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The Asian Crisis: A View from the IMF

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As the crisis has unfolded in Asia, the IMF has become, at least for this brief moment in history, almost a household name. But even if the institution has become more well known, its role in Asia and more broadly in the world economy is not widely understood. Thus, I am very pleased to have this opportunity to discuss the Asian crisis, what the IMF is doing to help contain it, and the institution's wider role in the international monetary system.

Asia's economic success

The crisis in Asia has occurred after several decades of outstanding economic performance. Annual GDP growth in the ASEAN-5 (Indonesia, Malaysia, the Philippines, Singapore, and Thailand) averaged close to 8 percent over the last decade. Indeed, during the 30 years preceding the crisis per capita income levels had increased tenfold in Korea, fivefold in Thailand, and fourfold in Malaysia. Moreover, per capita income levels in Hong Kong and Singapore now exceed those in some industrial countries. Until the current crisis, Asia attracted almost half of total capital inflows to developing countries--nearly $100 billion in 1996. In the last decade, the share of developing and emerging market economies of Asia in world exports has nearly doubled to almost one fifth of the total.

This record growth and strong trade performance is unprecedented, a remarkable historical achievement. Moreover, Asia's success has also been good for the rest of the world. The developing and emerging market economies of Asia have not just been major exporters; they have been an increasingly important market for other countries' exports. For example, these countries bought about 19 percent of U.S. exports in 1996, up from about 15 percent in 1990. Likewise, the dynamism of these economies helped cushion the impact of successive downturns in industrial economies on the world economy during 1991-93. In recent years, they have also been a source of attractive investment returns. For all these reasons, the developing and emerging market economies of Asia have been a major engine of growth in the world economy.

So what went wrong? Let me start with the common underlying factors.

The origins of the crisis

The key domestic factors that led to the present difficulties appear to have been: first, the failure to dampen overheating pressures that had become increasingly evident in Thailand and many other countries in the region and were manifested in large external deficits and property and stock market bubbles; second, the maintenance of pegged exchange rate regimes for too long, which encouraged external borrowing and led to excessive exposure to foreign exchange risk in both the financial and corporate sectors; and third, lax prudential rules and financial oversight, which led to a sharp deterioration in the quality of banks' loan portfolios. As the crises unfolded, political uncertainties and doubts about the authorities' commitment and ability to implement the necessary adjustment and reforms exacerbated pressures on currencies and stock markets. Reluctance to tighten monetary conditions and to close insolvent financial institutions has clearly added to the turbulence in financial markets.

Although the problems in these countries were mostly homegrown, developments in the advanced economies and global financial markets contributed significantly to the buildup of the imbalances that eventually led to the crises. Specifically, with Japan and Europe experiencing weak growth since the beginning of the 1990s, attractive domestic investment opportunities have fallen short of available saving; meanwhile, monetary policy has remained appropriately accomodative, and interest rates have been low. Large private capital flows to emerging markets, including the so-called "carry trade," were driven, to an important degree, by these phenomena and by an imprudent search for high yields by international investors without due regard to potential risks. Also contributing to the buildup to the crisis were the wide swings of the yen/dollar exchange rate over the past three years.

The crisis erupted in Thailand in the summer. Starting in 1996, a confluence of domestic and external shocks revealed weaknesses in the Thai economy that until then had been masked by the rapid pace of economic growth and the weakness of the U.S. dollar to which the Thai currency, the baht, was pegged. To an extent, Thailand's difficulties resulted from its earlier economic success. Strong growth, averaging almost 10 percent per year from 1987- 95, and generally prudent macroeconomic management, as seen in continuous public sector fiscal surpluses over the same period, had attracted large capital inflows, much of them short-term--and many of them attracted by the establishment of the Bangkok International Banking Facility in 1993. And while these inflows had permitted faster growth, they had also allowed domestic banks to expand lending rapidly, fueling imprudent investments and unrealistic increases in asset prices. Past success also may also have contributed to a sense of denial among the Thai authorities about the severity of Thailand's problems and the need for policy action, which neither the IMF in its continuous dialogue with the Thais during the 18 months prior to the floating of the baht last July, nor increasing exchange market pressure, could overcome. Finally, in the absence of convincing policy action, and after a desperate defense of the currency by the central bank, the crisis broke.

