The IMF and the Asian Crisis

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The Asian crisis and the Administration's request to Congress for IMF funding have focused unprecedented attention on the Fund. The ensuing debate should be a healthy part of the process by which the institution is held accountable to its member countries and governments. But the spotlight on the Fund has also revealed a number of critical misconceptions, relating both to its role in the international monetary system and to its recent activities in Asia.

On the role of the Fund: it is often stated that the Fund was established to manage the system of fixed exchange rates set up at the end of World War II, and that since the breakdown of that system in 1973, it has been searching for a rationale. The Fund has of course evolved and adapted since it began operating in 1946. Nonetheless, its current activities are closely consistent with its initial purposes -- testimony to the remarkable foresight of the founders of the international economic system set up after World War II, a system which has helped produce more growth and more prosperity for more people than in any previous fifty year period.

In Asia it has been charged, among others by Martin Feldstein in the March/April issue of *Foreign Affairs* that the Fund is applying traditional austerity remedies; that it is intervening excessively in borrowers' economies, thereby making countries increasingly reluctant to request financial assistance from the Fund; and that its activities bail out unwise lenders and lay the seeds for future excesses of private sector lending -- the moral hazard argument. I will argue that the Fund's macroeconomic advice in Asia is appropriate to the circumstances of individual countries; that the structural changes in these economies supported by IMF programs are necessary for the sustainable return of growth; that IMF lending should be conditional on changes in policy and not too easily available; and that while the existence of any insurance -- and the IMF's provision of backstop financing does provide insurance to its members and the markets -- produces moral hazard, most lenders to the Asian countries in crisis have taken large losses.

It will always be true, though, that the international community needs to find better ways of preventing crises and of dealing with the crises that will inevitably occur, and I will conclude by briefly discussing changes in the architecture of the international system now on the agenda.

The Purposes and Role of the IMF

The goal of the representatives of the 44 countries who met in Bretton Woods, New Hampshire in 1944 was to rebuild the international economic system, whose collapse had contributed to the Great Depression and the outbreak of war. To this end they proposed setting up the International Monetary Fund, the World Bank, and what much later became the World Trade Organization.

The primary purposes of the Fund are set out in Article I of the charter, which has remained essentially unchanged over the past fifty years. They include:

"To promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems";

"To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income ...";

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

"To assist in the establishment of a multilateral system of payments in respect of current transactions ... and in the elimination of foreign exchange restrictions which hamper the growth of world trade"; and

"To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity."

The world economy has prospered mightily and changed dramatically since 1944, but the approach laid out at Bretton Woods has stood the test of time. The IMF too has changed, but its original purposes remain valid on the verge of the twenty first century.

International economic cooperation

The Fund, with its 182 member countries, is the premier forum for international economic cooperation and consultation. Issues relating to the organization and functioning of the international system are generally discussed and where decisions are needed, decided on in the Fund -- by the Executive Board, **2** and by the Finance Ministers and Central Bank governors who constitute the Board of Governors of the Fund. Often the initiative may come from elsewhere, for example the G-7, or a member government, but it is the Fund that "provides the machinery for consultation and collaboration on international monetary problems" that is used to examine and make these suggestions operational. The Fund's highly professional staff, including 1000 economists, 450 of them with Ph.Ds, prepares the analysis that forms the basis for the discussion.

Almost every major international economic problem of recent years has been discussed and usually acted on (often together with other institutions, especially our Bretton Woods non-identical twin, the World Bank) by the IMF: the Mexican and Asian crises; technical and financial assistance to the economies in transition, including Russia; the debt problems of the poorest countries (in close cooperation with the World Bank); the attempt to improve international banking standards; economic assistance to Bosnia-Herzegovina; the ongoing effort, initiated following the Mexican crisis, to improve the quality and public provision of data, which has led to the Fund's Special and General Data Dissemination Standards; the unfortunately long-running problems of the Japanese economy this decade; the activities of hedge funds and their role in the Asian crisis; and the list goes on and will go on. **3**

Much of what the Fund does consists of *surveillance*, reporting by the staff to the Executive Board and thus to member governments on developments and problems in the international economy and in individual economies. The staff's surveillance of the international economy is published, after discussion by the Board, in the semi-annual *World Economic Report* and in the annual *International Capital Markets* report. In addition, the staff

reports regularly to the Board on world economic and market developments. Drawing on its continuous surveillance of the world economy, the Fund staff provides briefings on the international economy for meetings of the G-7 and other G's and organizations, including APEC.

