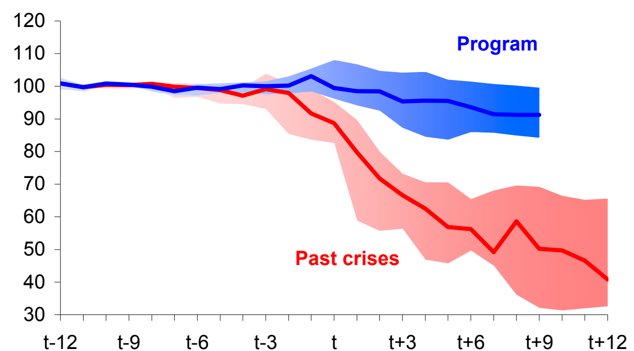
**Figure 20. Daily spot exchange rates under programs**
Percent change from June 2008 (- = depreciation), circles mark program approval dates 1/




Source: Bloomberg.
1/ Exchange rates are defined as units of national currency per euro for Bosnia & Herzegovina, Hungary, Iceland, Latvia, Romania, and Serbia, and per U.S. dollar for remaining countries.

45. **While the overshooting that typified past crises has largely been avoided so far, recent currency stability needs to be set against potential future needs for adjustment**. After the initial period of volatility, exchange rates have tended to stabilize (Figure 20): except for Hungary, Iceland, and lately Ukraine (which has experienced some depreciation since late August), no program country exchange rate fluctuated by more than 5 percent throughout May–August 2009. For the most part, this stability has not involved major direct exchange rate intervention, but rather a combination of the positive impact of confidence returning and, in some cases, moral suasion. However, very stable currency movements in some programs may hinder the objectives of unwinding pre-existing currency misalignments or adjusting to large terms-of-trade shocks, and avoiding a buildup of risky foreign exchange exposures in balance sheets.

**Nominal effective exchange rates**
Median and interquartile ranges, average of t-12 to t-7 = 100, monthly 1/




Source: IMF, International Finance Statistics and Fund staff estimates.
1/ "t" represents Oct 2008 for current programs, and beginning of crisis for past crises.

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**Box 8. Maintaining Latvia's peg**

**Maintaining the exchange rate peg has been a central element of Latvia's Fund-supported program**.

**At the outset, a number of exchange rate options were discussed**. The program staff report transparently laid out the options (IMF Country Report No. 09/3, pages 20-21 and 26-27). Widening the exchange rate bands to the full 15 percent range permitted under ERM2 would have facilitated economic recovery through improved competitiveness (after initial adverse balance sheet effects). Concurrent euroization would also have forestalled speculation and boosted confidence.

**These alternatives were, however, ruled out**. The Latvian and European authorities were firmly committed to the exchange rate peg, which commands widespread popular and political support as an anchor of stability and growth for more than 15 years, including through the 1998 Russian crisis. Any change in regime would have undermined ownership, and risked significant economic and social disruptions. Moreover, changing the parity along with immediate euroization would have been inconsistent with the Maastricht Treaty

**Abandoning the peg would have also involved immediate costs**:

- Devaluation would have led to an *immediate* deterioration in private sector net worth, with a risk of negative feedback loops on output. Some 70 percent of bank deposits and nearly 90 percent of loans are foreign currency denominated, and private sector net foreign currency debt is around 70 percent of GDP.
- External financing needs would have not been significantly reduced, with improvements in the current account offset by deteriorating private sector roll-over rates, as the external debt to GDP ratio increased sharply.
- There could have been potential spillover risks to neighboring economies, and possibly beyond, especially in the event of an unplanned and disorderly devaluation.

**Nevertheless, all stakeholders recognized that the commitment to the peg brings difficult consequences**. These included the need for challenging fiscal tightening and the likelihood of protracted recession.

46. **In some cases, the limitation of currency depreciation reflected concerns about immediate losses from foreign exchange exposures in private balance sheets** (Section V). In cases such as Hungary, Latvia, Iceland, and Ukraine, program policies gave significant weight to the potential disruptions in balance sheets from excessive currency depreciations, and in many cases, program reserve targets have given room for needed intervention in the foreign exchange market to avoid disorderly movements. In Iceland, the severity of the currency and banking crisis required a combination of large-scale foreign exchange intervention and capital controls to stabilize the krona, which depreciated by more than 30 percent against the euro in the months prior to the approval of the Fund arrangement.

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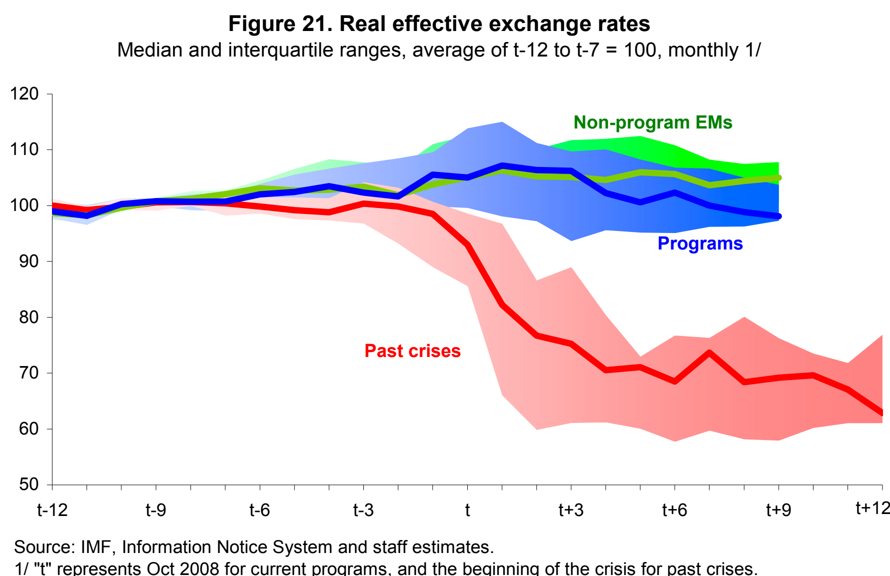
47. **In real terms too, currency depreciations have so far been strikingly more moderate than in past crises and closer to current nonprogram countries**. Inflation has been falling rapidly in program countries, although it remains higher than in their trading partners. As a result, in program countries, the median real exchange rate depreciation for October 2007 to July 2009 was negligible at 0.3 percent (Figure 21). This compares to a median appreciation of some 5 percent for nonprogram emerging market economies and a 33 percent depreciation in past crises at a similar stage. Pegs have seen their real exchange rates appreciating on average by about 6 percent, further eroding competitiveness. The modest real depreciations to date in many program countries mirror relatively mild current account adjustments, as noted in Section II, and suggest that further real exchange rate depreciation may be needed down the road to allow the unwinding of the large pre-crisis external imbalances that induced some program countries to turn to the Fund (Section VI).

