The Asian Crisis, the IMF and Japan

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1. In October 1997, when the Hong Kong dollar was attacked, for a few days the contagion threatened a global economic conflagration, that could have spread from Asia through Wall Street, and on to Latin America, Eastern Europe, and Russia. In the last few days, we have seen another round of crisis, with pressures spreading from Russia and Asia and threatening to engulf other markets. This has provided a vivid reminder -- not that we needed one -- that the Asian crisis is still very much with us. It will take determined policies to remove the threat that it poses not only to Asian countries but also to the global economy.

2. Let me briefly talk about the role of the Fund at times of intense market turmoil, such as now. In Russia, we have been closely involved in the preparation of the latest measures and we remain in close contact with Russia and other countries in that region. In South-East Asia, we work intensively with our program countries, Indonesia, Korea, the Philippines and Thailand and with other member countries, discussing ongoing events and their policy responses. In the Middle East, we have programs with Egypt, Pakistan and Jordan, in Latin America with Argentina and other countries, and we have programs in Africa -- and in all cases we work closely with these countries to strengthen their economies. We stand ready to do our duty, which is to help stabilize economies that may need financial assistance, provided they are willing to undertake appropriately ambitious economic reform and adjustment programs. As we have shown in the last 12 months, we are able to move rapidly and on a significant scale to provide assistance to countries willing to undertake the necessary policy measures. We stand willing to do that for others of our members that may need assistance.

3. Of course, the Fund's ability to continue to play this role requires that the envisaged rise in our capital base -- the 45 percent quota increase -- be implemented expeditiously. It is vitally important that the quota increase take place. This period of stubborn episodic fires that refuse to be extinguished and indeed threaten to spread is not the time to delay funding the fire department -- even if as some think the institution requires some reforms.

4. Let me now turn to the Asian crisis and leave further discussion of events elsewhere

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[1] First Deputy Managing Director of the International Monetary Fund. This presentation was prepared for delivery at the seminar on *Revitalization of the Japanese Economy and the Future of Asia*, organized by the Institute of International Monetary Affairs, Tokyo, June 2, 1998. The remarks draw extensively on an earlier presentation to the Asahi Shimbun symposium, held in Tokyo on April 8 1998. I am grateful to David Goldsbrough and Owen Evans for assistance. The views expressed are those of the author, and not necessarily of the International Monetary Fund.

for another day. For now, Korea and Thailand are well on the way to stabilizing their currencies. The situation in Indonesia remains extremely difficult, but after the recent political transition, there is a prospect of strong and credible reform policies that could gradually -- but only gradually -- reverse the excessive devaluation of the rupiah and begin the arduous task of restoring the economic health of that once fast-growing economy. I am glad to report that Mr. Neiss was extremely impressed by the determination of the new economic team, and will recommend that a full mission be sent to Indonesia this week.

5. While Korea, Malaysia, the Philippines, and Thailand are all dealing well with the crisis, we cannot today tell how long it will continue. At best, the countries just emerging from the worst of the financial crisis face a difficult year of slow or negative growth as they restructure their financial and business sectors. But the crisis could go on much longer, if the wrong policy decisions are made -- in the crisis countries themselves, and among their neighbors, most importantly China and Japan.

6. Today I would like to take advantage of the opportunity of speaking in this distinguished forum to cover three topics: first, the policy approach recommended by the IMF in the crisis countries in Asia; second, and very briefly, the prospects for the crisis countries, including Indonesia; and third, the critical economic policy choices that now confront Japan.

I. THE IMF AND THE ASIAN CRISIS

7. The Asian economic crisis has been all the more shocking for having struck countries with a sustained record of outstanding economic performance. Nonetheless, by the start of their IMF-supported programs, Thailand, Indonesia and Korea faced a number of similar problems, including the loss of market confidence, deep currency depreciation, weak financial systems, and excessive unhedged foreign borrowing by the domestic private sector. Moreover, all suffered from a lack of transparency about the ties between government, business, and banks, which has both contributed to the crisis and complicated efforts to defuse it. But the countries also differ in important ways, notably in the initial size of their current account deficits and the stages of their respective crises when they requested IMF support.

8. The designs of the programs that the IMF is supporting in Thailand, Indonesia and Korea reflect both these similarities and the differences.[2] These programs have sparked considerable controversy on a range of issues. Two main criticisms have been expressed in Asia. First some have argued that they are merely the same old IMF austerity medicine, inappropriately dispensed to countries suffering from a different disease, and that there is a kinder, gentler Asian way. Second is the criticism that by attempting to do more than restore

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[2] The full texts of the most recent letters of intent outlining their program objectives and commitments are publicly available via the IMF's website.

macroeconomic balance -- for instance in the measures to restructure the financial systems and improve corporate governance -- the programs go beyond what is necessary, and thereby impair their effectiveness.