Approximately once a year, the Fund staff prepares an *Article IV report* for each country, an in-depth analysis of the country's economic policies and performance. In its discussion of the paper, the Board conveys its views -- encouraging or critical -- to the policymakers of the country. Through this process, policymakers seek to encourage their colleagues in other countries to improve policies. In addition, the staff reports regularly to the Board on countries facing particular economic difficulties or whose programs with the Fund may be off track.

Article IV reports are not published: most member governments say they would not be willing to discuss their economic problems frankly with the Fund if the reports were to be published. However, last year the Board agreed to allow countries that want to do so, to publish the Chairman's summing-up of the Board discussion. So far 60 PINs (Press Information Notices) containing the summing-up and other information on the economy, about half the number of Article IVs discussed during the period, have been published, and are available on the Fund's website. In addition, at the end of its Article IV mission to each country, the Fund staff mission presents to the government a concluding statement, summarizing its views. The concluding statement generally foreshadows the conclusions of the Article IV report. Countries may, if they wish, publish these concluding statements, and an increasing number are doing so. Thus, gradually, the Fund's membership is moving to make public the conclusions of the Article IV consultation, a trend that is welcomed by Fund management.

In recent years, especially in the wake of the Mexican crisis, the IMF has strengthened and broadened its surveillance, paying particular attention to, among other factors, the quality and timeliness of the data it receives from member countries, the strength of their domestic financial systems, and the sustainability of private capital inflows. By providing warnings of impending problems, Fund surveillance should help prevent crises. When it does so, when a crisis is averted, surveillance has succeeded and is unlikely to be noticed -- and there are many cases in which Fund warnings were given and action taken that averted a crisis. But surveillance may fail, either because warnings are given and not heeded, or because the problem

was not anticipated.

In the Asian crisis, the Fund warned Thailand of an impending crisis but action was not taken. Fund staff also warned about financial sector weaknesses in several of the countries subsequently badly hit in the crisis. But we failed to foresee the virulence of the contagion effects produced by the widening crisis.

In drawing the lessons of this crisis, the Fund will have to seek both to make warnings more effective and to improve the quality of Fund economic forecasts, particularly of crises. Many have suggested that crises could be prevented, or at least mitigated, if the Fund went public with its fears. Two factors make this difficult. First, the Fund's access to information and its ability to act as a confidential advisor to governments would be lost if it made that information public; and absent such information, there is no good reason to think this is particularly a task for the public sector. Second, the Fund could by going public with its concerns create a crisis that otherwise would not have happened -- a responsibility that should not lightly be assumed. As to forecasts of potential crises, there should be no illusion that forecasting of this type will ever be perfect. Some impending crises will be missed. For this reason, and because in any case not all warnings are heeded, we shall have to continue to improve our capacity to deal with crises even as we strive to improve surveillance to prevent crises.

Promoting international trade

The Fund promotes international trade directly, by encouraging trade liberalization, both through surveillance and in its lending programs with member countries. It has always done so, and the purposes of the Fund require it to continue to do so. It is therefore a surprise that our Asian programs are criticized for including conditionality on trade liberalization measures. Although trade liberalization was at one time controversial, and import-substituting industrialization a popular prescription, the weight of experience, as well as more formal econometric evidence, have conclusively established the benefits of trade liberalization and integration into the world economy.

Even more important, the Fund promotes international trade indirectly, by encouraging countries to liberalize foreign exchange controls on trade in

goods and services ("the establishment of a system of multilateral payments in respect of current transactions"). These controls were pervasive at the end of World War II, but by now 142 member countries have accepted Article VIII status with the Fund, which certifies that they allow full convertibility of their currency for current account transactions. Remarkably, most of the transition economies moved to Article VIII status within a few years, a contrast with many of today's advanced economies which took well over a decade to get rid of these restrictions after the end of World War II.

Currency fluctuations

The pegged exchange rate system set up at the end of World War II lasted until 1973. In principle the IMF was assigned a major role in approving exchange rate changes, but in practice major countries tended to devalue first and seek approval immediately after. The fixed exchange rate system was a means of promoting exchange rate stability, not a goal. Once it lost its viability -- a result of the incompatibility of fixed exchange rates, capital mobility, and policies focused on domestic objectives -- there was no choice but to move to a more flexible system.

