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A. The Asian Crisis: Origins, Policy Response, and Lessons

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I am very grateful to have been invited on behalf of the IMF to take part in this important ILO Symposium. Cooperation between our institutions has continued to develop in recent years, most notably in our work in the field in a number of pilot country cases now under way, as well as in helping Indonesia implement international labor standards. We in the IMF see many benefits for our members from this cooperation, and I hope that the ILO feels the same way about our joint efforts. And we look forward to the strengthening of our relationship with the ILO under the leadership of Director-General Somavia — and congratulate him on his recent election.

Our topic today, the Asian crisis, could not be more timely, so let me turn to it immediately.

1. Origins

The countries of East Asia did indeed achieve an economic miracle over the last three decades, during which the living standards of over a quarter of the world's people increased more rapidly than ever before in history. This extraordinary success was based on outward-oriented policies, high rates of saving and investment, investments in human capital, entrepreneurship, sheer hard work, governments oriented to economic development, and prudent macroeconomic policies. That is why the crisis that beset the region starting in July 1997 — and particularly its depth and breadth — came as such a shock.

The Asian crisis has differed from previous financial crises in a number of respects. Although country circumstances varied, its origins lay primarily in the capital account rather than the current account of the balance of payments, and also in financial sector and other structural weaknesses. Conventional fiscal imbalances were relatively small. Broadly similar elements were present in the three crisis countries that have IMF programs — Indonesia, Korea, and Thailand:

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- Financial sector weaknesses, stemming from inadequate supervision and regulation and an excessive governmental role in the allocation of credit, along with poor corporate governance, led to a misallocation of credit, excessive borrowing, and inflated asset prices.

- These problems were exacerbated by large private short-term foreign currency borrowings, directly or indirectly encouraged by the governments later hit by the crisis, and increased not only by excessive risk-taking by corporations in the crisis countries, but also by inadequate risk assessment and low interest rates in the creditor countries.

- The limited degree of exchange rate variability prior to the crisis encouraged unhedged foreign currency borrowing that made currencies vulnerable to speculative attacks.

- Such a setting made the crisis countries extremely vulnerable to even a modest deterioration in the economic environment. A slowing of export growth in 1996, a result in part of the appreciation of the dollar-pegged local currencies, coupled with a decline in the prices of key export commodities, began to put pressure on external balances and economic growth. This led to a deterioration in corporate finances and bank soundness, which changed the perceptions of foreign investors. Rapid reversals of capital inflows, spreading through contagion, deepened and broadened the crisis.

2. The Policy Response

Policies adopted by the governments in the three crisis countries to deal with the crisis needed to be adapted to the distinctive features of the crisis. With the crisis reflecting deep-seated structural weaknesses, as well as in Thailand and Korea a virtual exhaustion of foreign exchange reserves, the policy response had three main features:

- First, an adjustment in macroeconomic policies aimed at restoring confidence, containing inflationary pressures, and limiting the outflow of capital. With fiscal imbalances relatively small, the planned fiscal policy tightening was modest, aimed mainly at easing the adjustment burden on the private sector imposed by the net outflow of private capital and corresponding current account adjustment. And, as the magnitude of the unexpectedly large economic downturn in each country became clearer, the fiscal policy stance was progressively eased. Monetary policy was assigned the task of seeking to contain the outflow of capital, which was putting strong downward pressure on exchange rates. This policy was aimed at avoiding depreciation-exchange rate spirals, a cycle of competitive devaluations, and undue burdens on the financial and corporate sectors that had borrowed heavily in dollars.

- Second, a comprehensive set of structural reforms aimed at re-establishing financial systems on a sound footing, restructuring corporate debt, and addressing problems of corporate governance, thereby helping put in place the conditions for a resumption of sustainable growth over the longer term.

- Third, large financing packages provided by the IMF and other international multilateral and bilateral agencies. The approach here aimed at providing a sufficiently large package to make an important direct contribution to easing the financing constraint while also helping restore market confidence quickly, thereby contributing to a reversal of capital outflows.