Contagion to other economies in the region appeared relentless. Some of the contagion

reflected rational market behavior. The depreciation of the baht could be expected to erode the competitiveness of Thailand's trade competitors, and this put some downward pressure on their currencies. Moreover, after their experience in Thailand, markets began to take a closer look at the problems in Indonesia, Korea, and other neighboring countries. And what they saw to different degrees in different countries were some of the same problems as in Thailand, particularly in the financial sector. Added to this was the fact that as currencies continued to slide, the debt service costs of the domestic private sector increased. Fearful about how far this process might go, domestic residents rushed to hedge their external liabilities, thereby intensifying exchange rate pressures. But the amount of exchange rate adjustment that has taken place far exceeds any reasonable estimate of what might have been required to correct the initial overvaluation of the Thai baht, the Indonesian rupiah, and the Korean won, among other currencies. In this respect, markets have overreacted.

So, in many respects, Thailand, Indonesia and Korea do face similar problems. They all have suffered a loss of confidence, and their currencies are deeply depreciated. Moreover, in each country, weak financial systems, excessive unhedged foreign borrowing by the domestic private sector, and a lack of transparency about the ties between government, business, and banks have both contributed to the crisis and complicated efforts to defuse it.

But the situations in these countries also differ in important ways. One notable difference is that Thailand was running an exceptionally large (8 percent of GDP) current account deficit, while Korea's was on a downward path, and Indonesia's was already at a more manageable level (3 1/4 percent of GDP). These countries also called in the IMF at different stages of their crises. Thailand called on the IMF when the central bank had nearly run out of usable reserves. Korea came still closer to catastrophe, a situation which has improved following the election of Kim Dae-Jung, the forceful implementation of the IMF-supported program even before he takes office, and the start of discussions with commercial banks on the rollover of Korea's short-term debt.

Indonesia, on the other hand, requested IMF assistance at an earlier stage, and at the start--in early November--the reform program seemed to be working well. But questions about the implementation of the program and the President's health, as well as contagion from Korea, all took their toll. Last week, after intense consultations and negotiations with the IMF, President Suharto decided to accelerate the reform program. Important measures to deal with banking sector difficulties and to increase confidence in the banks should be announced in the next few days. Corporate sector debt difficulties will have to be dealt with in a way that preserves the principle that the solution is primarily up to individual debtors and their creditors. The Philippines, for its part, has not escaped the turmoil, but its decision to extend the IMF-supported program that it had already been implementing successfully for several years has helped mitigate the effects of the crisis.

IMF-supported Programs in Asia

The design of the IMF-supported programs in these countries reflects these similarities and differences. All three programs have called for a substantial rise in interest rates to attempt to halt the downward spiral of currency depreciation. And all three programs have called for forceful, up-front action to put the financial system on a sounder footing as soon as possible.

To this end, non-viable institutions are being closed down, and other institutions are required to come up with restructuring plans and comply--within a reasonable period that varies according to country circumstances--with internationally accepted best practices, including the Basle capital adequacy standards and internationally accepted accounting practices and disclosure rules. Institutional changes are under way to strengthen financial sector regulation and supervision, increase transparency in the corporate and government sectors, create a more level playing field for private sector activity, and open Asian markets to foreign participants. Needless to say, all of these reforms will require a vast change in domestic business practices, corporate culture, and government behavior, which will take time. But the process is in motion, and already some dramatic steps have been taken.

The fiscal programs vary from country to country. In each case, the IMF asked for a fiscal adjustment that would cover the carrying costs of financial sector restructuring--the full cost of which is being spread over many years--and to help restore a sustainable balance of payments. In Thailand, this translated into an initial fiscal adjustment of 3 percent of GDP; in Korea, 1 1/2 percent of GDP; and in Indonesia, 1 percent of GDP, much of which will be achieved by reducing public investment in projects with low economic returns.

Some have argued that these programs are too tough, either in calling for higher interest rates, tightening government budget deficits, or closing down financial institutions. Let's take the question of interest rates first. By the time these countries approached the IMF, the value of their currencies was plummeting, and in the case of Thailand and Korea, reserves were perilously low. Thus, the first order of business was, and still is, to restore confidence in the currency. Here, I would like to dispel the notion that the deep currency depreciations seen in Asia in recent months have occurred by IMF design. On the contrary, as I noted a moment ago, we believe that currencies have depreciated far more than is warranted or desirable. Moreover, without IMF support as part of an international effort to stabilize these economies, it is likely that these currencies would have lost still more of their value. To reverse this process, countries have to make it more attractive to hold domestic currency, and that means temporarily raising interest rates, even if this complicates 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, Hong Kong, and the Czech Republic, all of which have fended off attacks on their currencies over the past few months with a timely and forceful tightening of interest rates along with other supporting policy measures. Once confidence is restored, interest rates should return to more normal levels.

Let me add that companies with substantial foreign currency debts are likely to suffer far more from a long, 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 in a determined way at the beginning has been one of the factors perpetuating the crisis. Higher interest rates should also encourage the corporate sector to restructure its financing away from debt and toward equity, which will be most welcome in some cases, such as Korea.

