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As delivered

The Asian Crisis and Implications for Other Economies

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1. We are meeting at a time of intense pressure in emerging markets, particularly in Asia and Russia, and of major economic difficulties in Japan. It is a time for determined policies, by individual countries, and the international community.
2. It is also a time for the IMF to act--and that we have been doing. In Russia, we have been closely involved in the preparation of the latest set of policies, and look forward to Russia taking the actions that will enable the management of the IMF to recommend to our Executive Board within a short time to make the \$670 million disbursement that Russia is due to receive under the Extended Fund Facility program. We are also in continuous contact with other countries in that region, particularly Ukraine. In Asia, we work continuously with countries that have programs supported by us--Indonesia, Korea, the Philippines and Thailand--and with other member countries, including Malaysia and Japan, discussing with them ongoing events and their policy responses.
3. We are ready to do our duty, which is to provide assistance to help stabilize economies that may need financial help, provided they are willing to undertake appropriately ambitious economic reform and adjustment measures. As we have shown in the last 12 months, we are able to move rapidly and on a very significant scale to provide assistance to countries willing to undertake the necessary policy measures. In the case of Korea in late 1997, it took the IMF just two weeks from the day we were invited until the day our Executive Board approved the program, the largest in the IMF's history, for some \$21 billion. And we are still in a position to provide assistance to other of our members that may need it.
4. Of course, the Fund's ability to continue to play this role requires that the envisaged increase in our capital base -- the 45 percent quota increase, equivalent to about \$90 billion -- be implemented expeditiously. We hope that the turmoil of the last few days reminds our shareholders of the vital importance of taking action. A period of stubborn episodic fires that refuse to be extinguished and from time to time threaten to spread is not the time to delay funding the fire department -- even if you may think the institution could perhaps do with reform in some aspects of its operations, not least transparency. And I should say on the transparency front, that the management of the IMF would like to make more information and data available to the public, and that the Fund has been moving gradually

to do that over the last few years. Much of that information is available on the Fund's web site.

5. I will concentrate today on the epicenter of the current crisis, East Asia, and will cover three topics: first, the prospects for the crisis countries in Asia, including Indonesia; second, the critical economic policy choices that now confront Japan; and third, the implications of these events for emerging economies outside Asia, and of course, in particular for Brazil.

I. Prospects for the crisis countries

6. The financial turnaround in most of the Asian countries that went into crisis in 1997 began early this year--after Korea had, on Christmas Eve 1997, agreed with the banks on the rollover of their debt. Since the start of 1998, the Thai baht has risen by 11 percent and the Korean won by 20 percent; the baht is now worth about 40 percent less and the won 36 percent less in terms of dollars than in June 1997, a year ago. These devaluations are still large, but not as outrageously excessive as at the end of 1997. Around that time, the Korean currency, which had exchanged for Won 890 per dollar in June 1997, briefly reached a trough of Won 2000 per dollar -- it is now back in the neighborhood of 1400. The Thai currency, which was at the level of Baht 26 per dollar in June 1997 reached Baht 55 per dollar in January 1998--but is now in the range of 41-42.

7. While the currencies have rebounded, the Korean and Thai stock markets, which had begun to recover in early 1998, have fallen back a further 20 and 25 percent respectively since the end of 1997 and are down by very large amounts since mid-1997--Thailand by 47 percent and Korea by 59 percent. These are truly extraordinary declines. The currencies of Malaysia and the Philippines have been basically flat since the start of 1998 and they are down by about 35 percent since June 1997. Their stock markets are down by similar amounts since the middle of last year. So we have stabilization of currencies in the region but not yet stabilization of stock markets.

8. Economic activity has been hit very hard, with the output declines in 1998 now expected to be about 5 percent for both Thailand and Korea. Indonesia's output drop in 1998 is expected to exceed 10 percent and a decline is also likely in Malaysia. However, the Philippines economy still seems likely to register some growth in 1998.