Exchange rates among the major countries, particularly between Japan and the United States, have fluctuated more than was expected by proponents of floating exchange rates, but no acceptable alternative is available for countries that -- unlike future members of the European Monetary Union -- are not willing to subordinate economic policy to the goal of stabilizing the exchange rate. Fluctuations such as those in the yen-dollar rate between 81 in the spring of 1995 and 133 late last year are so large that the search for a better way to promote exchange stability is bound to return to the agenda. Smaller countries, more dependent on the international economy than the United States, Europe, and Japan, do not have the luxury of ignoring the behavior of the exchange rate, and have tended either to choose some form of exchange rate peg or at least to adjust macroeconomic policies when the exchange rate threatens to move out of line. The peg of most ASEAN exchange rates to theappreciating dollar contributed to the Asian currency crisis.

The concern over competitive devaluations reflected in the Fund's charter, and the system-wide implications of changes in exchange rates, still motivate Fund policy recommendations. A major Fund concern in the

Asian crisis has been the fear that Asian currencies would become so undervalued and current account surpluses so large as to damage the economies of other countries, developing countries included. This is one reason the Fund has stressed the need first to stabilize and then to strengthen exchange rates in the Asian countries now in crisis -- and for this purpose, not to cut interest rates until the currency stabilizes and begins to appreciate.

Fund lending

Despite its other activities -- surveillance, information provision, and technical assistance -- the IMF is best known for its lending. The Fund operates much like a credit union, with countries placing deposits in the Fund, which are then available to loan to members who need to borrow and who meet the necessary conditions. Members' *quotas* in the Fund determine both the amount they have to subscribe, and their voting shares. The size of a member's quota reflects, but typically with a lag, the size of its economy and its role in the world economy. [4]

Total quotas now amount to a bit under $200 billion. Countries have to pay in 25 percent of their quota (the so-called reserve tranche) in any of the five major currencies in the SDR; the remainder can be paid in the country's own currency. This means that not all the quotas can be used for lending. Countries can have virtually automatic access to their reserve tranche, and the U.S. has drawn on its reserve tranche more than twenty times, most recently in defense of the dollar in 1978.

In September 1997 the members agreed to increase quotas by 45 percent, about $90 billion, with the United States' share of the increase amounting to nearly $14.5 billion. The Congress has before it at present both the Administration's request for the quota increase, and a request for $3.5 billion for the United States contribution to the New Arrangements to Borrow (NAB). The NAB will allow the IMF to borrow from a group of 25 participants with strong economies in the event of a risk to the international monetary system. [5] It would thus provide backup financing that could be available if the Fund runs short of regular quota-based resources. The NAB doubled the resources available to the Fund under the General Arrangements to Borrow established in the 1960s.

When a member in crisis approaches the Fund for a loan, the Fund seeks to

negotiate an economic program to restore macroeconomic stability and lay the conditions for sustainable and equitable growth, paying careful regard to the social costs of adjustment. The decision whether to support the country will be taken by the Executive Board, based largelyon the strength of the reform program the country is willing to undertake. The loan is typically *tranched,* paid out in installments, each conditional on the country's meeting the conditions to which it has agreed. These procedures, especially *conditionality*, constitute the adequate safeguards required by the Articles of Agreement.

The policies agreed in a Fund-supported program typically include fiscal and monetary policies, designed to restore viability to the balance of payments, help restore growth, and reduce inflation. Where appropriate, they also include structural policies designed to remedy the problems that led to the need to borrow from the Fund. When a country's problem is purely balance of payments related, and can be expected to be reversed in a short time, the Fund loan will typically cover policies for a year, with repayment starting after three years and concluding within five years. When the country's economic problems are more deep-seated and will take longer to deal with, the arrangement will last longer, covering policies for up to three or four years. In these cases, the program will contain, along with monetary and fiscal policy changes, more structural measures, such as reform of the financial system, the pension system, labor markets, agriculture, and the energy sector. Such extended arrangements typically include reforms that will be financed during the period of the program by World Bank loans. Such is also the case with the financial sector and other structural reforms in Asian countries.