Are the programs too tough?

9. In weighing this question, it is important to recall that when their governments approached the IMF, the reserves of Thailand and Korea were perilously low, and the Indonesian rupiah was excessively depreciated. Thus, the first order of business was to restore confidence in the currency. To achieve this, countries had to make it more attractive to hold domestic currency, which, in turn, required increasing interest rates temporarily, even if higher interest costs complicate the situation of weak banks and corporations. This is a key lesson of the tequila crisis in Latin America 1994-95, as well as from the more recent experience of Brazil, the Czech Republic, Hong Kong and Russia, all of which have fended off attacks on their currencies in recent months with a timely and forceful tightening of interest rates along with other supporting policy measures. Once confidence is restored, interest rates can return to more normal levels -- and they are, in both Korea and Thailand.

10. 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 in the Asian crisis countries is excessive, both from the viewpoint of the individual countries, and from the viewpoint of the international system.

11. Looking first to the individual country, companies with substantial foreign currency debts, as so many companies in these countries have, stand to suffer far more from a steep slide in the value of their domestic currency than from a temporary rise in domestic interest rates. Moreover, when interest rate action is delayed, confidence continues to erode. Thus, the increase in interest rates needed to stabilize the situation is likely to be far larger than if decisive action had been taken at the outset. Indeed, the reluctance to tighten interest rates forcefully at the beginning has been an important factor in perpetuating the crisis.

12. From the viewpoint of the international system, the devaluations in Asia are leading to massive current account surpluses in those countries, damaging the competitive positions of other countries and requiring them to run current account deficits. Although not by the intention of the authorities in the crisis countries, these are excessive competitive devaluations, not good for the system, not good for other countries, indeed a way of spreading the crisis -- precisely the type of devaluation the IMF has the obligation to seek to prevent.

13. On the question of the appropriate degree of fiscal tightening, the balance is a particularly fine one. At the outset of the crisis, countries needed to firm their fiscal positions, both to make room in their budgets for the future costs of financial restructuring, and -- depending on the balance of payments situation -- to reduce the current account deficit. Among the three Asian crisis programs, the balance of payments factor was important only in Thailand, which had been running a current account deficit of about 8 percent of GDP.

14. The amount of fiscal adjustment in the initial program for Indonesia was one percent of GDP; in Korea it was 1.5 percent of GDP; and in Thailand -- reflecting its large current account deficit -- the initial adjustment was 3 percent of GDP. After these initial adjustments, if the economic situation in the country weakened more than expected, as it has in the three Asian crisis countries, the IMF has generally agreed with the country to let the deficit widen, to let automatic stabilizers operate. Asian countries are not generally in favor of large deficits, and their willingness to let the automatic stabilizers operate in full has varied. Indeed, in two cases IMF staff suggested a higher fiscal deficit than country authorities were willing to accept. Today we believe that larger deficits could be warranted in some Asian countries -- and that will certainly be the case in Indonesia.

15. Thus on macroeconomics, the answer to the critics is that monetary policy has to be kept tight to restore confidence in the currency, and that fiscal policy was tightened appropriately but not excessively at the start of each program, with automatic stabilizers subsequently being allowed to do their work. That is as it should be. Moreover, these policies are showing increasing signs of success in Thailand and Korea, and interest rates in those countries have come down rapidly.

Structural policies

16. Macroeconomic adjustment is not the main element in the programs of Thailand, Indonesia, and Korea. Rather financial sector restructuring and other structural reforms are central to each program -- because the problems they deal with, weak financial institutions, inadequate bank regulation and supervision, and the complicated and non-transparent relations among governments, banks, and corporations, lie at the heart of the economic crisis in each country.

17. It would not serve any lasting purpose for the IMF to lend to these countries unless these problems were addressed. Nor would it be in the countries' interest to leave the structural and governance issues aside: markets have remained skeptical where reform efforts are perceived to be incomplete or half-hearted, and market confidence has not returned. Similarly, the Fund has been accused of encouraging countries to move too quickly on banking sector restructuring: we have been urged to support regulatory forbearance, leaving the solution of the banking sector problems for later. This would only have perpetuated these countries' economic problems, as experience in Japan has shown. The best course is to recapitalize or close insolvent banks, protect small depositors, require shareholders to take their losses, and take steps to improve banking regulation and supervision. Of course, the programs take individual country circumstances into account in determining how quickly all of this -- including the recapitalization of banks -- can be accomplished.

