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Summing Up by the Chairman
Fund-Supported Programs in the Asian Crisis
Executive Board Meeting 98/131
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Executive Directors welcomed the opportunity to undertake this review of Fund-supported programs that they had approved for the Asian crisis countries. It has been a wide-ranging discussion that has recognized that many of the questions addressed cannot be answered definitively. Directors noted that the Fund's initial response had been based on information available, and considerations relevant, at the time of the crisis. Now, with the benefit of hindsight, it was useful to review the approach taken, as well as alternatives in order to distill lessons that could help guide the Fund's response to future crises. Directors agreed that the paper, with appropriate revisions, and this summing up should be published in order to facilitate a better public understanding of Fund policy advice to the crisis countries, and to provide a basis for ongoing dialogue.

Directors agreed that in Indonesia, Korea, and Thailand the Fund had been confronted with a crisis that was quite different from most instances in which it provides its financial support. This crisis had originated mainly in deep-seated vulnerabilities in the financial and nonbank corporate sectors. Directors observed that long-standing commitments to exchange rate regimes with limited flexibility—which, in some cases, had been maintained even when no longer supported by fundamentals—had been viewed by investors as assurances of exchange value, thereby encouraging excessive foreign exchange exposure; creditors had also incorrectly assumed implicit government guarantees against default losses on certain types of loans. Owing in part to inadequate banking regulation and prudential rules, borrowed funds had been inefficiently intermediated, contributing to overinvestment, unsustainable asset prices, very high exposure to international capital flows, and serious fragilities in the balance sheets of both financial institutions and nonbank corporations. These factors made these countries highly sensitive to shifts in market sentiment. Some Directors also noted the role of the operations of highly leveraged institutional investors in aggravating this crisis. Directors were of the view that forestalling crises of this sort would require a more effective monitoring system, better regulation and supervision of domestic financial institutions, and broader efforts to strengthen the international financial system and to set appropriate incentives for pricing risk. More generally, it was noted that the Fund was examining a number of these issues in the context of its ongoing surveillance activities, and that surveillance was also the subject of an external evaluation now under way.

Directors agreed that a response to a crisis of this nature required a comprehensive focus, embracing macroeconomic and structural policies as well as external financing. They stressed that structural reforms—aimed, in particular, at addressing financial sector weaknesses and imbalances in corporate finances, improving governance, and strengthening and, in some cases, creating, safety nets—were an essential part of the overall package. Several Directors believed, however, that there might have been scope for a different pacing and sequencing of some of the structural reforms beyond the core financial and corporate sector reforms, or for limiting their number in the first instance, while relegating some to a subsequent post-stabilization phase.

Directors observed that the strategy followed in these programs had placed emphasis on restoring confidence through a combination of broad-based policy measures and external financing. Convincing policy packages were essential, as the official funds available fell far short of the countries' near-term exposure to capital outflows. In light of the potential for short-term capital outflows to continue if efforts to establish confidence were not immediately successful, this strategy involved substantial risk. However, Directors saw little alternative. They cautioned that neither the Fund nor the official community more generally could, or should, try to provide a full guarantee of any country's short-term external liabilities, nor should they risk any undue substitution of official resources for private financing. A number of Directors expressed the view that larger and more front-loaded packages could have helped to restore confidence more quickly and thereby limit the economic impact of the crisis. Some also observed that the decision not to disburse the second line of defense in Indonesia and Korea had compromised its usefulness in boosting confidence. Most Directors, however, emphasized that the scale of official financing had been unprecedented, and that financing should neither substitute for, nor delay, required policy adjustments.

Directors saw as a central lesson of this crisis the importance of ongoing efforts to devise appropriate ways of involving the private sector in forestalling and resolving financial crises. Indeed, a few Directors thought smaller official financing packages might have acted as a stimulus to greater private sector involvement. Several Directors expressed the view that earlier action should have been taken in these country cases to "bail in" the private sector.