**Figure 21. Real effective exchange rates**

Median and interquartile ranges, average of t-12 to t-7 = 100, monthly 1/




Source: IMF, Information Notice System and staff estimates.
1/ "t" represents Oct 2008 for current programs, and the beginning of the crisis for past crises.

## Capital controls

48. **Capital controls were needed to stabilize market conditions in some cases**. Loss of market confidence coupled with acute shortfalls in foreign exchange liquidity had the potential of setting currencies on a free fall (Iceland) or trigger deposit runs (Latvia). Programs therefore allowed the continuation of controls imposed before the start of the program—including the comprehensive capital controls imposed in Iceland and the exchange restrictions arising from the partial deposit freeze at Parex, the largest domestic bank in Latvia (a key element of the bank restructuring strategy). Controls are planned to be lifted in stages in both countries, as stability and confidence gradually return. In other cases, such as in Ukraine and Pakistan, programs generally encouraged timely elimination of exchange restrictions imposed on current payments and transfers as they run counter to the authorities' objective of encouraging greater currency flexibility.

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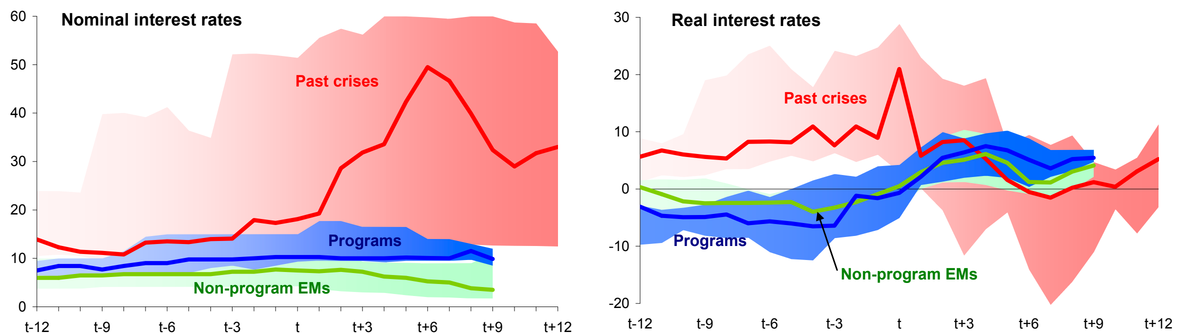
## C. Monetary policy

49. **Recent Fund programs use a variety of nominal anchors for price stability**. For those countries that do not peg their currencies, monetary programs either establish a combination of quantitative targets on monetary aggregates (net domestic assets of the central bank or base money) or preserve existing inflation targeting frameworks. Complementary floors on the central bank's net international reserves aim to safeguard Fund resources, while providing adequate room for foreign exchange intervention. Even in programs that use monetary aggregates as intermediate policy targets, policy rates have been adjusted in a discretionary way in the face of volatile market conditions. As with other program targets, monetary policy goals are revised periodically as conditions change: for example, some programs have recently relaxed targets on domestic credit. Policy rates were also reduced as inflation has eased and risks of disorderly currency movements have abated.

50. **The increase in policy interest rates to bring real rates into positive territory and stabilize market confidence have been modest compared to past crises** (Figure 22). In fact, in some cases, outright policy tightening was accompanied by injections of (domestic and foreign currency) liquidity to address shortages of liquidity in financial systems (Section V). All things considered, monetary conditions were overall tightened initially to prevent excessive currency depreciations while exchange rates found their new equilibria and contain second-round effects of currency depreciation on inflation.

**Figure 22. Interest rates**

Medians and interquartile ranges, monthly 1/

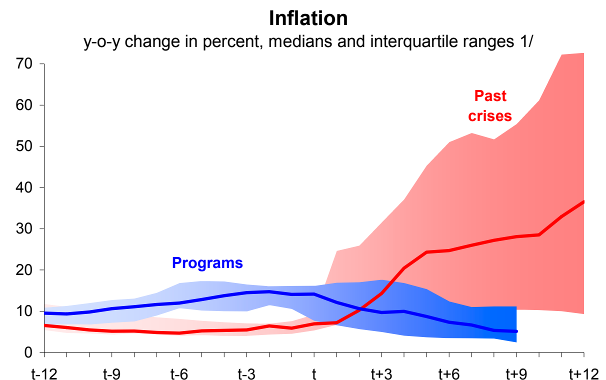



Source: IMF, International Finance Statistics and Fund staff estimates.
1/ "t" represents Oct 2008 for current programs, and the beginning of the crisis for past crises. EMs include Argentina, Brazil, Chile, China, Croatia, Czech Republic, Ecuador, India, Indonesia, Jordan, Korea, Lithuania, Malaysia, Mexico, Morocco, Peru, Poland, Russia, Thailand, Turkey, Venezuela, Vietnam.

51. **In recent months, falling inflation and financial stability have created space for monetary policy easing**. Against the backdrop of a global deflationary environment, the avoidance of large exchange rate depreciations in most program cases has set inflation on a downward trajectory. This is in stark contrast with past crises, where inflation picked up sharply in tandem with significant exchange rate depreciations. As a result, where

**Inflation**

y-o-y change in percent, medians and interquartile ranges 1/




Source: IMF, International Finance Statistics and Fund staff estimates.
1/ "t" represents Oct 2008 for current programs, and beginning of crisis for past crises.

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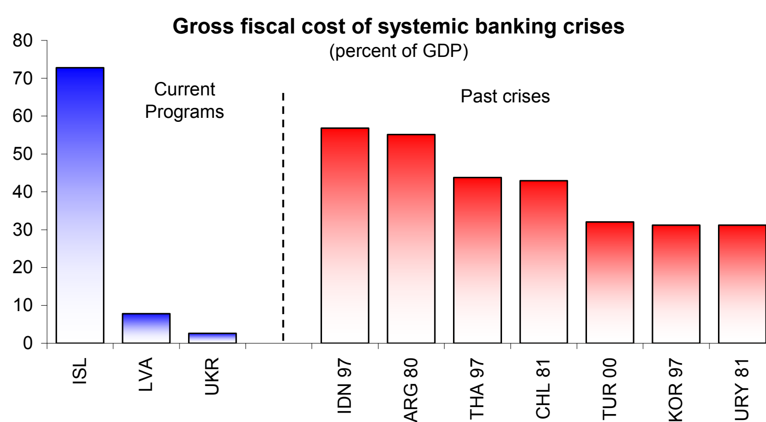
financial stabilization has taken hold, prudent relaxation of program targets and policy rates has begun. However, the more rapid pace of interest rate cuts observed in nonprogram emerging market countries, suggests that there may be room for some further reduction in policy rates in program cases, although such easing would need to be consistent with individual country constraints and inflation objectives.