This is not the occasion to provide a detailed review and assessment of the IMF-supported programs in the three large Asian crisis countries. This has been done at length in the IMF's report that was issued in January and that is available on our website. The conclusion from our recent self-assessment is that the strategy was broadly appropriate — and it is now clearly yielding results. Although uncertainties about the political and security situations have contributed to recent exchange rate volatility and set back prospects for economic recovery in Indonesia, a turnaround is under way in Korea and Thailand: pressures on currency markets have eased or reversed, interest rates have come down to very low levels, fiscal policies have turned to stimulus — the thrust of macroeconomic policies is now reflationary — and recession is beginning to turn to growth.

3. **Social sector policies**

I would like to dwell for a moment on social sector policies in these economic programs. In case there is any doubt on the issue, let me state that the Executive Board of the IMF, the staff, and the management, all regard it as essential that programs attempt to ameliorate the impacts that the crisis and the associated need for adjustment are bound to have on the poor and vulnerable segments of society. While the IMF must and does accept the responsibility for ensuring that such measures are included in IMF-supported programs, I should note that in the division of labor between the World Bank and the IMF, our mutual shareholders have given the primary responsibility for dealing with social welfare issues to the Bank. We of course work closely with both the Bank and the ADB in dealing with these and other aspects of the crisis.

In the Asian context, where social programs before the crisis were not well developed, programs to deal with the social impacts of the crisis were bound to take time to put in place. Nonetheless, the intent to develop such measures was explicit from the beginning, in the first letters of intent. These elements of the programs were developed primarily by the countries together with the World Bank and ADB and put in place as rapidly as possible.

The social sector policies included measures to limit unemployment, increase income transfers, and broaden social safety nets. Let me give a few examples:

- In Indonesia, policies focussed on the availability of key commodities and services at subsidized prices, and on limiting unemployment. The program allowed for substantial subsidies on rice and other basic foodstuffs, as well as on fuel, electricity, and essential drugs. Mostly financed by the World Bank, ADB and other foreign donors, labor-intensive public works and temporary employment programs were introduced and expanded over time.

- In Thailand, in addition to subsidies on urban bus and rail transport and support to health and education, a broad range of measures were included to provide jobs and increase support for the unemployed. These included temporary civil works projects, the expansion of severance pay provided by employers, and the extension of eligibility for social security benefits to the unemployed.

- In Korea, most notable are the labor market reforms based on the Tripartite Agreement that brought together the representatives of government, business and labor unions. These reforms included an expansion in the coverage and eligibility requirements of the unemployment insurance scheme, together with an increase in benefits. Public works program were expanded, and budgeted social assistance allocations were raised significantly.

In designing social sector policies, the programs sought to target assistance to the most vulnerable while maintaining labor market flexibility and avoiding an unsustainable burden on the budget. Given the severity of the economic downturn, and the absence of well-developed social insurance programs before the crisis, it was unfortunately inevitable that social misery would increase substantially during the crises. Nonetheless the programs accepted large increases in budget outlays on social programs — for 1998, from 2 percent of GDP for Korea to 6 percent of GDP in Indonesia.

4. Lessons from the Crisis

Notwithstanding the conclusion from our recent study that the approach taken to dealing with the crisis — and particularly the decision to move as rapidly as possible on financial sector and corporate debt restructuring — was broadly appropriate, that the doom and gloom at the height of the crisis now seems to be giving way to increased confidence regarding prospects for recovery, and that steps have been taken to mitigate the impact of the crisis on society, we of course must do better. Indeed, there is a broad consensus that both individual countries and the international financial system need to adapt to the new circumstances of globally integrated financial markets, to reduce the volatility of international capital flows and to increase the resiliency of financial systems and economies to the shifts in market confidence and investor sentiment that will certainly occur in future.

To that end, work is under way, some of it inside the IMF, to identify the key policy requirements and policy reforms. This work involves three sets of players: governments and

the private sector in the emerging market economies; governments and the private sector in the lending countries — that is, the industrialized countries; and international institutions. These reforms to the international financial system have been the subject of countless papers and conferences, and already several books, but allow me to summarize briefly.

In **emerging market countries**, efforts should focus on the following areas:

- First, of course, sound **macroeconomic policies**. Here one lesson relates to the choice of exchange rate regime. Fixed exchange rate systems are crisis-prone. We are thus likely in coming years to see more countries adopting flexible exchange rate systems or, if they choose to fix, to do so in a definitive way, for example by adopting a currency board arrangement.