Despite the common usage, "IMF program", the Fund itself is careful to speak of a "Fund-supported program". Ideally the program should be that of the country, and one that its government is committed to carry out. Of course, in the loan negotiations, the Fund will usually ask the government to do more than it initially wanted. But because a program is unlikely to succeed unless those who have agreed to it intend to carry it out, a key element in the evaluation of any agreement is the degree of the government's commitment to the economic program which it has signed -- a conclusion which is reinforced by the recent Asian experience, in which the Korean and Thai financial markets both turned around when new governments, strongly committed to carrying out the programs, came into office. The government's commitment may be difficult to judge, especially

if it is divided, and if, as happens not rarely, the program is being used by those who favor reform as a vehicle to implement changes that some of their colleagues oppose. Although a Fund-supported program is often seen in the press as the international community's way of imposing changes on a country's economy, it is more often the international community's way of supporting a government or a group within the government that wants to bring about desirable economic reforms conducive to long-term growth.

But why then are programs so often unpopular? The main reason is that the Fund is typically called in only in a crisis, generally a result of the government's having been unwilling to take action earlier. If the medicine to cure the crisis had been tasty, the country would have taken it long ago. Rather the medicine will usually be unpleasant, in essence requiring the country to live within its means or undertake changes with short-term political costs. Probably the government knew what had to be done, but rather than take the reponsibility, finds it convenient to blame the Fund when it has to act. Similarly, when structural changes have to be made, the losses are often immediate and the gains some way off. Despite all this, there are countries where the Fund is popular, among them transition economies that have seen hyperinflation defeated and growth begin during Fund-supported programs.

The secrecy that until recently has often attended Fund-supported programs may well have contributed to their unpopularity. A public that does not know what is being done, nor why, is less likely to support measures that are difficult in the short-run but that promise longer-run benefits. Governments have often been reluctant to publish their agreements with the Fund, disliking to give the impression that their policies were in any way affected by outsiders. Recently, in the Korean, Thai and Indonesian programs, the government's Letter of Intent, its letter to the management of the Fund describing its program, has been published --another change welcomed by the management of the Fund.

Evolution of the world economy and the IMF

While the purposes of the IMF have not changed, it has over the years been called upon to advise and assist an ever wider array of countries facing an ever greater diversity of problems and circumstances -- not only industrial economies with temporary balance of payments problems, but also low-income countries with protracted balance of payments difficulties;

transition countries struggling to establish the institutional infrastructure of full-fledged market economies; and emerging market countries seeking to secure the private capital inflows needed to maintain high rates of economic and human development.

Of course, the IMF has maintained its primary focus on sound money, prudent fiscal policies, and open markets as preconditions for macroeconomic stability and growth. But increasingly, the scope of its policy concerns has broadened to include other elements that also contribute to economic stability and growth. Thus, to different degrees in different countries, the IMF is also pressing, generally together with the World Bank, for sound domestic financial systems; for improvements in the quality of public expenditure, so that spending on primary health and education is not squeezed out by costly military build-ups and large infrastructure projects that benefit the few at the expense of many; for increased transparency and accountability in government and corporate affairs to avoid costly policy mistakes and the waste of national resources; for adequate and affordable social safety nets to cushion the impact of economic adjustment and reform on the most vulnerable members of society; and in some countries for deregulation and demonopolization to create a more level playing field for private sector activity.

This broadening of the scope of IMF policy concerns has met with mixed reactions. Some applaud the Fund for tackling the structural problems and governance issues that, in many countries, stand in the way of macroeconomic stability and sustained growth. But others roundly criticize the IMF, either for intruding too far in what they see as the domesticaffairs of sovereign nations, or for failing to go far enough.

Finally, the diversity of its membership and the problems they face has led the IMF to establish a wider array of facilities and policies through which the Fund can provide financial support to its members. In addition to the traditional stand-by arrangement that usually lasts twelve to eighteen months and is designed to help finance temporary or cyclical balance of payments deficits, the Extended Fund Facility (EFF) supports three to four-year programs aimed at overcoming more deep-seated macroeconomic and structural problems. The Enhanced Structural Adjustment Facility (ESAF) also finances longer-term programs, but at a concessional interest rate for low-income countries. At other times in the IMF's history, new facilities have been established to address particular problems. The most recent of

these is the Supplemental Reserve Facility (SRF), which was created in December 1997 to assist emerging market economies facing crises of market confidence, while providing strong incentives for them to return to market financing as soon as possible: it allows the Fund to make large short-term loans at higher rates than it normally charges. The first borrower under the SRF was Korea.