## V. Financial Sector Policies

### A. Incidence of financial sector crisis

52. **Banking systems in program countries have largely been shielded so far from the dislocations observed in some advanced countries or previous crises**. In only Iceland and, to some extent, Latvia and Ukraine can it be plausibly argued that the financial sector was key in triggering or exacerbating the crisis (Box 9). By contrast, banking system meltdowns were hallmarks of most other recent capital account crisis cases. Even so, banking problems typically lag the economic cycle and pressures are likely to materialize going forward.



Source: Laeven and Valencia (2008); FAD-MCM: Public Interventions in Financial Systems.

**Box 9. Financial sector problems in Iceland, Latvia, and Ukraine**

**Iceland** was already in the middle of a full-scale banking crisis for some months prior to the launching of the program, reflecting a collapse of confidence with a boom—resulting in extremely high leverage and dependence on foreign financing—turning into a bust. The crisis culminated in the second half of 2008 with the collapse of the country's three largest banks, accounting for 85 percent of the system and with total liabilities of almost 900 percent of GDP.

**Latvia's** banking system strains were rising at least since mid–2008, with deposits declining by some 10 percent between August and end-year, largely resulting from a run on the country's second largest bank. Banking system problems mainly reflected mounting concerns for the solvency of the corporate sector and the bursting of a real estate bubble.

**Ukraine's** banking system came under strain in the second half of 2008 as both liquidity and solvency problems emerged. Following the decision to put the country's sixth largest bank under receivership, a deposit run led the authorities to impose limits on early withdrawals. In addition, preliminary diagnostic tests under the program revealed large capital deficiencies, with the needed recapitalization estimated at least 8 percent of GDP.

53. **The relative banking system resilience in most emerging market countries reflects both past institutional reforms and decisive policy responses in this crisis**. Emerging markets have made substantial progress in recent years in strengthening

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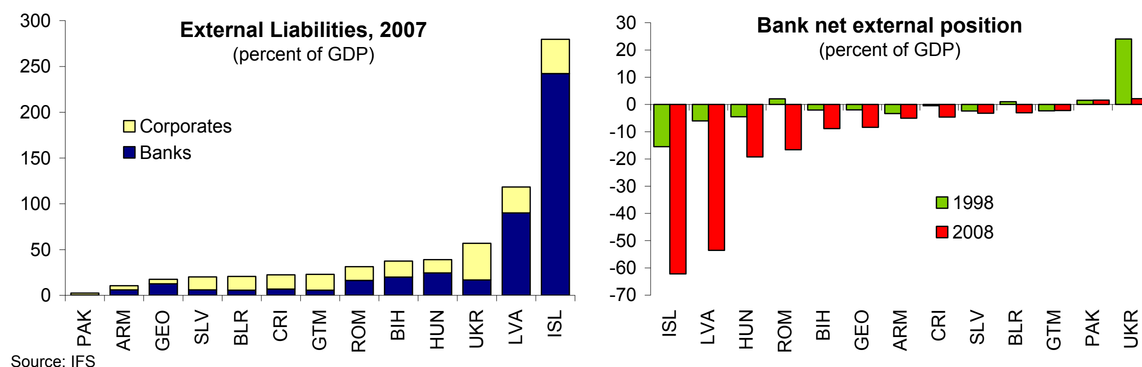
supervision, addressing systemic risks, and reducing balance sheet vulnerabilities—as a result, for most program countries financial system initial conditions were generally benign compared to previous crisis episodes. The policy response to the current crisis internalized early on the potential for sharp reductions in cross-border flows from global deleveraging, by adopting comprehensive measures to address incipient liquidity needs. At the same time, efforts were made to avoid disruptive currency overshooting in light of large foreign currency exposures in private balance sheets.

## B. Policy considerations

54. **Avoiding liquidity runs and addressing underlying bank vulnerabilities were key to contain the effects of the crisis**. The risk of liquidity pressures was significant given banking systems' reliance on external financing. Such risks were most concentrated in Iceland and Latvia with bank external debt liabilities approaching 250 percent and 100 percent of GDP respectively, but were also prevalent in many other countries (Figure 23). The high incidence of foreign ownership of domestic banks was also a source of potential instability given that advanced-country parent banks themselves were under serious pressures. Program design also took into account country-specific domestic vulnerabilities, including pre-existing insolvency of key banks (Iceland, Ukraine); corporate sector distress (Georgia, Latvia, Pakistan); and deficient supervisory and legal frameworks (Belarus, Costa Rica, Guatemala), as well as directed lending concerns (Belarus and Guatemala).

**Figure 23. Bank cross-border exposures**



Source: IFS

55. **It was also important to avoid currency overshooting given widespread liability dollarization**. The incidence of unhedged foreign currency liabilities was considered to be serious in Belarus, Georgia, Guatemala, Hungary, Iceland, Latvia, and Serbia. Moreover, in many of these cases, net external exposures were also very large.

## C. Policy measures and outcomes

56. **Financial policies focused on maintaining bank liquidity and solvency**. Curbing *liquidity* pressures and financial stress (including by safeguarding external credit lines, Box 10) took precedence over structural measures aimed at strengthening balance sheets and addressing *solvency* concerns. Measures, some of which were incorporated in program conditionality, took different forms depending on the nature of shocks and country situations

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(Table 3, Box 11). Measures to facilitate *household and corporate debt restructuring* also formed an important element of the longer-term agenda in some countries (Box 12).

**Table 3. Summary of financial sector measures**

| | Immediate stabilization | | | | | | | Longer-term structural | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | Liquidity Support | | | | | | | | | | |
| | Introduction of central bank liquidity facility | Broadening eligible collateral | Cuts in reserve requirements | Strengthen-ing deposit insurance | Regulatory forbearance | Deposit freeze | Intervention of distressed banks | Resolution framework | Supervision | Bank recapitaliz-ation | Debt restructuring |
| Armenia | • | • | | | • | | | • | | | |
| Belarus | | • | • | | • | | | | • | • | |
| Bosnia | | | • | • | | | | | | | |
| Costa Rica | • | | | • | | | | • | | • | |
| El Salvador | | | | | | | | • | • | | |
| Georgia | • | | • | | | • | | | • | | |
| Guatemala | • | | • | | • | | | • | • | • | |
| Hungary | • | • | • | • | | | | • | • | • | • |
| Iceland | | • | • | • | • | • | • | | • | • | • |
| Latvia | | • | • | • | | • | • | • | • | • | • |
| Mongolia | | | | • | | | • | | | | |
| Pakistan | | | | | • | | | • | • | | • |
| Romania | • | • | • | • | • | | | • | • | | |
| Serbia | • | • | • | • | • | | • | | • | | |
| Ukraine | • | • | • | • | | • | • | • | • | • | • |

Source: Program documents

**Box 10. Bank Coordination Initiative (BCI) in CEE countries**

The BCI was established by the IMF, the European Commission, and the EBRD to involve the private sector in stabilizing CEE banking systems, preventing disorderly deleveraging, and reducing uncertainty. Since early 2009, coordination meetings have taken place for Bosnia, Hungary, Romania, and Serbia. Other countries (including Latvia) are expected to join this Initiative soon.

