The Asian Crisis, the IMF, and the Japanese Economy

Stanley Fischer[1]

History has yet to decide the precise date on which the current Asian economic crisis began. It could be July 1998, when Thailand devalued. Or it could be October 1998, when the Hong Kong dollar was attacked, and 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. For now the *financial* crisis appears to be contained, with Korea and Thailand well on the way to stabilizing their currencies, and Indonesia and the IMF moving towards an agreement that, if rigorously implemented, could gradually -- but only gradually, as it is implemented -- reverse the excessive devaluation of the rupiah and begin the arduous task of restoring the economic health of that once fast-growing economy.

While we know to within a few months when the crisis began, today we can only speculate on 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.

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.

---

[1] Stanley Fischer is First Deputy Managing Director of the International Monetary Fund. These remarks were prepared for delivery at the Asahi Shimbun symposium, "The Asian Economic Crisis and the Role of Japan", held in Tokyo on April 8 1998. The views expressed are those of the author, and not necessarily of the International Monetary Fund.

I. THE IMF AND THE ASIAN CRISIS

The Asian economic crisis has been all the more shocking for having struck countries with a sustained record of outstanding economic performance.[2] 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.

The designs of the programs that the IMF is supporting in Thailand, Indonesia and Korea reflect both these similarities and the differences.[3] 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 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?

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, and still is, to restore confidence in the currency. To achieve this, countries have to make it more attractive to hold domestic currency, which, in turn, requires 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.

---

[2] In this section I draw on my paper "The IMF and the Asian Crisis", March 1998, available on the IMF website (www.imf.org). That paper covers several issues omitted from this presentation, including the controversy over the potential moral hazard of IMF lending.

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

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.

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.

From the viewpoint of the international system, the devaluations in Asia will lead to large 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.

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. In calculating the amount of fiscal tightening needed to offset the costs of financial sector restructuring, the programs include the expected *interest* costs of the intervention, not the capital costs. For example, if the cost of cleaning up the financial sector is expected to amount to 15 percent of GDP -- a realistic estimate for some countries in the region -- then the corresponding fiscal adjustment would be about 1.5 percent of GDP. This is an attempt to spread the costs of the adjustment over time rather than concentrate them at the time of the crisis. 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.

The amount of fiscal adjustment in 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 somewhat, that is, to let automatic stabilizers operate. However, the level of the fiscal deficit cannot be a matter of indifference, particularly since a country in crisis typically has only limited access to borrowing and the alternative of printing money would be potentially disastrous in these

circumstances. Nor does the IMF need to persuade Asian countries of the virtues of fiscal prudence -- indeed, in two of the crisis countries, the government has insisted on a tighter fiscal policy than the Fund had suggested.

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 could begin to come down if market confidence and the currencies continue to strengthen.

Structural policies

Macroeconomic adjustment is not the main element in the programs of Thailand, Indonesia, and Korea. Rather financial sector restructuring and other structural reforms lie at the heart of 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.

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.

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.

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.

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

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 18 percent; they are now worth about 38 percent less in terms of dollars than they were in June 1997. Their devaluations remain excessive, but they are not now outrageously so. The Korean and Thai stock markets are up about 20 percent since the start of the year. The currencies of Malaysia and the Philippines are up about 4 percent this year, down about 30 percent since the middle of last year. Their stock markets are both higher than they were at the turn of the year, and well down from the middle of last year.

The prominent exception is Indonesia, whose currency has lost 70 percent of its value since the middle of last year, and about 35 percent of its value since the beginning of this year. Indonesia is nearing an agreement with the IMF that, if rigorously adhered to, will strengthen the rupiah and financial stability, while at the same time putting in place a series of structural reforms -- including in the financial sector -- that are needed to begin restoring the health of the economy and investor confidence in it.

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.

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.

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.

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.

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

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. There has been good reason for concern for some time, but the *tankan* survey last week and recent public comments in Japan, including the remarkable statement by Governor Hayami, have reinforced the urgency of dealing with the situation.

Japan's economic performance is of course a matter of grave *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 little disagreement about what needs to be done. There is an immediate need for a

substantial fiscal expansion. There is also a need, as in the IMF-supported economic programs in the crisis countries, to deal with deep-rooted structural problems, particularly in the financial sector.

On fiscal policy, the recent suggestion of a package of 16 trillion yen, about 3 percent of GDP, would be a good starting point. But, unlike on previous occasions, the program that is implemented should be close to the starting point. The well-known reservations about increases in wasteful public spending are correct: that is why much of the package, at least half, should take the form of tax cuts. Anyone who doubts the effectiveness of tax measures need only consider the effectiveness of last year's tax increases in curbing demand.

The IMF is not famous for supporting fiscal expansions. And it is true that Japan faces a long-term demographic problem that has major fiscal implications. But after so many years of near-stagnation, fiscal policy must help get the economy moving again. There will be time to deal with the longer-term fiscal problem later.

But fiscal action is not 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. 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 the problem assets.

The experience of other countries in dealing with distressed assets suggests that a recovery can begin only after prices of distressed assets have touched bottom and a liquid market is re-established. The time has now come for a decisive break with the past. To be sure, in some areas important progress is being made -- notably the big bang financial reforms, which are now well under way and are following a clear road map. But the approach to dealing with key banking sector (and also fiscal policy issues) retains an ad hoc, reactive flavor. Markets will react more favorably to a clear, decisive strategy, even if it involves, as it must, difficult initial adjustments.

The government's recent commitment of public funds to deal with banking sector weakness is a welcome step, but there is a risk that a major opportunity will be missed. While the broad-based injection of funds did relieve short-term strains, the fundamental problem remains to be addressed. Indeed, by continuing to cushion weak banks, the injection may further delay the resolution of the problem by undermining banks' incentives to adjust. Market participants are clearly still not convinced about the longer-term viability of some Japanese banks, and credit ratings have continued to be marked down. 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.

What is needed now is a comprehensive and transparent approach that would leverage the use of public funds to ensure that the bad debt problem is finally put behind us, 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.

There is a lot to be done. It is not easy. But such measures are being 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 they should not be tolerated any longer.

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 what precisely is included in a fiscal package in Japan -- and this contributed to the miscalculation of the impacts of the tax increase in 1997. And the lack of transparency in the financial sector has also allowed this problem to linger for far too long. The need for transparency is one of the key lessons we have drawn from the Asian crisis, and the point applies to Japan too.

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. The Asian crisis has been contained, and 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.

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

Thank you.