18. In a recent article in *Foreign Affairs*, Martin Feldstein proposes three questions the IMF should apply in deciding whether to ask for the inclusion of any particular measure in a program. First, is it really necessary to restore the country's access to the international capital markets? The answer in the case of the Asian programs is yes. Second, is this a technical matter that does not interfere unnecessarily with the proper jurisdiction of a

sovereign government? The answer here is complicated, because we have no accepted definitions of what is technical, or what is improper interference. Banking sector reform is a highly technical issue, far more than the size of the budget deficit -- a policy criterion Feldstein is apparently willing to accept as fit for inclusion in a Fund program. Nor is it clear why trade liberalization -- which has long been part of IMF and World Bank programs -- is any less an intrusion on a sovereign government than banking sector reform. Nor does Feldstein explain why the programs supported by the Fund in the transition economies, including Russia -- which are far more detailed, far more structural, and in many countries as controversial as in Asia -- are acceptable, but those in Asia are not. Third, if these policies were practiced in the major industrial economies of Europe, would the IMF think it appropriate to ask for similar changes in those countries if they had a Fund program? The answer here is a straightforward yes.

19. Interesting as they are, Feldstein's three criteria omit the most important question that should be asked. Does this program address the underlying causes of the crisis? There is neither point nor excuse for the international community to provide financial assistance to a country unless that country takes measures to prevent future such crises. That is the fundamental reason for the inclusion of structural measures in Fund-supported programs. Of course, many of these measures take a long time to implement, and many of them are in the purview of the World Bank, which is why the overall framework for longer-term programs, such as those in Asia, typically include a series of World Bank loans to deal with structural issues.

20. The structural elements in the Indonesian reform program -- in particular those relating to the ending of monopolies -- have been especially controversial. Those elements were included for two reasons: first, because everyone in Indonesia understood that confidence in the country's economy could not be restored unless there was a change in the way of doing business in that country; and second, because in several cases, especially the clove monopoly, the changes benefitted small-scale individual producers who had been penalized by ~~the~~ monopolies granted to purchasers of their output. It is noteworthy that in all the recent troubles in Indonesia, the IMF was not blamed *within* the country for the civil unrest, which Indonesians well knew had deeper roots -- and that today the IMF program still draws widespread support from all groups within Indonesia.

21. Thus on the inclusion of structural measures in IMF-supported programs, the answer to the critics is that such measures should be included in a program if they are essential to restoring the health of the economy -- and that frequently these measures, while included in the overall framework provided by a longer-term IMF program, will be implemented with the technical and financial support of the World Bank and the ADB. That is not to claim that all structural measures are fair game for inclusion in an IMF-supported program, nor to deny the legitimacy of questions about the inclusion of particular measures. It is to claim that the emphasis on financial and corporate sector restructuring and governance in the current IMF-supported programs in Asia is entirely appropriate.

II. PROSPECTS FOR THE CRISIS COUNTRIES

22. The financial turnaround in most of the Asian crisis countries began early this year. Since the start of the year, the baht and the won have each strengthened by about 20 percent; they are now worth about 36 percent less in terms of dollars than they were in June 1997. Their devaluations remain excessive, but they are not now outrageously so. While the currencies have rebounded, the Korean and Thai stock markets have fallen a further 10-15 percent since the end of 1997 and are down by very large magnitudes since mid-1997-- Thailand by 37 percent and Korea by 57 percent. The currencies of Malaysia and the Philippines have been basically flat since the start of 1998 and are down by about 36 percent since the middle of last year.

23. The prominent exception is Indonesia, whose currency has lost almost 80 percent of its value since the middle of last year, and about 60 percent of its value since the beginning of this year. Recent events teach lessons about the interactions of politics and economics at times of crisis, that we will no doubt analyze for years. But I will not attempt to go into those lessons here. After the recent political transition, events are inevitably difficult to predict but the initial steps taken by the new economic team are promising. If political stability and the reform momentum are maintained, the Indonesian government program supported by the IMF -- no doubt with adjustments and changes, but not on the structural side -- should provide a basis for a gradual restoration of the health of the economy and investor confidence.

24. The restoration of confidence is never immediate: as we have seen in the Korean and Thai cases, credibility has to be earned -- gradually, through actions, not promises. That will be doubly true in the Indonesian case.

25. While financial stability is slowly returning to those economies that are implementing stabilization and reform programs, it bears repeating that they all still face politically and economically difficult periods of adjustment. No financial recovery is ever completely smooth sailing. There will be days and weeks in which the East Asian currencies and financial markets will weaken, and the authorities are tested. Those are the periods in which the credibility of the program and the authorities can be strengthened -- or lost.

26. Countries face both internal and external risks. Internally, governments could fail to follow through on politically difficult reforms -- because early successes lead to unwarranted 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. The determination of the new Korean and Thai governments to follow through on their programs has been impressive, and should be maintained.

27. But there is also the risk that the external environment will turn adverse. We are fortunate that this crisis comes at a time when North America and Europe are growing strongly. That seems likely to continue. But there are often-expressed concerns about the Chinese and Japanese economies, about the possibilities of a Chinese devaluation, and the danger of continued slow growth and a deteriorating banking sector in Japan.

