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In Defense of the IMF

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Response

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Specialized Tools for a Specialized Task

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Martin Feldstein makes three criticisms of the International Monetary Fund's remedies for the Asian crisis ("Refocusing the IMF," March/April 1998). First, he argues that they are simply the same old IMF austerity medicine, inappropriately dispensed to countries suffering from a different malady. Second—and the main theme—he contends that by including in the program a number of structural elements, the IMF is unwisely going beyond its essential task of correcting the balance of payments and intruding into the countries' political processes. Third, he is troubled by the problem of moral hazard—the bailout issue.

In fact, the IMF-supported programs in Thailand, Indonesia, and South Korea are anything but the usual medicine, precisely because of their heavy structural components, which are included because structural problems lie at the heart of the economic crises in the three countries. To ignore the structural issues would invite a repetition of the crisis. The macroeconomic parts of these programs consist of a combination of tight money to restore confidence in the currency and a modest firming up of fiscal policy to offset in part the massive costs of financial restructuring. And the moral hazard concern, while essential to deal with, is easily exaggerated. Before turning to these issues, a brief discussion of the origins of the crisis is helpful.

CAUSES AND CONTAGION

The economic crisis in Asia unfolded against the backdrop of several decades of outstanding economic performance. Nevertheless, in 1996 some problems were becoming evident. First, Thailand and other countries were showing signs of overheating in the form of large trade deficits and real estate and stock market

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bubbles. Second, pegged exchange-rate regimes had been maintained for too long, encouraging heavy external borrowing, which led, in turn, to excessive foreign exchange risk exposure on the part of domestic financial institutions and corporations. Third, lax prudential rules and financial oversight had permitted the quality of banks' loan portfolios to deteriorate sharply.

Developments in the advanced economies and global financial markets also contributed to the unstable situation. Large private capital flows to emerging markets were driven in part by low interest rates in Japan and Europe, along with international investors' imprudent search for high yields. The appreciation of the dollar (to which local currencies were pegged) against the yen in mid-1995 was also important.

In Thailand, the crisis, if not its exact timing, was predicted. In the 18 months leading up to the floating of the Thai baht in July 1997, neither the IMF in its continuous dialogue with the Thai authorities nor increasing market pressure could overcome the government's reluctance to take action. Finally, in the absence of convincing policy action, and after Thailand had used up a large part of its reserves, the crisis broke out.

Should the IMF have gone public with its fears of a crisis? While the IMF knew that Thailand was extremely vulnerable, it could not predict with certainty whether, or when, a crisis would strike. For the IMF fire brigade to arrive with lights flashing and sirens wailing before a crisis occurs risks provoking a crisis that might not otherwise happen. That was not a risk that should have been taken.

Once the crisis hit Thailand, the contagion was relentless. Some of the infection reflected rational market behavior. The depreciation of the baht made Thai exports cheaper and therefore put downward pressure on neighbors' currencies. Moreover, after the Thai devaluation, investors took a closer look at Indonesia, South Korea, and neighboring countries and saw similar problems, particularly in the financial sector. Further, as currencies fell, residents rushed to buy foreign exchange to cover their dollar liabilities, intensifying exchange-rate pressures. But even if individual market participants behaved rationally, currencies depreciated far more than was required to correct their overvaluation. Put bluntly, markets overreacted.

Thailand, Indonesia, and South Korea faced a number of similar problems, including the loss of market confidence, deep currency depreciation, weak financial systems, and excessive unhedged foreign borrowing. All suffered from a lack of transparency about the ties between government, business, and banks. But when they requested IMF assistance, the countries also differed in the size of their current account deficits and the stages of crisis they were in. The design of the programs reflects these similarities and differences.

TOO TOUGH?

When they approached the IMF, Thailand and South Korea had perilously low reserves, and the Indonesian rupiah was excessively depreciated. The first order of business was to restore confidence in the currencies. To achieve this, countries have to make their currencies more attractive, which requires increasing interest rates temporarily—even if higher interest costs complicate the situation of weak banks and corporations. Once confidence is restored, interest rates can return to more normal levels.

Why not operate with lower interest rates and a greater devaluation? This is a relevant tradeoff, but there can be no question that the degree of devaluation of the Asian currencies from mid-1997 to the trough in early 1998 was excessive, for both the individual countries and the international system.