**Foreign banks' participation and originating countries, 2009**

| | Bosnia | Hungary | Romania | Serbia |
|---|---|---|---|---|
| Foreign banks' market share (percent of assets) | 95 percent | 70 percent | 88 percent | 75 percent |
| Country of origination of foreign banks | Austria, Italy, Slovenia | Austria, Italy, Germany | Austria, France, Greece, Italy | Austria, Italy, Greece, France |

Under the BCI, parent banks commit to maintaining exposure in host countries and maintaining adequate capital and liquidity in subsidiaries. Such commitments do not have legal standing and are intrinsically difficult to monitor. But their nonobservance would eventually expose parent banks to reputational costs.

As part of the BCI, host countries commit to sound policies under IMF-supported programs, focusing on the stability and solvency of banking systems. To this end, bank stress tests in individual countries and at the regional level have either been completed or are underway. Policies in some cases afford greater flexibility to the overall banking system. For instance, in Romania, capital shortfalls were allowed to be met with Tier 2 instead of Tier 1 instruments; in Bosnia & Herzegovina and Romania, reserve requirements were eased; and in Serbia, central banks established liquidity facilities.

A concern raised with the BCI is that it could shift the location of deleveraging to other countries. Thus, regional coordination is essential for the ultimate success of the Initiative.

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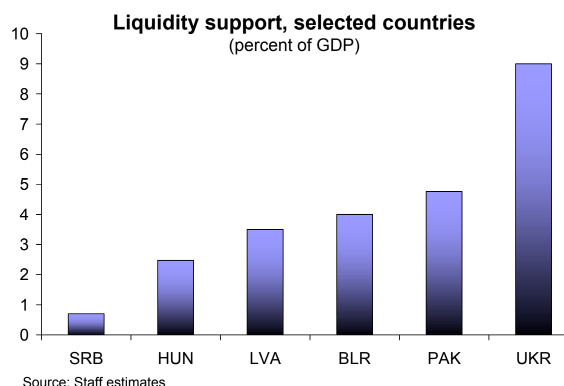
**Box 11. Financial sector measures in program countries**

***Liquidity support*** has been substantial in some cases.

Strengthening ***deposit insurance*** has included the creation of new frameworks, extension of coverage, including blanket guarantees in some cases, and the boosting of resources backing guarantee funds. In some countries, measures in this area have been limited as insurance had already been strengthened in recent years, or the authorities were concerned about adverse signaling effects.




***Deposit freezes*** have been used sparingly and on a temporary basis. In some cases, the imposition of controls has effectively put limits on deposit withdrawals.

***Regulatory forbearance*** measures included easing prudential requirements or allowing banks more time to meet them. At the same time, supervisory powers were also strengthened in certain areas in response to the crisis.

***Interventions of distressed banks*** have involved: Iceland—three largest banks, via adoption of "new bank/old bank" approach, as well as four other financial institutions; Latvia—takeover of 85 percent of the shares and a subsequent recapitalization of the second largest bank; Mongolia—one bank was placed into conservatorship; Serbia—a small bank was put under receivership; and Ukraine—the sixth largest bank, and a number of smaller banks, were put under receivership, and the authorities are resolving two systemic banks.

***Bank recapitalization*** is crucial to restore bank viability, but progress in this area has typically been slow reflecting a variety of factors including insufficient progress in resolving asset valuation issues, low private investor interest, and ambiguities on the role of the public sector.

Key areas under the ***resolution framework*** include setting up mechanisms to support bank intervention, restructuring and recapitalization, including legislative changes where needed.

57. **Financial sector stability has been maintained for the most part, helped by liquidity measures and relative currency stability**.

- Initial measures have generally avoided deposit runs and limited pressures on domestic and forex liquidity. In particular, liquidity support, complemented in some cases by administrative measures and controls, as well as early bank interventions, were successful in stemming deposit runs in Iceland, Latvia, and Ukraine. The more persistent deposit declines in Georgia and, to a lesser extent, Mongolia and Ukraine, appear to reflect broader, including (in the case of Ukraine) solvency concerns.

- Bank external credit lines have held up better that initially assumed. For the most part, parent banks appear committed to funding their subsidiaries, and in some cases

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**Box 12. Household and corporate debt restructuring**

Effective debt restructuring plays an important role in addressing debt overhangs and restart credit flows and investment. Progress in this area has, however, been uneven. In all cases (except for Pakistan), program measures were intended to support *voluntary* debt restructuring.

***Latvia*** is implementing a comprehensive debt restructuring strategy, ranging from changes to the insolvency regime to the establishment of a scheme providing incentives for banks to restructure mortgage loans, which is to be implemented as the fiscal situation improves.

In ***Hungary***, the bankruptcy regime was strengthened to create incentives for early debt restructurings. Relief to unemployed mortgage debt holders and a partial mortgage guarantee for debtors facing large debt-service-to-income burdens were adopted. Schemes to partially guarantee loans to funding-constrained SMEs are also being considered.

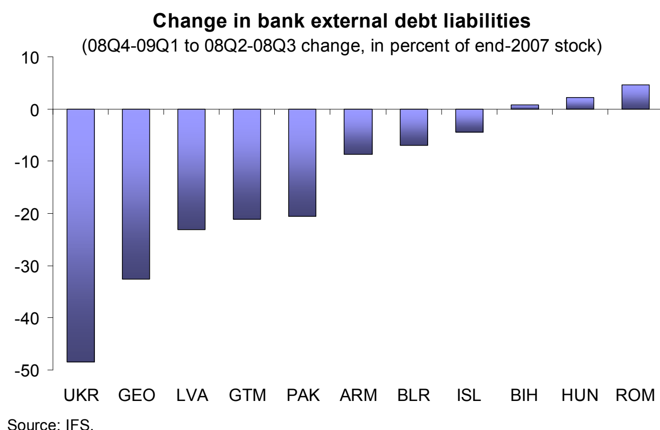
In ***Romania***, a voluntary agreement with banks to facilitate restructuring of mortgage debt in foreign currency was reached.

In ***Iceland***, frameworks to facilitate household and corporate debt workouts are being developed in lieu of earlier temporary emergency measures. These frameworks will be supported by legal changes to the insolvency regime to expedite court-approved rehabilitation agreements and deal efficiently with nonviable debtors.