9. The worst hit crisis country has been Indonesia, whose currency has lost an astonishing 83 percent of its value since the middle of last year, and 67 percent of its value since the beginning of 1998. These events teach lessons about the interactions of politics and economics at times of crisis, that we will no doubt analyze for many years. But I will not attempt to go into those lessons here. Now that the political transition has taken place, events are difficult to predict but the initial steps taken by the Habibie administration are promising, especially with regard to democratization and the promise of new elections by the end of next year. Further, the banks and the Indonesian Government have agreed on an approach for dealing with debt issues. This should provide some relief to the balance of payments.

10. If political stability and the reform momentum are maintained, the Indonesian government program with the IMF-- no doubt with some adjustments in light of the

changing circumstances -- should provide a basis for the gradual restoration of the health of the economy and investor confidence. Today there is an IMF team in Jakarta discussing a revised program with the authorities. There is no doubt that these discussions will bear fruit, since the cooperation between the Fund and the new Indonesian economic team is very close. It is reasonable to expect that next week there will be an agreement on the macroeconomic framework and the rest of the economic program and that the IMF will, within a matter of weeks, be able to resume disbursements to Indonesia--the next disbursement being a tranche of \$1 billion. We know, from all of the experiences in crises, that the restoration of confidence is never immediate. As we have seen in the Korean and Thai cases, credibility has to be earned -- it takes a long time, through actions, not promises. That will be doubly true in the Indonesian case.

11. We expected -- and we said as much -- that currency stability would return to the economies in crisis, provided they ran tight monetary policies and defended their exchange rates. Currency stability is returning. But we have also emphasized that the restoration of the stability of the currency is only the first step and that all these countries face politically -- and economically -- difficult periods of adjustment. In the period immediately ahead -- this month and the next two quarters, in particular -- these countries will have to deal with the hardest part of their economic programs, namely financial sector and corporate sector restructuring. This has been known for a long time, and it has been said for a long time, but the markets are apparently only now beginning to realize it.

12. There will be days and weeks and months ahead in which the East Asian currencies and financial markets will weaken and the authorities will be tested, as they have been this week. These are the periods in which the credibility of the authorities and their economic program can be strengthened -- or lost. This week, Korea and Thailand have stood fast, despite strong external pressures. Everything that both countries have done since the changes in government last year has indicated a strong willingness to carry through with difficult measures and to comply with the programs.

13. And if I may be permitted an aside, many observers once believed that it takes an authoritarian government to undertake economic reform. However, in both the Thai and the Korean cases, the programs did not start to succeed until there was a democratic change in government. It was extraordinary and salutary that, within a few days, the atmosphere shifted, the willingness of the governments to carry out the programs changed and the markets began to recover. We may discover that the same becomes true in the Indonesian case.

14. Returning to economic matters, the prime need is to follow through on the difficult structural reforms that are critical to restoring the long-term health of these economies. And that means, first of all, cleaning up the banking system. It also means, as the banking troubles are dealt with, financial restructuring and, in some cases, restructuring of the physical production plant of the economy. Banking sector plans are due to be presented in Korea by the end of this month, a few days from now, and should then be put into place during July. Such efforts are already underway in Thailand.

15. All these countries face both internal and external risks. Internally, governments could fail to follow through on politically difficult reforms -- possibly, and we saw this for a few days in some countries, because early successes lead to complacency, *or* because, although

willing, they cannot muster the political strength to overcome vested interests, *or* because they lose heart as the going gets tough. I do not expect any of these things to happen. The determination of the new Korean and Thai governments to follow through on their programs has been impressive. I expect it will be maintained.

16. But there is also the risk that the external environment will turn adverse. We are fortunate--both the global economy and individual countries, such as Brazil-- that this crisis comes at a time when the North American and European economies are growing strongly. Growth in North America and Europe seems likely to continue. But there remain often-expressed concerns about China and Japan, about the possibilities of a Chinese devaluation, and the dangers of continued slow growth and a deteriorating banking sector in Japan.