On the appropriate degree of fiscal tightening, the balance is a particularly fine one. At the onset of the crisis, countries needed to firm up their finances, both to cover the costs of financial restructuring, and—depending on the balance-of-payments situation—to reduce their current account deficits, which depend in part on the budget deficit. In calculating the fiscal tightening needed to offset financial restructuring costs, the programs included the expected interest costs—not the capital costs—to spread the costs of the adjustment over more time.

In Indonesia, the initial fiscal adjustment was one percent of GDP. In South Korea it was 1.5 percent of GDP. And in Thailand—reflecting its large current account deficit—it was 3 percent of GDP. After these initial adjustments, if the economic situation in a country weakens more than expected, as it has in these three Asian countries, the IMF has generally agreed to let the deficit widen and the stimulus of increased social spending and deficit expenditure take effect.

Thus in the macroeconomic picture, monetary policy had to be tight to restore confidence in the currency, and fiscal policy was tightened appropriately but not excessively at the start of each program, with automatic stabilizers subsequently allowed to work.

THE CENTRAL QUESTION

Feldstein proposes three questions the IMF should consider in deciding whether to include a particular measure in a program: whether it is needed to restore access to international capital markets, whether it is a technical measure that does not interfere unnecessarily with the jurisdiction of a sovereign government, and whether the IMF would ask for similar measures in major industrial countries. The IMF programs for the countries embroiled in the Asian crisis pass all three tests.

However, these three criteria omit the central question: Does the program address the underlying causes of the crisis? Financial sector and other structural reforms are vital to the reform programs of Thailand, Indonesia, and South Korea because the problems of weak financial institutions, inadequate bank regulation and supervision, and the complicated and non-transparent relations among governments, banks, and corporations were central to the economic crisis. IMF lending to these countries would serve no purpose if these problems were not addressed. Nor would it be in the countries' interest to leave the structural and governance issues aside: markets are skeptical of halfhearted reform efforts.

The charge that the IMF risks a moral hazard by coming to the assistance of countries in crisis has two parts: that officials in member countries may take excessive risks because they know the IMF will be there to bail them out, and that because the IMF will come to the rescue, investors do not appraise risks accurately and are too willing to lend. To think that policymakers pursue risky courses of action because they know the IMF safety net will catch them if things go badly is far-fetched. Countries try to avoid going to the fund; policymakers whose countries end up in trouble generally do not survive politically. In this regard, attaching conditions to assistance gives policymakers incentives to do the right thing. Indeed, these incentives have been evident in the preemptive reforms some countries have adopted.

The thornier issues arise on the side of investors. Most investors in the Asian crisis countries have taken heavy losses, including equity investors and many who lent to corporations and banks. By the end of 1997, foreign equity investors had lost nearly three-quarters of the value of their equity holdings in some Asian markets. Many Asian firms and financial institutions will, unfortunately, go bankrupt, and their foreign and domestic lenders will share the losses. Some short-term creditors, notably those involved in the interbank market, were protected for a while because the IMF sought to avert a formal debt moratorium for fear it would lead to a rapid withdrawal of funds from other countries. In the case of South Korea, the creditor banks have now been bailed *in,* and a similar process is getting under way in Indonesia. Further, earnings reports indicate that, overall, the crisis has been costly for foreign commercial banks.

None of this is to deny the existence of a moral hazard. Better ways of dealing with it must be found. But surely investors will not conclude that they need not worry about risks because the IMF will save them. Investors have been hit hard, as they should have been, for lending unwisely.

BRINGING BACK GROWTH

The alternative proposed by some critics is to leave it to countries and their creditors to sort out their debts. Given that the debts involved generally include both public and private obligations, and because everyone benefits whether or not they make the sacrifices necessary to help out, the experience—from the interwar period and the 1980s—is that such solutions have been protracted and that countries that have undertaken them have been denied market access for a long time at a significant cost to growth. By contrast, in the Mexican crisis of 1994-95, market access was regained in just a few months, and within a year Mexico, assisted by its ability to tap international capital markets, registered impressive growth. Similarly, South Korea has already returned to international markets, and Thailand will soon. The second reason that the IMF tried to help countries avoid a standstill was a fear of contagion. The IMF continues to believe that a standstill in one country, when markets were highly sensitive, would have spread to other countries and possibly other continents.

The basic approach of the IMF to these crises has been appropriate—not perfect, to be sure, but far better than if the structural elements had been ignored or the fund had not been involved. Of course, one cannot know for certain what would have happened had there been no official lending. But despite the instability in Indonesia, the crisis has been contained, and it is reasonable to believe that, deep and unfortunate as the crises in individual countries have been, growth in Korea and Thailand can resume by the end of the year.