In ***Pakistan,*** the approach involves a one-year deferral of all principal repayment, which raises moral hazard issues and risks undermining the banks' financial position.

In all countries with high levels of foreign-currency borrowing, immediate debt service burdens have been reduced by the sharp cuts in advanced-country interest rates, which offset the effects of currency depreciation on monthly payments. But this effect is likely to unwind in the future as interest rates rise, coupled with higher principal repayment costs in local currency.

central banks of the parents' jurisdiction (e.g., Nordic central banks) have publicly committed the use of their credit lines for liquidity support of program country subsidiaries. Hence, contrary to initial concerns, foreign bank ownership has so far proved a net strength, with foreign bank flows remaining on balance much more stable than other types of private capital flows in most program countries. Still, recent figures suggest that external bank financing has showed marked declines in some cases, including Ukraine and, to a lesser extent, Georgia, Guatemala, Latvia, and Pakistan.




- As discussed in Section IV, exchange rate stability has been a major factor in ensuring financial sector stability, especially for countries with large net open forex positions in financial, corporate, and household balance sheets.

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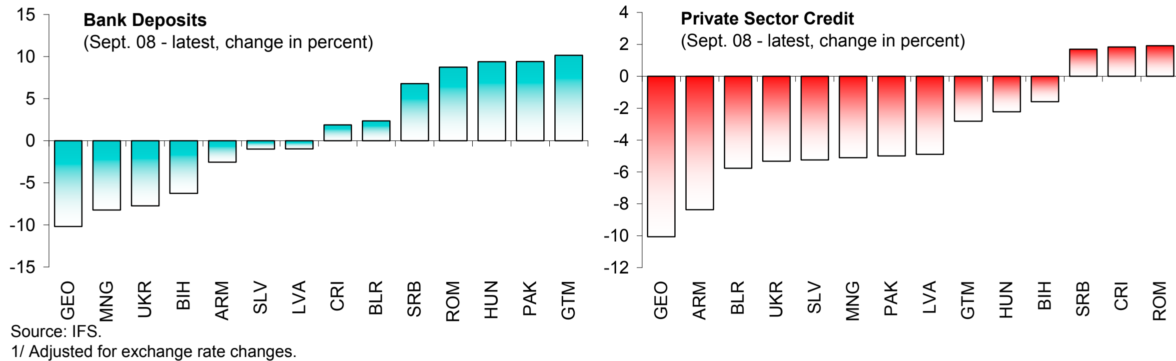
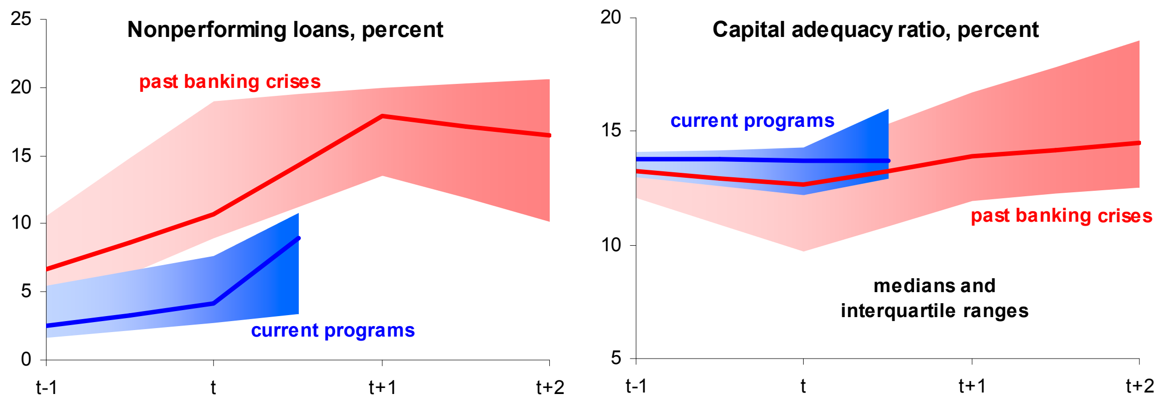
**Figure 24. Deposit and credit developments** 1/




Source: IFS.
1/ Adjusted for exchange rate changes.

58. **On the other hand, the asset side of banks' balance sheets is evolving less favorably than originally envisaged in most programs**. In particular, credit to the private sector continues to decline in most cases, in part reflecting weaker demand, but also tighter lending standards (Figure 24). While the evolution of non-performing loans (NPLs) has been mostly benign so far, the experience of past crises suggests that NPLs are typically recognized with long lags (Figure 25) and could be expected to peak in the next couple of years in countries experiencing deep recessions, putting renewed pressure on bank capital. Thus, rapid progress in recapitalizing banks based on forward-looking assessments of asset quality, and in restructuring household and corporate debts would prevent the recurrence of banking sector problems and pave the way for a recovery in credit flows.

**Figure 25. Bank balance sheet indicators**




Source: Staff calculations

## VI. Crisis Recovery and Exit From Fund Support

59. **Stabilization is taking hold, although a slow recovery could jeopardize debt sustainability and exit from Fund support in some program countries**. While the earlier stabilization than seen in past crises bodes well for recovery, exit from Fund support will likely hinge on continued progress in structural reforms to address pre-existing (external) and new (fiscal) vulnerabilities and on efforts to regain market access. From this perspective, a key unknown is whether potential growth will recover robustly post-crisis.