Other observers have advocated more expansionary fiscal programs to offset the inevitable

slowdown in economic growth. The balance here is a fine one. As already noted, at the outset of the crisis, countries need to firm their fiscal positions, to deal both with the future costs of financial restructuring and--depending on the balance of payments situation--the need to reduce the current account deficit. Beyond that, if the economic situation worsens, the IMF generally agrees with the country to let automatic stabilizers work and the deficit to widen somewhat. However, we cannot remain indifferent to the level of the fiscal deficit, particularly since a country in crisis typically has only limited access to borrowing and since the alternative of printing money would be potentially disastrous in these circumstances.

Likewise, we have been urged not to recommend rapid action on banks. However, it would be a mistake to allow clearly bankrupt banks to remain open, as this would be a recipe for perpetuating the region's financial crisis, not resolving it. The best course is to recapitalize or close insolvent banks, protect small depositors, and require shareholders to take their losses. At the same time, banking regulation and supervision must be improved. Of course, we take individual country circumstances into account in deciding how quickly all of this can be accomplished.

In short, the best approach is to effect a sharp, but temporary, increase in interest rates to stem the outflow of capital, while making a decisive start on the longer-term tasks of restructuring the financial sector, bringing financial sector regulation and supervision up to international standards, and increasing domestic competition and transparency. None of this will be easy, and unfortunately, the pace of economic activity in these economies will inevitably slow. But the slowdown would be much more dramatic, the costs to the general population much higher, and the risks to the international economy much greater without the assistance of the international community, provided through the IMF, the World Bank, and bilateral sources, including the United States.

Most major industrial countries appear well positioned to absorb the adverse effects of the Asian crisis. In the United States, consumer spending and investment remain strong and incoming data for the fourth quarter point to further robust growth in output and household spending. Consumer confidence remains at or near all-time highs, and the unemployment rate stood at 4.7 percent in December, only slightly above the November rate of 4.6 percent, which was the lowest rate in 24 years. Direct measures of prices indicate that inflationary pressures are receding, and the strong dollar and weak import and commodity prices suggest that this trend will continue for a while longer. Nevertheless, it does not take a great deal of imagination to see how the problems in Asia could take on larger proportions, with more profound effects on global growth and financial market stability. That is why the international community has decided to work together through the IMF to try to overcome the crisis in a way that does the least damage to the global economy.

Moral Hazard

Of course, not everyone agrees with the international community's approach of trying to cushion the effects of such crises. Some say that it would be better simply to let the chips fall where they may, arguing that to come to the assistance of countries in crisis will only encourage more reckless behavior on the part of borrowers and lenders. I do not share the view that we should step aside in these cases. To begin with, the notion that the availability of IMF programs encourages reckless behavior by countries is far-fetched: no country

would deliberately court such a crisis even if it thought international assistance would be forthcoming. The economic, financial, social, and political pain is simply too great; nor do countries show any great desire to enter IMF programs unless they absolutely have to.

On the side of the lenders, despite the constant talk of bailouts, most investors have made substantial losses in the crisis. With stock markets and exchange rates plunging, foreign equity investors have lost nearly three-quarters of the value of their equity holdings in some Asian markets. Many firms and financial institutions in these countries will go bankrupt, and their foreign and domestic lenders will share in the losses. International banks are also sharing in the cost of the crisis. Some lenders may be forced to write down their claims, especially against corporate borrowers. In addition, foreign commercial banks are having to roll over their loans at a time when they would not normally choose to do so. And although some banks may benefit from higher interest rates on their rollovers than they would otherwise receive, the fourth quarter earnings reports now becoming available indicate that, overall, the Asian crisis has indeed been costly for foreign commercial banks.

In effect, we face a trade-off. Faced with a crisis, we could allow it to deepen and possibly teach international lenders a lesson in the process; alternatively, we can step in to do what we can to mitigate the effects of the crisis on the region and the world economy in a way that places some of the burden on borrowers and lenders, although possibly with some undesired side effects. The latter approach--doing what we can to mitigate the crisis--makes more sense. The global interest, and indeed the U.S. interest, lies in an economically strong Asia that imports as well as exports and thereby supports global growth.

Simply letting the chips fall where they may would surely cause more bankruptcies, larger layoffs, deeper recessions, and even deeper depreciations than would otherwise be necessary to put these economies back on a sound footing. The result would not be more prosperity, more open markets and faster adjustment, but rather greater trade and payments restrictions, a more significant downturn in world trade, and slower world growth. That is not in the interest of the United States, nor of any other IMF member.