On capital controls, a few Directors saw advantages in resorting to them, at least on a temporary basis and as a last resort in particularly difficult circumstances. However, most Directors were of the view that attempts to restrict outflows in the midst of a crisis would almost certainly have hindered the restoration of market access for the country concerned and exacerbated contagion to other countries. More broadly, several Directors noted that the Asian crisis underscored the need for appropriate sequencing of the liberalization of capital movements, and considered that further work on the appropriate regulatory and prudential regimes was warranted.

Directors discussed the several factors that had contributed to the protracted process of restoring confidence. Political uncertainties, and in some instances early hesitations on the part of the authorities in implementing policies in line with the programs, had undermined confidence by casting doubt on the authorities' commitment to, and ownership of, the programs. Some Directors focused on what they saw as ill-timed revelations under the programs of previously unreported financial information. In this connection, it was observed that, besides facilitating earlier diagnosis and corrective measures, more complete and continuous provision of financial information would have obviated the need to release disquieting data in the midst of the crisis. Some Directors also observed that public communications on the part of both the country authorities and the Fund may, at times, have adversely influenced market perceptions. Also, the debate that arose over the efficacy of the initial policy packages had exacerbated uncertainties.

Directors expressed concern over the severe recessions in these countries, and observed that the macroeconomic projections on which the initial programs had been based had greatly underestimated the actual economic downturns. This reflected, in part, the fact that the program projections were predicated on the success of the programs themselves. In the event, capital outflows had far exceeded expectations, forcing massive current account adjustment through precipitous depreciations and a sharp decline in domestic demand. At the same time, given the weakness of other economies in the region, the increase in exports had proved too small to provide sufficient support for economic activity. In Indonesia and Thailand, deteriorating terms of trade had imposed a large and additional negative shock. Some Directors observed that the underestimation of the economic downturn had adversely influenced policy prescriptions, especially with respect to fiscal policy. Directors suggested that, to better assess the growth outlook in crisis situations, more attention should be paid in the future to the experience of earlier crisis situations, as well as to regional interlinkages. To this end, they considered that more emphasis on regional approaches to surveillance would be desirable.

Most Directors agreed that in the midst of the crisis, and in the specific circumstances of these countries, it had been appropriate to formulate these programs on the basis of floating exchange rates. Available reserves had been inadequate to defend a new exchange rate peg. Supporting a pegged exchange rate would have required the full subordination of monetary policy to the exchange rate, which would likely have required substantially higher interest rates than those actually experienced. Moreover, failed attempts to repeg exchange rates at new levels under crisis conditions would have risked a further erosion of credibility.

Directors noted that the main goal of monetary policy in these countries had been to avert a depreciation-inflation spiral, and that, in this, the programs, after a hesitant start, had been largely successful. Turbulent market conditions required a flexible approach to monetary policy, leaning against the wind rather than pursuing a fixed target for the exchange rate. Directors generally endorsed the tightening of monetary policy recommended in the programs in order to arrest and then reverse the excessive depreciation of exchange rates that had occurred. Several Directors pointed out that initially these efforts had been less than successful, owing in part to the hesitant and often uneven monetary policy tightening in the crisis countries, and some argued that the situation had warranted a more aggressive and rapid tightening. The eventual degree of monetary restraint was significant, but was typical of a crisis situation in which a country's risk premium is driven up by market forces. Most Directors saw the alternative of keeping interest rates low and allowing the currencies to depreciate as riskier, because the likely result would have been an even worse downward spiral rather than a temporary depreciation. A few Directors argued that monetary policy tightening alone could not have stabilized the exchange rate; it had to be accompanied by comprehensive actions to address the fundamental problems that had contributed to the crisis of confidence in the first instance, which, of course, was also the aim of the programs.