28. The Chinese authorities have left no doubts that they understand the importance of not devaluing, and their determination not to do so. They understand that a devaluation 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 its way out. They show no signs of wavering in their intent, nor is there reason to think they will waver. For this they have earned the commendation of the international community.

III. THE JAPANESE ECONOMY

29. No-one in this audience needs to be reminded that Japan today faces momentous economic decisions. After forty years of outstanding performance, the economy has virtually stagnated in this decade. At the heart of the protracted slowdown appear to be structural problems associated with the financial system and corporate governance that were revealed by the bursting of the asset price bubble. More recently, the slowdown over the last year has interacted with weaknesses elsewhere in Asia, reinforcing the urgency of dealing with these long-standing problems.

30. Japan's economic performance is of course a matter of *domestic* concern. But given the prominent role of Japan in the world economy, and especially in Asia, it is also a legitimate matter for concern by Japan's neighbors and by the international community. There is substantial agreement about what needs to be done, and the Government has begun action on some of the critical steps.

31. Deep-rooted structural problems, particularly in the financial sector, need to be addressed in a comprehensive manner. At the same time, macroeconomic policies should provide adequate short-term support to the economy. So the IMF welcomes the recently approved fiscal stimulus package of over 16 trillion yen, including about 12 trillion yen (or 2.5 percent of GDP) of "real water", measures that will have a direct effect on aggregate demand.

32. It is true that Japan faces a long-term demographic problem that has major fiscal implications. But in this crisis, fiscal policy must first help get the economy moving again. There will be time to deal with the longer-term fiscal problem later.

33. It is also important that the stimulus not be withdrawn too abruptly in FY1999. One useful way of ensuring this, consistent with longer-term fiscal consolidation, would be to introduce further tax measures by combining up-front cuts in tax rates with a phased broadening of the tax base over the medium term.

34. But fiscal action is not enough. The bad loan problem inherited from the bubble years has continued to fester, contributing to unprecedented financial sector failures in late 1997, a sharp loss in confidence, and a tightening in credit availability despite record low interest rates. The long, slow, decline in property prices since 1990 has reflected banks' unwillingness -- implicitly supported by a policy of regulatory forbearance and compounded

by impediments to debt workouts -- to recognize the full extent of problem assets. Market participants are clearly still not convinced about the longer-term viability of some Japanese banks. If a credible solution to the problem is not achieved, any other action to stimulate the economy will provide only temporary relief, and the risk of a further prolonged slowdown will be greatly increased. Markets will react more favorably to a clear, decisive strategy, even if it involves, as it regrettably must, difficult initial adjustments.

35. Fortunately there appears to be a growing recognition that the time has now come for a decisive break with the past, and important steps have been taken in recent months. A framework for self-assessment of asset quality and prompt corrective action (PCA) is being put in place and preparations are under way for setting up the independent financial supervisory agency. These are fundamental for the creation of a modern, sound, banking system. Public money has also been made available to strengthen the finances of the deposit insurance system and to help restructure under-capitalized banks. Plans to establish a new mechanism to accelerate debt workouts are also under discussion.

36. What is needed now is to build upon these recent initiatives to establish a comprehensive and transparent approach that would 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, some of which are already under way, include:

-- vigorous efforts to recognize the full extent of bad loans; the self-assessment framework is the right approach, but will need to be rigorously enforced by supervisors;

-- a strengthened framework for prompt resolution of insolvent institutions, but with appropriate safeguards -- which are already in place -- to protect depositors and creditors;

-- linking future injections of public funds to strong restructuring plans;

-- aggressive efforts to dispose of problem loans and to improve the institutional mechanisms for debt workouts;

-- increased independence, authority and staff resources for the new financial supervision authority, to allow it to fulfill its mandate.

37. There is a lot to be done. It is not easy. But such measures have been taken in other countries, some of them in crisis, in this region and elsewhere, to deal with banking sector problems. There is no advantage to further delay. Those delays have contributed to the sustained period of slow growth in Japan, and it is urgent to overcome them.

38. One more word -- on the need for transparency. In both the banking and fiscal areas, problems have persisted in part because of a lack of transparency. It is always difficult to work out the precise content and timing of a fiscal package in Japan, and this contributes to

uncertainties in estimating their impact. Introduction of a consolidated, multi-year, budgetary framework is long overdue. And the lack of transparency in the financial sector has also allowed problems to linger for far too long. The need for transparency is one of the key lessons we have drawn from earlier financial crisis, including those in Asia.

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39. The strategy followed in the IMF-supported programs in Korea and Thailand is beginning to work, and we are confident that it can work too in Indonesia, with the help of the international community. It is reasonable to believe that, deep and unfortunate as the crises in individual countries have been, growth in this region can resume within a reasonable period.

40. But that will require courageous policy decisions in all the countries in this region, not least Japan.

Thank you.