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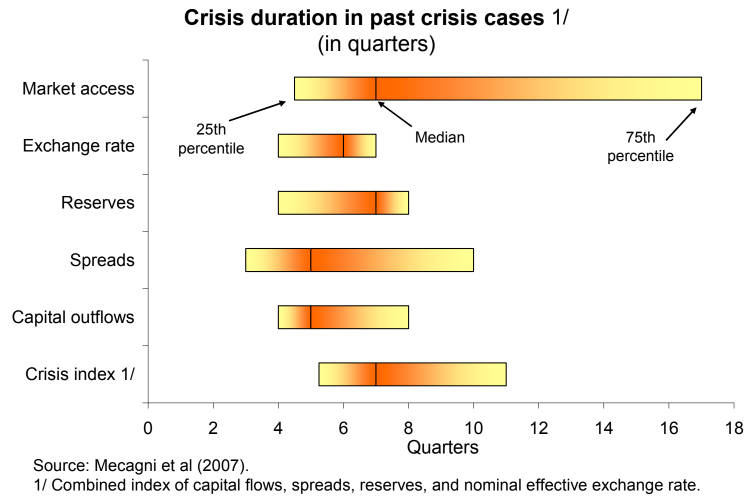
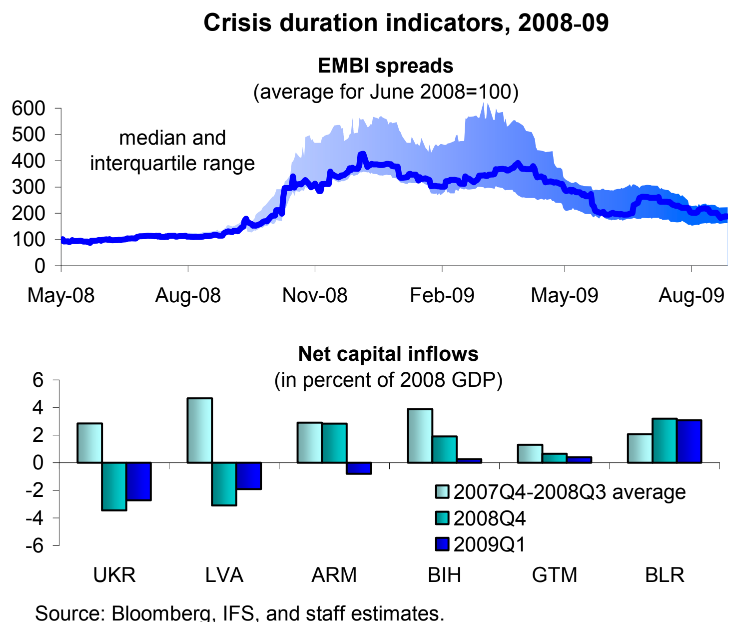
## A. Early signs of stabilization

60. **Evidence from previous crises points to a duration of capital and exchange market pressures of around two years**. In previous crisis episodes, spreads have returned to their pre-crisis levels, exchange rates have stabilized, and capital flows have resumed on average after about 1½ years of crisis inception (Mecagni et al, 2007). However, there has been greater variation in the time required to regain market access (defined as first primary issuance of international government bonds since the beginning of the crisis), although this may reflect cases where the country did not need to place bonds, despite having the capacity to do so at favorable rates (for instance, despite a V-shaped recovery, Korea's first sovereign bond issuance took place only several years after crisis inception).




61. **Stabilization in recent program cases appears so far to be on a relatively fast track compared to this past experience**. After almost a year since Lehman's bankruptcy, currencies have largely stabilized in all program countries, barring for Ukraine, which remains subject to bouts of market volatility. And, although spreads remain well above their pre-Lehman level, they have declined significantly since April, in line with developments elsewhere. In particular, with some exceptions, median values for spreads are significantly below their pre-SBA approval levels. Capital inflows have also resumed, albeit at low levels, to most countries except for Latvia and Ukraine, partly thanks to continued net inflows of FDI, EU transfers, and portfolio flows. The recent market stabilization has also created a window of opportunity for sovereign Eurobond placements. Among program countries, Hungary successfully placed a five-year €1 billion Eurobond in July, and Romania has announced plans to issue a €0.5–1 billion Eurobond in September 2009.

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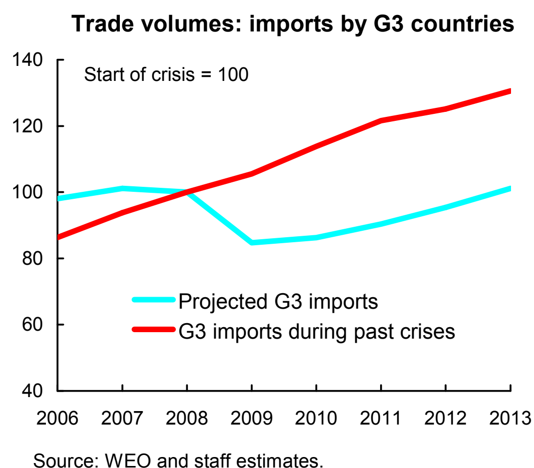
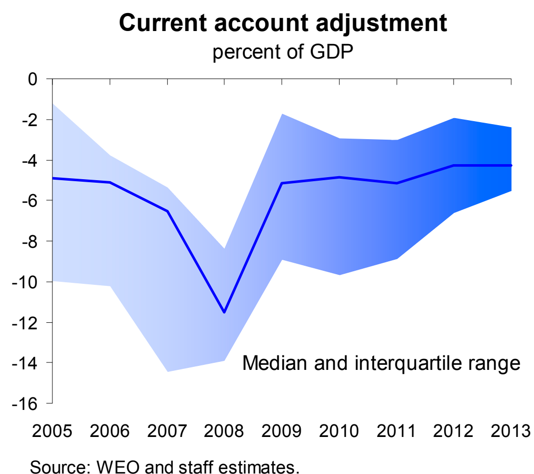
## B. Recovery and risks to external sustainability

62. **Following the sharp downturn in 2009, the recovery in program countries is projected to be slow, with large downside risks**. Current program countries are unlikely to be able to benefit from the buoyant external demand and large exchange rate adjustments that have underpinned export-driven recoveries in past crises. As a result, the recovery in current programs is expected to be more subdued than in previous crises. Relatedly, it is as yet unclear whether potential growth can return to the rates seen in the past, which puts a premium on making rapid progress in structural reforms.



Source: WEO and staff estimates.

63. **Medium-term current account adjustments are projected to be limited in most cases, pointing to continued large external financing pressures**. With a few exceptions, following the fluctuations in 2008–09, current account deficits are expected to return to levels only marginally below pre-crisis, which is in stark contrast to the sharp current account turnarounds observed in past crises. But, if these projections prove accurate, the vulnerabilities that contributed to this crisis will continue to persist in the medium term.



Source: WEO and staff estimates.

64. **However, continued current account deficits do not necessarily imply external debt sustainability problems**. Given projected FDI, EU capital transfers, and other nondebt creating flows, in most cases external debt is projected to remain manageable, though there are significant downside risks to this outlook (Figure 26). Moreover, even compared to the highest debt cases of past crises, Iceland and Latvia face a very challenging debt burden, made heavier by low growth and deflation. Hungary also shows only a slowly declining trend, with the external debt ratio remaining well above 100 percent of GDP mainly due to weak long-term growth.

65. **Continued large financing needs and high debt ratios pose risks to regaining full market access, both for the private and public sectors**. The timing and extent to which program countries will have access to market financing has a bearing on their capacity to repay the Fund.