Role of the IMF

If I am emphatic on that point, it is because the IMF was founded in the hope that establishing a permanent forum for cooperation on international monetary problems would help avoid the competitive devaluations, exchange restrictions, and other destructive economic policies that had contributed to the Great Depression and the outbreak of war. The international economy has changed considerably since then, and so has the IMF. But its primary purposes remain the same; they are (and here I quote from the IMF's Articles of Agreement):

- "to facilitate...the balanced growth of international trade, and to contribute thereby to...high levels of growth and real income"--and we have consistently promoted trade liberalization;

- "to promote exchange rate stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation"; and

- to provide members "with opportunities to correct maladjustments in their balance of

payments, without resorting to measures destructive of national or international prosperity."

Our approach to these tasks is straightforward: it is to encourage all members to pursue sound economic policies and to open their economies to trade and investment. It is also to seek to avert crises by keeping close watch on member countries' economies and to warn them when trouble threatens. Sometimes we succeed, in that we warn countries and they take action. Sometimes we warn, but our advice is not followed, even when it is timely and on the mark. And sometimes despite our continuous efforts to strengthen our surveillance over member policies and performance, we might see some of the key elements of an emerging crisis, but fail to draw their full implications. We will continue to seek to strengthen surveillance--but it would be unrealistic to expect that every crisis can be anticipated.

When crisis does strike, the IMF has been willing to act in accordance with its purposes to deal with major problems confronting the international economy. On numerous occasions, the IMF has helped provide the expertise and vision needed to come up with pragmatic solutions to important international monetary problems, and it has helped mobilize the international resources to make them work. This was true during the energy crisis in 1973-74, when the IMF established a mechanism for recycling the surpluses of oil exporters and helping to finance the oil-related deficits of other countries. It was true in the mid-1980s, when the IMF played a central role in the debt strategy. It was true in 1989 and after, when the IMF helped design and finance the massive effort to help the 26 transition countries cast off the shackles of central planning. And it was true in 1994-95, when the IMF came forward to help avert Mexico's financial collapse--and to prevent the crisis from spilling over into the markets, forcing other countries to resort to exchange controls and debt moratoria, and possibly causing a dramatic disruption in private capital flows to developing countries. Because of the authorities' efforts and IMF support, Mexico's markets remained open and capital continued to flow.

There is no denying that each of these crises has been difficult--especially for the IMF members most adversely affected. In each case we, the IMF and the international community as a whole, learned from our experiences. And in each case, it is clear that without Fund assistance, things would have been much worse. The IMF's effectiveness derives from the fact that as an international institution with a nearly global membership, it can carry on a policy dialogue with member countries and make policy recommendations in situations where a bilateral approach would not be accepted. At the same time, the IMF provides a mechanism for sharing the responsibility of supporting the international monetary system among the entire international community.

IMF Resources

Part of that shared responsibility is to provide resources to the IMF. Let me emphasize that the IMF is not a charitable institution, nor does it carry out its operations at taxpayers' expense. On the contrary, it operates much like a credit union. On joining the IMF, each member country subscribes a sum of money called its quota. Members normally pay 25 percent of their quota subscriptions out of their foreign reserves, the rest in their national currencies. The quota is like a deposit in the credit union, and the country continues to own it. The size of the quota determines the country's voting rights, and the United States, with

over 18 percent of the shares, is the largest shareholder. Many key issues require an 85 percent majority, so that the United States effectively has a veto over major Fund decisions.

When a member borrows from the Fund, it exchanges a certain amount of its own national currency for the use of an equivalent amount of currency of a country in a strong external position. The borrowing country pays interest at a floating market rate on the amount it has borrowed, while the country whose currency is being used receives interest. Since the interest received from the IMF is broadly in line with market rates, the provision of financial resources to the Fund has involved little cost, if any, to creditor countries, including the United States.

As you are no doubt aware, the Fund's membership has recently agreed to increase IMF quotas by 45 percent, about $88 billion, which will raise the capital base of the institution to some $284 billion. The United States' share of this increase would be nearly $16 billion. In addition, the Fund has taken steps to augment its financial resources through the agreement on the New Arrangements to Borrow (NAB). Under the NAB, participants would be prepared to lend up to about $45 billion when additional resources are needed to forestall or cope with an impairment of the international monetary system, or to deal with an exceptional situation that poses a threat to the stability of the system.

These are large sums. They are often described as an expense to the taxpayer. We are deeply aware in the IMF that our support derives ultimately from the legislatures that vote to establish their countries' quotas--their deposits--in the IMF. We must justify that support. But it must also be recognized that contributions to the IMF are not fundamentally an expense to the taxpayer; rather, they are investments. They are an investment in the narrow sense that member countries earn interest on their deposits in the IMF. Far more important, they are also an investment in a broader sense, an investment in the stability and the prosperity of the world economy.

Thank you.