17. The Chinese authorities have left no doubts that they understand the importance of not devaluing, nor about their determination to avoid doing so. They understand that such a step could set off another round of devaluations in the region, thus frustrating its purpose. They understand also that it would most likely spark further financial instability, that would deepen the crisis from which the region is now painfully digging out. For this approach, they have earned the commendation of the international community. But as the yen weakened, they publicly expressed their concerns at the worsening regional environment, and the risks this posed for the stability of the renminbi. The concerted foreign exchange market intervention in support of the yen that began on Wednesday June 17 was surely in part a response to China's concerns, and to those of other countries in the region. And, since then, the Chinese Government has repeated its intention of maintaining the value of its currency, recognizing that to do otherwise would create major difficulties for both Hong Kong and other countries in the region.

II. The Japanese economy

18. Let me turn now to the other main economy in Asia, Japan, which accounts for 60 percent of East Asia's GDP. Japan faces an extraordinarily difficult economic situation. The way that the authorities address the situation will have significance not just for Japan but for the entire global economy. After forty years of outstanding performance, the economy has virtually stagnated in this decade. By the end of 1998, growth in Japan since 1991 will have averaged about 1 per cent per annum during the 1990's. There has been good reason for concern about Japan for some time, but the recently released first quarter national accounts data -- which showed a decline in production in the first quarter, larger even than had been expected, and an economy now definitively in recession -- underscored the seriousness of the situation.

19. Given the prominent role of Japan in the world economy, and especially in Asia, its economic performance is a legitimate matter for concern by other countries. The weakness of the economy, particularly the decline in the first quarter, was reflected in the rapid fall of the yen. And as the yen declined, there has been pressure on the capital markets and the currencies of other countries in the region and indeed elsewhere. There is very little disagreement among mandate economists, or even among Japanese policy makers, about what needs to be done to deal with Japan's problems. First, there is an immediate need for a substantial fiscal expansion. Second, there is a need to deal decisively with the weaknesses in the banking sector.

20. On fiscal policy, the Government has just passed an expansionary fiscal package amounting to over 2 percent of GDP that is scheduled to go into effect in the third and fourth quarters. The IMF is not famous for supporting fiscal expansions. But we strongly support this package. Indeed, we believe there is an immediate need for a further and very substantial fiscal expansion, consisting mainly of tax cuts, and that this should be done as soon as possible.

21. Fiscal action is essential to get the economy growing soon, but by itself this will not be enough. A weak financial system has hampered the recovery of the economy for most of this decade. The bad loan problem inherited from the bubble years has continued to fester, contributing to unprecedented bank failures in late 1997, a sharp loss in confidence, and a tightening in credit availability despite record low interest rates. It is an extraordinary fact that today, with essentially zero interest rates, there is nevertheless a credit crunch in Japan. The banks do not want to lend to corporations. The long, slow decline in property prices since 1990 has reflected banks' unwillingness -- implicitly supported by a policy of regulatory forbearance -- to recognize the full extent of their problem assets. You know that the IMF has been accused of moving too quickly to correct banking sector problems in East Asia, that we should instead have supported a policy of regulatory forbearance. Actually, I think the reverse is true. The most important lesson of the East Asian crisis is that, if banking problems are not attended to, they do not get better. They get worse and they may drag down the economy. We now have Japan, after seven years of regulatory forbearance, having to deal on a bigger scale with its banking problems than if it had taken action in 1992 or 1993.

22. The Japanese government's recent commitment of public funds, amounting to six percent of GDP, to deal with banking sector weakness is a welcome step. But this needs to be embedded in an overall plan. What is needed now is a comprehensive and transparent approach to ensure that the bad debt problem is finally dealt with, and the banking system restored to profitability and a sound capital position. Essential ingredients of this approach include:

- early identification and prompt closure of insolvent institutions;
- aggressive efforts to dispose of problem loans;
- linking future injections of public funds to strong restructuring plans, including a requirement to raise funds from the market;
- an end to regulatory forbearance in recognizing the extent of bad loans;
- adoption of international disclosure standards; and
- a large increase in resources for the new financial supervision authority, more than currently envisaged, to allow it to fulfill its mandate.