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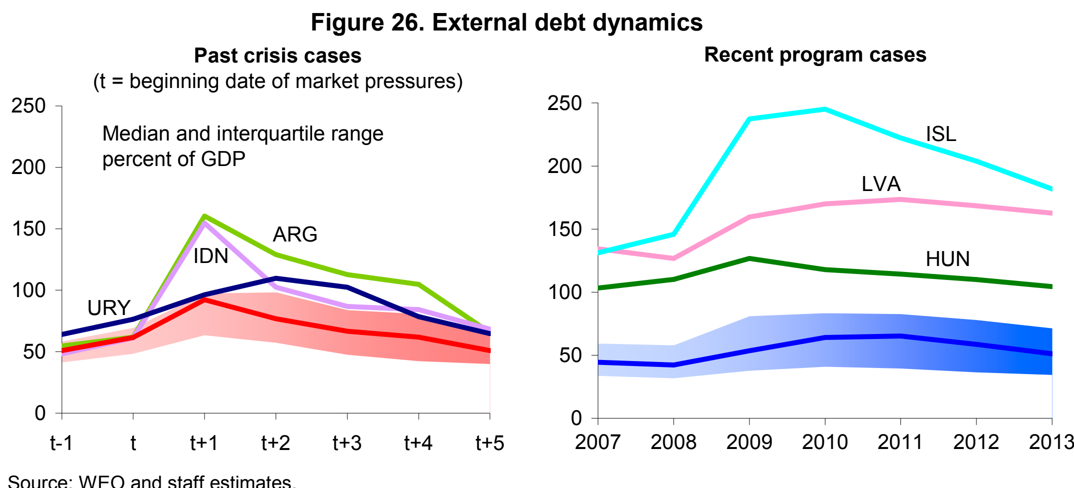


Source: WEO and staff estimates.

## C. Exit from Fund support

66. **The length of current Fund arrangements is comparable to that of past cases at inception, but extensions and successor arrangements are a possibility**. Current programs have an average duration of about two years in line with past programs. Nevertheless, in the past, several programs have been extended and successor arrangements put in place, with the overall duration of Fund support reaching 10 years for Uruguay, nine years for Turkey, and eight years—on a precautionary basis—for Peru. Almost 20 percent of past extensions have also entailed augmentation of access—notable are the cases of Uruguay and Brazil in 2002 (with the latter arrangement turning precautionary at the time of its extension) and Serbia in 2009. Thus, if downside risks to the global economy materialize, extensions of current arrangements or successor arrangements may be required for some current program cases. In contrast, early exits from Fund support and greater use of precautionary financing could well occur if upside risks materialize. Following the program period, capacity to repay the Fund would be monitored in most current program countries under Post-Program Monitoring.

# VII. Conclusions and Issues for Discussion

67. **The Fund-supported programs are helping countries to weather the worst of the crisis**. Exchange and interest rate overshooting, excessive current account adjustment, and banking crises have generally been avoided—although banking problems typically lag the economic cycle. These outcomes have helped prevent already sharp declines in output and employment from becoming more catastrophic collapses, and have spurred early signs of stabilization. Nevertheless, there are clear risks ahead, both of further deteriorations in some program countries (including from a lack of durability of policy commitments) and of adverse shocks from a worsening global environment. Withdrawal of stimulus and unwinding of emergency financial sector support in advanced countries could also have adverse effects on program country recoveries and banking systems.

68. **Policy settings appear to be broadly right in most cases but it is too early to be definitive on this point**. Absent more clarity about the future course of growth in the program countries and the external environment, it is impossible to evaluate whether policies

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represent the optimal balance of short-term accommodation and medium-term adjustment. But the analysis in the paper suggests that policies are appropriate and consistently applied, in the sense that policy settings across countries can generally be explained by a combination of common factors, initial conditions, and individual country circumstances.

69. **The new program cases have differed sharply from past crises, but much less so from other comparable emerging market countries caught up in the present crisis**. This has been the case both in terms of economic outcomes (growth, inflation, current account adjustment, real exchange rates, and bank distress) as well as policies (fiscal expansion, exchange rate policy, and monetary and financial sector policies). Two possible interpretations of this finding are:

- **First, compared to the past, this crisis has been more imported than home-grown, allowing more accommodative policy responses**. While initial vulnerabilities, in particular large current account imbalances, contributed to the scale of economic distress, the balance between external shocks and domestic policy weaknesses was much more tilted to the former than in past cases. In such circumstances, the appropriate role of the Fund has been to provide countries with needed financing to bridge to an improvement in external conditions, while imposing fewer restrictions on the countries' policy choices. Countries' own choices of exchange rate regimes have largely been supported, fiscal policy has been loosened to a large extent in response to declining output and government revenue, and interest rate hikes have been relatively modest. Structural conditionality also appears to have been less intrusive than in the past.

- **Second, program design has learned the lessons of the past**. This too appears to have validity, in particular regarding the rapid provision of large-scale, frontloaded financing, and flexible use for both private and public sector support; the importance of protecting the financial sector from liquidity squeezes and exchange rate shocks; and structural measures focused better on areas of vulnerability.

70. **Directors may wish to consider whether these observations are accurate and if mid-course adjustments are required in existing programs**:

- *Was the mix of fiscal and monetary policy accommodation adequate or insufficient to deal with the large output losses observed in many countries ?*
- *When should the focus shift to address underlying vulnerabilities that led countries to need support in the first place, including fiscal and external sustainability?*
- *Has the heterogeneous approach to exchange rate regimes been successful? Is there a risk that real exchange rates will be maintained at too appreciated a level?*
- *What explains the relative success in avoiding more serious financial sector problems, and will further efforts be required to address deteriorating credit quality?*

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## Appendix I. Current Nonconcessional Arrangements

**Access under arrangements currently in place**

(As of August 6, 2009)

(In percent of quota, unless otherwise indicated)