What is the net effect of all these changes? Certainly, the IMF has not been completely transformed. One important feature that remains the same is the emphasis on sound policies at national level and effective monetary cooperation at the international level. The corollary of this is that the IMF is not just a source of financing or a mechanism for crisis management, as is commonly believed, but mostly, in its daily business, a cooperative institution for multilateral surveillance. It must also be acknowledged, however, that from its relatively simple origins, the IMF has evolved into a complex institution with complex tasks to fulfill. So even if the IMF continues to look at all its member countries through the same prism -- the requirements for economic stability and growth -- it has to deal in a differentiated way with the full spectrum of problems and possibilities in 182 distinctive member countries.

The IMF and the Crisis in Asia

Among the many questions raised by the Asian economic crisis, I will focus on a set of issues about the nature of IMF-supported programs that have been raised by several critics, among them Martin Feldstein in *Foreign Affairs*. Before doing so, I will briefly discuss the origins of the crisis. I will not deal in any detail with the question of whether the Asian miracle is dead, beyond saying that I believe it is not, and that within a year or two the countries now in crisis will once again be growing at rates well above the world average.

Origins of the crisis

The economic crisis in Asia unfolded against the backdrop of 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 lastdecade. Moreover, during the 30 years preceding the crisis per capita income levels had increased tenfold in Korea, fivefold in Thailand, and fourfold in Malaysia. Indeed, per capita

income levels in Hong Kong and Singapore now exceed those in some Western industrial countries. And until the current crisis, Asia attracted almost half of total capital inflows to developing countries—nearly $100 billion in 1996.

Nevertheless, there were problems on the horizon. First, signs of overheating had become increasingly evident in Thailand and other countries in the region in the form of large external deficits and property and stock market bubbles. Second, pegged exchange rate regimes had been maintained for too long, encouraging heavy external borrowing, which led, in turn, to excessive exposure to foreign exchange risk by domestic financial institutions and corporations. Third, lax prudential rules and financial oversight had permitted the quality of banks' loan portfolios to deteriorate sharply.

Developments in the advanced economies and global financial markets contributed significantly to the buildup of the crisis. In particular, weak growth in Europe and Japan since the beginning of the 1990s had left a shortage of attractive investment opportunities in those economies and kept interest rates low. Large private capital flows to emerging markets, including the so-called carry trade, were driven, to an important degree, by these phenomena, along with an imprudent search for high yields by international investors without due regard for the potential risks. Also contributing to the crisis were the wide swings in the yen/dollar exchange rate over the previous three years.

In the case of Thailand, the crisis, if not its exact timing, was predicted. Beginning in early 1996, a confluence of domestic and external shocks revealed vulnerabilities in the Thai economy that, until then, had been masked by rapid economic growth and the weakness of the U.S. dollar to which the Thai baht was pegged. But in the following 18 months leading up to the floating of the Thai baht in July 1997, neither the IMF in its continuous dialogue with the Thai authorities, nor increasing market pressure, could overcome their sense of denial about the severity of their country's economic problems. Finally, in the absence of convincing policy action, and after a desperate defense of the currency by the central bank, the crisis in Thailand broke.

Should the IMF have gone public with its fears of impending crisis? While we knew that Thailand was extremely vulnerable, we could not predict

with certainty whether, or when, crisis would actually strike. For the IMF to arrive on the scene like the fire brigade with lights flashing and sirens wailing before a crisis occurs, would risk provoking a crisis that might never have occurred. Short of that, IMF management and staff did do everything possible to convince Thailand to take timely, forceful action, but without success.

Once the crisis hit Thailand, the contagion to other economies in the region appeared relentless. Some of the contagion reflected rational market behavior. The depreciation of thebaht could be expected to erode the competitiveness of Thailand's trade competitors, and this put 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 differing 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 even if individual market participants behaved rationally, the degree of currency depreciation that has taken place exceeds by a wide margin 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. To put it bluntly, markets overreacted.

Thailand, Indonesia and Korea face 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 design of the programs that the IMF is supporting in Thailand, Indonesia and Korea reflects these similarities and these differences. [6] These programs have sparked considerable controversy on a range of issues. First, some have argued that they are merely the same old IMF

austerity medicine, inappropriately dispensed to countries suffering from a different disease. 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 intrude inappropriately on matters that should be left to the country to handle. Further, it is argued, that by doing so, the Fund discourages others from coming to the Fund for financial assistance before they have absolutely no choice. Yet others criticize the programs for not intervening enough, for instance for failing to tackle further reforms in such areas as workers' rights and environmental protection. Third, many people are troubled by questions of moral hazard, especially as regards foreign commercial lenders.