23. On the value of the yen, the substantial concerted intervention in exchange markets that began earlier this week has reversed the slide of the currency. This is a very important move, one that could mark the point at which the downward slide of the economies of East

Asia was halted. But intervention by itself is unlikely to have a very large and enduring effect unless backed up by more fundamental policy steps. In their statements welcoming the coordinated intervention, the Minister of Finance of Japan and Governor of the Bank of Japan committed their country to rapidly implementing fiscal expansion and banking sector interventions. These actions remain essential.

24. There is a lot for Japan to do. It is not easy for Japan to take action. But such measures are being taken in other countries, some of them in crisis, to deal with banking sector problems. There is no advantage to further delay and Japan needs to act now -- primarily for its own sake, but also to do its share in restoring the health of the global economy.

III. Implications for other Economies

25. What does this crisis mean for other countries? The required policy framework is clear. Macroeconomic policy needs to be put on a sound footing with limited fiscal deficits, and a coherent approach to monetary policy and exchange rate management. Where an exchange rate peg is in place, countries have to be willing to adjust macroeconomic policies quickly if market sentiment turns and pressures emerge against the peg. Policymakers have to pay attention to current account deficits, their financing and to external debt, especially its short-term component. As the Asian crisis has forcefully brought home, banking and financial systems need to be strong and well-supervised. The transparency of corporate and government accounts needs to be improved. All this sounds like the usual propaganda that you hear from the IMF, and it is -- but the propaganda is true. If you don't believe it, then look at some countries now in crisis.

26. What about the outlook for Brazil and the implications of this crisis for your country? The Brazilian economy has weathered this storm so far. Several factors have been responsible. First, Brazilian policymakers have been implementing a range of efficiency-enhancing structural reforms for a number of years, which have supported higher levels of investment and contributed particularly to increased foreign direct investment in the Brazilian economy. These reforms have included important efforts to restructure the banking system. I spoke yesterday with a range of officials in Brasília and I was very impressed, indeed, by the changes that have been made in the last few years -- a stepped-up privatization program, important administrative reforms, important improvements in bank supervision, and reform of the social security system.

27. Most important, when the Brazilian *real* was attacked in October 1997, the authorities decisively defended the currency. I want for a moment to expand on the importance of the actions taken last October and November. It is a fact that so far in this crisis, countries that were not willing to use interest rates to defend their currency have gone into deep crises, and those that defended their currencies have avoided a deep crisis. Thus what Brazil did last October was critical for the Brazilian economy. But it was even more important than that. At the time the Brazilian currency was under attack, global financial markets were extremely fragile. If Brazil had not defended the *real*, the crisis would most likely have spread to other countries in Latin America. We are all grateful for what Brazil did. I expect that having done it once, Brazil will again be willing to defend its currency if it is attacked. That is an important reassurance that the markets should have, based on last year's experience.

28. For the Brazilian economy, IMF staff expects output growth of 1 ½ to 2 percent for 1998 as a whole, while unemployment is likely to decline from 8 ½ percent now to 7 percent or perhaps lower in coming months, partly for seasonal reasons. Moreover, inflation remains low, between 4 and 5 percent. For 1998, a trade deficit of about \$5 billion is projected, down from a much larger \$8 ½ billion in 1997. The current account deficit would decline by somewhat less, to about 4 percent of GDP, because of increased interest payments. The last few months have seen a recouping of foreign reserves, to \$72 billion at end-May 1998, equivalent to over 10 months of imports of goods and services; at this quantity, they are significantly above their level before the pressures in October 1997.