| | | IMF | | | | | | | | Burden sharing | | | **Total Financing Package** |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | Effective date of arrangement | Exceptional Access 1/ | Precautionary 2/ | Duration *(months)* | Amount of arrangement *(US$ m)* | Amount of arrangement *(% of quota)* | Average annualized rate of access 3/ | Balance drawn as of 8/6/09 *(US$ m)* | EU *(US$ m)* | WB *(US$ m)* | Other *(US$ m)* | ***(US$ m)*** |
| **Stand-By Arrangements** 4/ | | | | | | | | | | | | | |
| Armenia, Republic of | ARM | 3/6/2009 | • | | 28 | 838 | 580 | 249 | 416 | 0 | 525 | 637 | 2,000 |
| Belarus, Republic of | BLR | 1/12/2009 | • | | 15 | 3,560 | 587 | 470 | 1,499 | 0 | 200 | 1000 | 4,760 |
| Bosnia & Herzegovina | BIH | 7/8/2009 | | | 36 | 1,592 | 600 | 200 | 287 | 137 | 259 | 74 | 2,062 |
| Costa Rica | CRI | 4/11/2009 | • | • | 15 | 772 | 300 | 240 | 0 | 0 | 500 | 500 | 1,772 |
| El Salvador | SLV | 1/16/2009 | • | • | 14 | 806 | 300 | 257 | 0 | 0 | 450 | 900 | 2,156 |
| Gabon | GAB | 5/7/2007 | | • | 36 | 121 | 50 | 17 | 0 | … | … | … | 121 |
| Georgia | GEO | 9/15/2008 | • | | 32 | 1,172 | 497 | 186 | 452 | 184 | 328 | 606 | 2,290 |
| Guatemala | GTM | 4/22/2009 | • | • | 18 | 989 | 300 | 200 | 0 | 0 | 393 | 361 | 1,743 |
| Hungary | HUN | 11/6/2008 | • | | 17 | 16,529 | 1,015 | 716 | 11,900 | 8400 | 1300 | 0 | 26,229 |
| Iceland | ISL | 11/19/2008 | • | | 24 | 2,196 | 1,190 | 595 | 878 | 100 | 0 | 9000 | 11,296 |
| Latvia, Republic of | LVA | 12/23/2008 | • | | 27 | 2,387 | 1,200 | 533 | 840 | 4382 | 565 | 3251 | 10,584 |
| Mongolia | MNG | 4/1/2009 | • | | 18 | 240 | 300 | 200 | 120 | 0 | 60 | 125 | 425 |
| Pakistan | PAK | 11/24/2008 | • | | 23 | 11,349 | 700 | 365 | 7,376 | 0 | 3400 | 6800 | 21,549 |
| Romania | ROM | 5/4/2009 | • | | 24 | 17,948 | 1,111 | 555 | 6,854 | 6550 | 1310 | 1310 | 27,118 |
| Serbia, Republic of 5/ | SRB | 1/16/2009 | • | | 27 | 4,108 | 560 | 249 | 1,100 | 411 | 350 | 0 | 4,869 |
| Seychelles | SYC | 11/14/2008 | | | 24 | 28 | 200 | 100 | 12 | … | … | … | 28 |
| Sri Lanka | SRL | 7/24/2009 | | | 20 | 2,594 | 400 | 240 | 325 | … | … | … | 2,594 |
| Ukraine | UKR | 11/5/2008 | • | | 24 | 17,253 | 802 | 401 | 10,979 | 1000 | 1750 | 1250 | 21,253 |
| *Total SBAs* | | | | | | *84,482* | | | *43,039* | *21,164* | *11,391* | *25,814* | *142,850* |
| **Flexible Credit Lines** | | | | | | | | | | | | | |
| Colombia | COL | 5/11/2009 | • | • | 12 | 10,926 | 900 | 900 | 0 | … | … | … | 10,926 |
| Mexico | MEX | 4/17/2009 | • | • | 12 | 49,451 | 1,000 | 1,000 | 0 | … | … | … | 49,451 |
| Poland | POL | 5/6/2009 | • | • | 12 | 21,472 | 1,000 | 1,000 | 0 | … | … | … | 21,472 |
| *Total FCLs* | | | | | | *81,849* | | | *0* | | | | *81,849* |
| **Grand Total** | | | | | | **166,331** | | | **43,039** | | | | **224,699** |

Sources: Executive Board documents, and information provided by the Finance Department.

1/ Programs with total access of over 600 percent of quota, or an annual access of over 200 percent of quota, are considered "exceptional access." Programs noted above were exceptional access at the time of approval.

2/ Stand-By Arrangements wherein members have stated their desire not to draw on available resources are termed "precautionary" arrangements.

3/ Total access in terms of quota divided by length of arrangement (in years), except where otherwise specified.

4/ The current paper covers all SBAs, with the exceptions of Gabon, Seychelles, and Sri Lanka.

5/ Approved on 12/19/08 as a precautionary SBA with total access of 75 percent of quota. Table shows amounts post augmentation (and conversion to a non-precautionary status).



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## Appendix II. Recent Cases of Direct Budget Support

| Country | Central bank independence | BoP need justification | Rationale for direct budget support |
|---|---|---|---|
| **Hungary** (November 2008) | Yes, direct central bank lending to the government not allowed. | Multiple needs, including financing of the current account deficit, financial sector support, and increasing gross reserves. | The first two purchases under the SBA were disbursed to the government through its agent, the Hungarian Debt Management Office. Part of the resources were set aside for the bank support package and some were lent to domestic banks to help with immediate funding needs. The government also used the domestic currency counterpart of part of the Fund purchase to meet the government's financing need, partly due to nonresidents reducing their holdings of domestic currency government bonds. The associated increase in domestic liquidity was sterilized through the issuance of central bank bills. |
| **Latvia** (November 2008) | Yes, quasi currency board arrangement. | Loss of international reserves, needed to bolster the banking system and to re-establish confidence. | The government faced acute liquidity constraints because of the increasing fiscal deficit and the need to provide liquidity assistance to a systemically important bank (and potentially others) that could not be channeled through the Bank of Latvia. |
| **Ukraine** (November 2008) | Yes. Its preservation is a key program objective. | Rebuild gross international reserves. | Sharp revenue shortfalls, the lack of access to international capital markets, and an underdeveloped domestic bond market meant that there were no realistic alternatives but to finance the programmed budget deficit target using Fund resources. Direct budgetary support from the Fund was seen as preferable to (indirect) central bank financing of the deficit as it helped preserve the independence of the central bank and prevented the entrenchment of monetization mechanisms that would burden the institutional set up in Ukraine going forward. |
| **Armenia** (March 2009) | Direct central bank lending to the government not allowed. | Increase gross reserves and address the current account deficit. | Fiscal policy was eased in response to the crisis, which led to pressure on the balance of payments, and resources from the augmentation were therefore transferred directly to the government to address the resultant balance of payments needs. In the absence of additional financing for fiscal purposes, Armenia would have been forced into a more severe external and domestic adjustment that would further worsen growth and require sizeable cuts in social spending. |
| **Georgia** (August 2009 Augmentation) | Direct central bank lending to the government not allowed. | Increase gross reserves, address current account deficit in the face of a more prolonged global crisis than originally envisaged. | Part of the support provided by the Fund in 2009 and all the support for 2010 is to be used to finance directly a higher fiscal deficit stemming from a sharper-than-expected economic slowdown. Given Georgia's under-developed domestic financial markets, Fund financing would allow a less restrictive fiscal policy while avoiding funding pressures and maintaining adequate reserve coverage. |
| **Pakistan** (August 2009 Augmentation) | Limits on direct central bank lending to the government. | Allow for a further strengthening of gross reserves to deal with increased risks to the external outlook. | The augmentation was also designed to pave the way for a donor-supported relaxation of the fiscal deficit target in 2009/10. The program envisages that a portion of Fund credit (92 percent of quota) be used to finance the social spending element of the expanded budget as a bridge loan in advance of pledged donor support so as to reduce pressure from associated budgetary imports as a result of backloaded donor inflows. |

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