Are the programs too tough?

In weighing this question, it is important to recall that when they 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.

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 tolarge 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.

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. Ofcourse, 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.

Moral hazard

The charge that, by coming to the assistance of countries in crisis, the IMF creates moral hazard has been heard from all points of the political compass. The argument has two parts: first, that officials in member countries may take excessive risks because they know the IMF will be there to bail them out if they get into serious trouble; and second, that because the IMF will come to the rescue, investors do not appraise --

indeed do not even bother to appraise -- risks accurately, and are too willing to lend to countries with weak economies.

It would be far-fetched to think that policymakers embarking on a risky course of action do so because the IMF safety net will save them if things go badly. All the evidence is many countries do their best to avoid going to the Fund. Nor have individual policymakers whose countries end in trouble generally survived politically. In this regard, Fund conditionality provides the right incentives for policymakers to do the right thing -- indeed, these incentives have been evident in the preemptive actions taken by some countries during the present crisis. These incentives may even be too strong, and I agree with Martin Feldstein that it would generally be better if countries were willing to come to the Fund sooner rather than later. But I do not believe countries should have too easy access to the Fund: the Fund should not be the lender of first resort; that is the role of the private markets.

The thornier issues arise on the side of investors. Economists tend to point to the problems of moral hazard and the inappropriate appraisal of risks; others are more concerned that some investors who should have paid a penalty -- and typically they refer to the banks --may be bailed out by Fund lending. These are two sides of the same coin: if investors are bailed our inappropriately, then they will be less careful than they should be in future.

First the facts. Most investors in the Asian crisis countries have taken very heavy losses. This applies to equity investors, and to many of those who have lent to corporations and banks. With stock markets and exchange rates plunging, foreign equity investors had by the end of 1997 lost nearly three quarters of the value of their equity holdings in some Asian markets -- though to be sure, those with the courage to hold on, have done better since the turn of the year. Many firms and financial institutions in these countries will unfortunately go bankrupt, and their foreign and domestic lenders will share in the losses.

Some short-term creditors, notably those lending in the inter-bank market, were protected for a while, in that policies aimed to ensure that these credits would continue to be rolled over. In the case of Korea, where bank exposure is largest, the creditor banks have now been bailed *in*, with the operation to roll over and lengthen their loans having been successfully completed earlier this week. Further, we should not exaggerate the extent to

which banks have avoided damage in the Asian crisis: fourth-quarter earnings reports indicate that, overall, the Asian crisis has been costly for foreign commercial banks.

None of this is to deny the problem of moral hazard. It exists, and it has always to be borne in mind, and we need to find better ways of dealing with it. But surely investors will not conclude from this crisis that they need not worry about the risks of their lending because the IMF will come to their rescue. Investors have been hit hard. They should have been, for they lent unwisely. But there remains the question: if it was not mainly moral hazard that led to the unwise lending that underlies the Asian crisis, what was it? The answer is irrational exuberance.

Financial crises based on swings in investor confidence -- on irrational exuberance, and also on irrational depression, not really irrational in lacking some foundation in fact, but sometimes representing an excessive reaction -- far predate the creation of the IMF, and would not be avoided even if the IMF did not exist. This is not something to applaud. Rather we have to do everything we can to provide the information and incentives that will encourage rational investor behavior. We *do* need, as I will discuss shortly, to find better ways to bail in the private sector more systematically. But we cannot build a system on the assumption that crises will not happen. There *will* be times at which countries are faced by a massive reversal of capital flows and potentially devastating loss of investor confidence. Thus we need in the system the capacity to respond to crises that would otherwise force countries to take measures unduly "destructive of national or international prosperity".

The IMF is part of that system of response, to help countries when markets overreact. Here I would like briefly to discuss the role of IMF lending -- and I emphasize that the IMF *lends* money, and gets repaid, it does not give it away -- and the issue of bailouts on a more fundamental level.

When the IMF lends in a crisis, it helps moderate the recession that the country inevitably faces. That means that the residents of that country, its corporations, and some of the lenders to that country, do better than they otherwise would have. That is not in any meaningful sense a bailout, provided lending of this type can be sustained in future crises. Rather, if properly designed to avoid as far as possible creating the wrong incentives for the private sector, it represents rational lending -- not grants or handouts

-- in conditions when markets appear to have overreacted.