29. Nevertheless, the economic and financial situation remains difficult, as indicated by the volatility of the stock market and the high spreads on Brazilian paper in international markets. These factors inevitably constrain monetary policy. The authorities have been able to reduce interest rates in recent months, and that is, of course, a major blessing for both growth and the budget. Nevertheless, the intention to maintain a flexible interest rate policy in the months ahead is important. Given both the domestic fragility and the turbulence in international financial markets, it cannot be excluded that interest rates could need to be raised again in the period ahead. I say that, not in the expectation that they will need to be raised, because I am encouraged by the actions that were taken to strengthen the yen earlier this week. I believe that could be a turning point in this crisis. But the truth is that, in a crisis of this magnitude, you do not know what is coming down the road and you have to be ready to act.

30. The key macroeconomic problem for Brazil continues to be the public finances. The consolidated public sector deficit at above six percent of GDP is large, but fortunately in the next few years a large part can be financed through privatization receipts. Further, there is reason to expect the public sector deficit to decline towards the end of the year as the interest bill comes down. Still, without a substantial and sustained reduction in the public sector deficit -- and that of course includes, importantly, state governments -- the economy will remain vulnerable to shifts of market sentiment. Against the pressures of last October, the November fiscal package was important and courageous. Indications are that, while the revenue component was largely implemented and appears to be yielding the intended gains, spending has not declined as much as envisaged. Moreover, the deficit of the social security system seems likely to increase from its 1997 level, reflecting the adjustment of pensions in June and the delays in parliamentary approval of the proposed constitutional reform of the social security system.

31. In the absence of corrective steps, our staff estimates that the primary balance of the consolidated public sector would show a small deficit in 1998, perhaps similar to that in 1997, while the overall public sector borrowing requirement could rise a little in 1998 from an already high level. The authorities should move quickly--and I believe that they know this--to implement in full the spending cuts for the federal government and the federal enterprises included in the November package. That package was bold, it remains government policy, and should be implemented. It will also be important to take steps to ensure that the adjustment programs agreed on with the states are fully implemented. And clearly the finances of the social security system remain a critical long-term issue for the Brazilian economy. In saying these things, I am not telling anyone here any secrets. These are things the government wants to do. It is committed to doing everything it can in these

areas. It has made the effort to take measures to the Congress as needed. What I am saying is not a criticism of the government. It is a statement about what needs to be done and the desirability of doing it. Not doing these things does not mean that a crisis is at hand. But doing them would substantially reduce the risks.

32. In sum, we see the Brazilian economy as having so far withstood the pressures emanating from the Asian crisis relatively well. Prompt action was taken last year on both monetary and fiscal policies; the markets were calmed; and foreign reserves were more than recouped. But a central lesson from this crisis is the need for vigilance and a readiness to act quickly and on occasions pre-emptively. In my discussions in Brasília yesterday, I was left in no doubt that this lesson is understood. Monetary policy has to be alert to the possible re-emergence of pressures on the currency. The fiscal reforms announced last November were strong and they should be implemented in full -- and more would be better. At the same time, the momentum for structural reform must not abate.

33. This country is potentially in the midst of a structural transformation of enormous historical significance. A culture of stability seems gradually to be taking hold. Structural reforms are taking place that can decisively strengthen the Brazilian economy and integrate it fully into the modern global economy -- where Brazil belongs. By sticking to the firm policy approach initiated in 1994, your country should be able to continue both to grow and to withstand the pressures that this unpredictable crisis may conceivably yet bring. I fully expect your policy makers to stay with the approach they have pursued so successfully for the last four years.

Thank you.

1 Stanley Fischer is First Deputy Managing Director of the International Monetary Fund. This presentation was prepared for delivery at the seminar on *The Brazilian and the World Economic Outlook*, organized by *Internews*, Sao Paulo, Brazil, June 19, 1998. He is grateful for the assistance of Owen Evans in the preparation of this paper. The views expressed are those of the author, and not necessarily of the International Monetary Fund.