- Second, steps to **strengthen the financial system, especially the banking system.** A weak banking system has been at the heart of all the Asian crises, and preventive efforts to strengthen supervision and prudential regulation, as well as restructuring and recapitalizing banking systems already under stress, are critical.

- Third, provision of better **economic and financial information** on private and public sector activities, which will also require efforts toward the adoption of sound accounting and disclosure standards.

- Fourth, better **corporate governance and more prudent methods of corporate finance**, accompanied by the establishment and implementation of appropriate bankruptcy legislation and procedures.

- Fifth, **dealing with international capital flows** and finding the appropriate response to capital flow reversals. It is clear that countries need to be cautious in both the pace and sequencing of capital account liberalization, and that it is a mistake to start liberalizing the capital account at the short end. For countries with weak financial systems in particular, there can be benefits from imposing market-based controls, Chilean-style, on capital inflows, designed to shift flows to the longer term. But despite the concerns over this issue that have been raised at various stages of the crisis, almost all countries have concluded they have much to gain from participation in the international capital markets — and it is thus also clear that capital account liberalization will continue.

In the **advanced industrialized countries,** a major hurdle was passed last year with the approval of the IMF quota increase. This confirmed the commitment of its membership to the IMF's role as lender to countries experiencing balance of payments crises, to cushion the disruptive effects of crises on economic conditions in these countries. In addition:

- **Prosperity in the world economy requires growth in the industrialized countries** and macroeconomic policies should be aimed at that goal.

- The industrial economies need to ensure the **maintenance of healthy financial systems** in their own countries. In that regard discussions are now under way as to how to monitor and regulate the activities of highly leveraged institutions.

And of course, **the international financial institutions** have to do their part to improve the resiliency of the system. And we are accepting those responsibilities. Examples of ongoing initiatives are:

- The **design and adoption of international standards and principles** aimed at strengthening financial and corporate governance.

- International efforts to encourage the improved **provision of better economic and financial data** to the public by emerging market economies.

- **Strengthening the process of surveillance,** to detect emerging problems in specific countries and in the system as a whole, as well as to help in the adoption of international standards.

- Potential **changes in IFI lending facilities and practices**. At the end of 1997, the IMF introduced the Supplementary Reserve Facility, or SRF, which makes it possible to provide large short-term loans to countries undertaking strong adjustment programs. This new facility was used for the first time in the Korean case. We are now considering a new Contingency Lending Facility, which could provide precautionary loans to countries with generally good policies facing risks of contagion.

- Finally, efforts are being made to deal with what is probably the most difficult issue in modern crisis prevention and management: **how to involve the private sector**. Uncertainties regarding the restoration of market confidence and the behavior of private creditors were a major risk in all the Asian crisis programs. In the event, the adjustment process was severely complicated by market reactions that were considerably less favorable than hoped for. Efforts to involve the private sector are intended both to ensure adequate financing for countries facing balance of payments difficulties and to strengthen market discipline and help limit moral hazard in international capital markets. Proposals in this area have been debated in numerous fora, including the G-7, G-10, G-22, and IMF — and I believe we made significant progress in this direction in recent Board discussions. There are no easy solutions: steps that make it easier to involve private creditors once a crisis is under way may cause investors to run sooner and faster in anticipation of a crisis, thus increasing the

likelihood of crises; and solutions in one country may spread contagion to other markets.

5. Conclusions

- The strategies adopted by Asian crisis countries, with the support of the IMF and other IFIs and the ILO, are beginning to work. Nonetheless, much work remains to be done, particularly in corporate debt restructuring, to assure a full recovery and return to high rates of growth.
- Increasingly, as the crisis has proceeded, governments with support from the international financial institutions have put in place measures to help ameliorate the adverse social consequences of the crisis. These measures can be seen as contributing to the strengthening of officially-provided social safety nets in the countries of the region.
- In many countries, policy changes are needed to contain the risks associated with domestic financial liberalization and openness to international capital flows.
- Governments need to provide a suitable regulatory framework to support efficient markets, as well as to sustain appropriate macro policies.
- The IFIs and industrialized country governments should move rapidly to strengthen the international system — and fortunately that work is now getting under way.

Thank you.