To ensure that lending of this type can be sustained in future crises, we have to be surethat the required size of Fund loans does not keep rising, which means that in seeking to improve the architecture of the international system, we will have to find ways of discouraging unwise private lending -- that is to help ensure that risk is properly priced, and to limit the required scale of official lending, in part by finding ways of sharing the burden between the official and private sectors.

The alternative proposed by those who would abolish the IMF is to leave countries and their creditors to sort out the country's inability to service its debts. That sounds simple, but it has rarely been so in practice. That is one reason that the IMF assisted the Asian crisis countries to avoid defaults or debt moratoria. In the absence of an accepted bankruptcy procedure for dealing with such cases, given that the debts involved generally involve both sovereign and private obligations, and given the free rider problem, the experience -- from the inter-War period and the 1980s -- is that workouts have been protracted, and that countries have been denied market access for a long time, at a significant cost to growth. By contrast, in the Mexican crisis of 1994-95, market access was lost for only a few months, and Mexico returned within a year to impressive growth assisted by its ability to tap the international capital markets. Similarly, in the present Asian crisis, it is quite likely that both Korea and Thailand will be back to the international markets within a few months. That surely bodes well for their recoveries, which it is reasonable to expect will begin later this year.

The second reason that the IMF tried to help countries avoid a standstill was the fear of contagion. We believed, and continue to believe, that a standstill by one country, at a time when markets were highly sensitive, would have spread to other countries and possibly other continents. That nearly happened in October, but due to prompt and courageous action by Brazil, did not.

Of course, we cannot know what would have happened had there been no official lending in the Asian crisis. But we do know that the crisis has been contained, and it is reasonable to believe that, deep and unfortunate as the crises in individual countries have been, growth in those economies can resume soon.

Architecture of the international financial system

After every crisis, the international community reflects on what needs to be done to reduce the probability of future crises, and to ensure that crises that do occur can be handled more effectively. After the Mexican crisis the emphasis was on better provision of information to the market. Now the focus is on the architecture of the international system, specifically *crisis prevention* through the arrangements for monitoring and regulating flows of international capital, and *crisis response* to improve the system's response when a crisis occurs.

Let me make five points on crisis prevention. First, there is a need to increase the flowof timely, accurate, and comprehensive data to the public. Through the Special Data Dissemination Standard, the IMF is encouraging countries to move toward greater transparency and fuller disclosure; and it will be necessary to strengthen the standard, for instance by providing data on forward transactions by central banks. Better data provision should lead not only to better informed investor decisions, but also to better policies by governments, for some of the off-balance sheet activities of central banks that were instrumental in the recent crisis could not have continued for as long as they did had they been public knowledge. It is also clear from the present crisis that we need better and more timely data on short term debt exposures, not only of banks, but also of corporations. The Bank for International Settlements is already working hard to improve the short-term debt data. At the same time as we work to improve the coverage, quality and timeliness of data, we need to recognize that data do not provide information until they are processed by human intelligence -- which means we need to improve our ability to read the meaning of the data, through research into crisis indicators, and through official and private sector surveillance of the international system.

Thus, second, ways need to be found to enhance the effectiveness of Fund surveillance --by ensuring, among other things, that all the relevant data is being supplied to the Fund, that countries' exchange rate regimes are consistent with other policies, and that capital inflows are sustainable. The question, already discussed, of whether the Fund should provide more public information, and if necessary issue public warnings, is sure to be agenda. Many have argued that the efficient functioning of the international system requires greater transparency at the IMF itself. This is happening, and the trend should continue.

The international system also needs to monitor international capital flows far more actively, to seek to identify potential trouble spots. The provision of better data on short-term debt flows and exposures will be critical to this effort. Henry Kaufman, who has written convincingly on the need for such monitoring, has suggested we consider setting up a separate international institution for this purpose, but we are not short of international institutions and do not need another one to do this.

Third, since crises are often provoked by problems in the financial sector or intensified by them, much more needs to be done to strengthen domestic financial systems. The IMF has been working in this direction by helping to develop and disseminate a set of best practices in the banking area, so that standards and practices that have worked well in some countries can be adapted and applied in others. These standards are codified in the Basle Committee on Banking Supervision's 25 core principles, introduced last year. This standard-setting effort is extremely important. But the international system also needs to develop mechanisms to monitor the implementation of the standards, to help ensure that countries meet the standards to which they have subscribed. IMF surveillance will play an important role in this regard.

