

[Home](#) | [Search](#) | [Map](#) | [Index](#) |[About](#) | [News](#) | [Publications](#) | [Fund Rates](#) | [Data Standards](#)

IN DEFENSE OF THE IMF'S EMERGENCY ROLE IN EAST ASIA

By Hubert Neiss

Director of the International Monetary Fund's
Asia and Pacific Department

International Herald Tribune

October 9, 1998

Reproduced with the permission of the *International Herald Tribune*

The policy responses to the Asian financial crisis and economic slowdown, under programs supported by the International Monetary Fund, have attracted wide-ranging criticisms. Some are mutually contradictory. All benefit from 20-20 hindsight.

The debate is valuable, of course. We all must seek to draw the right lessons from this searing experience. But a systematic assessment should start by distinguishing between the policy packages that were designed to overcome the immediate foreign exchange crisis, and the adaptations of policies that were made to initiate a recovery after market stabilization had been largely achieved.

Policies adopted at the outset must be seen in the context of the options available in the circumstances that actually prevailed, not against the clean slate of academic theory.

The three countries that have suffered most - Thailand, Indonesia and South Korea - each got into deep trouble on their own before they were prepared to follow the recommendations of the IMF.

By the time the Fund was called in to help each country, all the low-cost options had been foreclosed. Important decisions in several complex and painful areas had to be made almost overnight and without full information.

To the extent that the programs were broadly similar, it was not the result of blindly following some standard recipe but of broadly similar, and highly unfavorable, initial situations in the three countries.

Exchange rate policy: The first example of a policy option overtaken by events was that of keeping the exchange rate fixed, whatever happens.

A fixed rate can provide an anchor for anti-inflationary policies and maintain market confidence. But it requires a strong, credible government, the willingness to accept very high interest rates whenever the peg comes under market pressure, and plenty of reserves to intervene. None of the three countries met those prerequisites when they turned to the IMF.

Thailand and South Korea had already lost almost all their reserves while trying to support their exchange rates. Indonesia was initially unwilling to use tight monetary policy to defend its currency.

Some advocate the opposite approach: Let the exchange rate fall freely while pursuing an expansionary monetary policy, in particular low interest rates. It is argued that this would avoid the recessionary

impact of the balance of payments crisis. However, there is the risk that the currency will over-depreciate. This could lead to hyperinflation and also severely damage companies with unhedged obligations needing to repay large foreign loans, as was the case in all three countries.

The approach that was taken lies between the two extremes. The exchange rate was initially allowed to depreciate, but the fall in the value of the currency was limited by a temporary tightening of monetary policy, which led to sharply higher interest rates.

The aim was to stop the drain on reserves by letting the exchange rate adjust, but keep inflation under control and restore market confidence. The stabilization in Thailand and South Korea was largely achieved in the early months of 1998, and is still under way in Indonesia.

Foreign exchange management: The IMF supported authorities in all three countries in seeking to maintain an exchange system free of major restrictions. Malaysia's recent introduction of controls in the hope of curbing capital flight and speculation, while lowering interest rates to spur a quick recovery, will test the opposite approach.

The problems with introducing exchange controls are well known. They are difficult to enforce and only partially effective; they create new distortions; they delay restoration of market confidence and the needed inflow of capital.

Moreover, as Japan has shown, reviving growth in economies with serious structural problems cannot be achieved through low interest rates alone.

External debt management: The three crisis countries were also caught between a rock and a hard place because of the huge foreign currency debts of their domestic banks and corporations. Full debt service could not be maintained without some debt relief in the shape of loan rollovers and restructuring to allow more time for repayment.

Defaulting on debt service would have forced foreign banks and other creditors to suffer immediate losses. "Moral hazard" penalties to borrowers would have been avoided, while immediate balance of payments relief was provided. But default can also result in curtailment of trade financing and a lasting interruption of the country's financial relations with the rest of the world, with consequent disruptions in the domestic economy. The experience of the Philippines in 1983 should be remembered.

Default during the rolling crisis of 1998 could also have triggered sudden, massive capital outflows from other countries with vulnerable external positions.

Each of the three Asian countries receiving billions of dollars in international loans martialed by the IMF decided to support continued debt servicing while seeking to negotiate debt relief with creditors. The IMF arranged additional official inflows of money to strengthen national reserve positions. It also facilitated debt negotiations with foreign commercial banks to provide the necessary balance of payments relief and some burden sharing by creditors.

Structural reforms: Should the economic programs have been less ambitious, and limited to pursuing stabilization? One argument is that simultaneous reform efforts overload the capacity of policymakers to implement, and of society to endure, a large number of difficult policy changes; another is that overemphasis on structural reform could undermine political credibility. We chose to combine stabilization with structural reform, as we had done earlier in other cases, most notably in the Indian

program in the early 1990s.

The root causes of the crisis in the three East Asian countries were not macroeconomic imbalances, although they played a role in Thailand. The causes lay mostly in weak banking systems and heavily indebted corporate sectors. Failure to tackle these issues would have been devastating to domestic and foreign confidence, and would not have produced the basis for durable recovery.

This applies in particular to the financial sector, where simply keeping ailing institutions alive through central bank liquidity injections would only have aggravated the banking problem, led to more runs on banks, and made control of inflation more difficult. Instead, a program of closures, mergers and recapitalization, together with a revamping of supervision, was started immediately. This was followed by corporate debt restructuring, which is also crucial for getting the economy back to normal.

Program adaptations: After stabilization was achieved in Thailand and South Korea, priority shifted to counteracting the recession and laying the ground for a resumption of growth. Recession was the unavoidable consequence of the preceding large outflow of capital, the collapse of asset prices, the general loss of confidence, and the tightness of monetary policy required to arrest the external crisis.

However, at the start of the crisis, the depth of recession was underestimated. In particular, we did not foresee the collapse of investment as a consequence of the problems in the banking system, the virulence of contagion resulting from the working of capital markets, and the severity of Japan's recession, which put additional pressure on the crisis countries.

Policies were adjusted in each country, including Indonesia. Macro policies were shifted toward expansion by gradually reducing interest rates and moving the budget into substantial deficit to support domestic demand. Structural reforms were accelerated, with emphasis put on rehabilitation of the banking system and corporate restructuring to open the way for new lending and a resumption of production.

A social safety net was established, with the main focus on unemployment and health insurance, and retraining of retrenched workers, so as to maintain social peace in a difficult period of adjustment when the traditional family support system has been eroding.

This is how the policy approach was formulated and adapted in the Asian crisis countries undertaking IMF programs. The choice between available options was carefully made. I believe that the basic strategy has been sound, although we could not have been expected to, and did not, get everything 100 percent right.

In retrospect, an earlier decisive shift to fiscal expansion would have been desirable. It would also have been desirable to bring in external commercial creditors earlier, and to start dealing with corporate debt right away. The Asian crisis has been a difficult learning process for all involved, and policies will, of course, have to be adapted further as we proceed.