Fourth, we need to improve the way capital markets operate, in both advanced andemerging market countries. One possibility would be to encourage countries to adopt international standards in areas needed for the smooth operation of financial markets, such as bankruptcy codes, securities trading, and corporate governance, including accounting. Market participants would then have clearer basis for making their lending decisions. Once again the international system would need to find a way of monitoring the implementation of these standards, and this is a formidable task. Observance of these standards would be encouraged if the risk weightings on international loans applied by bank regulators in the lending countries reflected compliance of the borrowing countries with the standards.

Fifth, the opening of countries' capital accounts should be handled prudently. This means neither a return to pervasive capital controls, nor a rush to full immediate liberalization, regardless of the risks: the need is for properly sequenced and careful liberalization, so that a larger number of countries can benefit from access to the international capital markets. In

particular, macroeconomic balance and a strong and well-supervised financial system, are prerequisites for successful liberalization. To facilitate this process -- to encourage the *orderly* liberalization of the capital account -- the IMF is at work on an amendment of its charter that will make the liberalization of capital movements a purpose of the Fund.

Some steps have been taken in the direction of crisis response. Through the creation of the Emergency Financing Mechanisms, the IMF's internal procedures for dealing with crisis situations have been streamlined, an initiative that allowed the program for Korea to be negotiated, signed, and approved in less than two weeks. The IMF has also tailored the new Supplemental Reserve Facility to fit the special circumstances of financial crises in emerging markets.

Considerable thought is also being given to finding a mechanism for involving the private sector in the resolution of financial crises in a timely way -- the bail-in question, an issue that was intensively discussed after the Mexican crisis, and to which there is no easy solution. There have been many suggestions, among them that we need the equivalent of an international bankruptcy court or code, and that the international system needs to find a way to authorize a temporary stay on payments in an external financial crisis. There are formidable legal problems in this area, but the search for ways to deal with this problem must continue. Whatever solutions may be suggested, it will be important to bear in mind the dangers of contagion, the possibility that an effort to involve the private sector in solving the problems of one country will lead to capital outflows from others, thus spreading the crisis even as it may be contained in the originating country.

Finally, it should be apparent that the IMF cannot perform a central role in crisis prevention and crisis management without adequate resources, including in particular, the increase in IMF quotas now being considered by the Congress.

The new architecture of the international financial system is still on the drawing board, and it remains to be seen how the international community will decide to deal with these issues, and what precisely the role of the IMF will be. But even if the IMF has its shortcomings -- and like all of us, it does -- it provides a flexible framework for the international community to address global economic and financial problems that exceed the capacity of

individual countries to resolve alone, and for sharing fairly the burden of managing the international system. That has been the source of the strength of the IMF, an institution established more than half a century ago to help restore an international economic system ravaged by depression and war.

Under the steadfast leadership of the United States during this long period, that goal has been achieved, and we again have a truly global international system. Its benefits in improved living standards in the United States and around the world far outweigh the costs that have been evident in recent crises. But we can do better yet, and for that purpose United States leadership remains indispensable.

Thank you.

1 Stanley Fischer is First Deputy Managing Director of the International Monetary Fund. He is grateful to Mary Elizabeth Hansen for assistance. This paper was prepared for delivery as the Forum Funds Lecture at UCLA on March 20 1998.

2 The Executive Board has 24 members, called Executive Directors, appointed by and representing the 182 member countries. Eight Executive Directors, those for the largest countries, represent only their own countries; the 16 other chairs are organized into constituencies, each representing several countries. Each country's vote is proportional to its share in the Fund, with the United States currently holding about 18 percent of the shares. A majority of 85 percent is required for most major decisions.

3 Information about Fund activities and publications is available on the Fund's website (www.imf.org).

4 Because of the lag, fast-growing countries tend to have relatively low quotas, one of the reasons that the November 1997 loan to Korea was so big relative to the country's quota.

5 Among the countries that joined the NAB when it was set up in the wake of the Mexican crisis were Korea and Thailand. They are not now in a position to lend to the Fund.

6 The full texts of the most recent letters of intent outlining their program objectives and commitments are publicly available via the IMF's web-site:

(www.imf.org)

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