While Directors expressed concern over reports of a credit crunch in these countries, and a few of them were concerned that monetary policies had been too tight, most were of the view that some strains on borrowers were unavoidable in a situation of excessively leveraged firms and large, unhedged foreign currency exposures. There was a view, nevertheless, that further study of the role of monetary policy in countries experiencing structural banking problems was warranted. Most Directors also saw the primary problem as one of the distribution of credit in the economy rather than its aggregate amount, with the main lesson being the need to move ahead forcefully with structural reforms in the financial and corporate sectors and to support viable financial institutions in the midst of a banking crisis. Directors welcomed the fact that interest rates in Korea and Thailand had now moved back to below pre-crisis levels, and that market conditions in Indonesia were stabilizing.

Directors viewed fiscal policy as having played a quite different role in the programs from that originally envisaged. Initially, and particularly in Thailand with its large current account deficit, when a relatively contained slowdown in growth had been expected, a limited fiscal adjustment had been seen as needed to prevent an excessive burden of external adjustment from falling on the private sector, and to help meet the quasi-fiscal costs of financial sector restructuring. However, after taking into account the unexpected severity of the recessions and the sharp improvements in current account positions, the programs' original fiscal targets now appeared to have been tighter than necessary. Some Directors questioned the appropriateness of fiscal restraint in the first instance, arguing that such restraint was not needed to boost confidence in countries with generally strong budgetary positions and low levels of government debt.

Directors welcomed the adaptation of the programs—particularly the easing of fiscal policy in response to unfolding circumstances—although some thought that the easing should have been quicker as the severity of the economic slowdown became increasingly apparent. It was observed that, in practice, the countries had found it difficult to use fully the scope afforded them for more expansionary budgetary policies under the revised programs, because of the time needed to develop new social spending programs, as well as the conflict between rapid shifts in fiscal policy and careful management of the quality of government spending.

Directors agreed that the nature of the crisis and the complementarity among different reforms had necessitated a comprehensive package of structural measures. These reforms had been needed, and continued to be needed, to address the root causes of the crisis and to lay the groundwork for sustainable medium-term growth. Many Directors felt that the package of structural reforms in each country was essential to restoring confidence on a sustainable basis, but they acknowledged the difficulties entailed in trying to alter market perceptions with policies that were often politically sensitive and that took time to implement and take effect.

Several Directors expressed concern that the programs may have been overloaded with reform measures. In their view, better sequencing and prioritization would have involved certain reforms being left to the second stage of the programs. All Directors, however, stressed the need to address, early in the programs, the core areas from which the crisis had arisen, especially the banking and corporate sectors. Given the comprehensiveness of the reforms pursued, success depended critically on cooperation with other international financial institutions, notably the World Bank and the Asian Development Bank. Directors supported ongoing efforts to strengthen such cooperation. Also, noting the difficulties experienced in securing political consensus for reforms, especially when faced with strong vested interests, they emphasized the importance of the Fund's efforts to ensure the authorities' commitment to, and ownership of, the programs.

Directors also stressed the importance of reforms in governance, together with the host of issues touching on the establishment of appropriate incentives for private market behavior and the need to ensure that the costs of failure are borne by private investors. They saw weaknesses in these areas as the underlying cause of many of the vulnerabilities that had led to the crisis. They thus saw improvements in governance as fundamental to fostering reforms in other areas, including financial and corporate restructuring, competition policy, trade liberalization, and privatization.

Directors saw the establishment and strengthening of social safety nets to cushion the adverse impact of the crisis on the poor as an essential element of the programs, and welcomed the ongoing improvements in the targeting of social expenditure and the increased efforts of the World Bank in this domain.

Directors welcomed signs that market conditions were stabilizing and indications that the recessions were bottoming out. They cautioned, however, that risks remained, and emphasized that resolute and rapid structural reform would be key to consolidating the progress and laying the foundation for sustainable growth.

In summing up the central lessons from the programs with these three countries, Directors highlighted the importance of the following:

Actions to forestall crises:

- Analyze on a regular basis, in the context of Fund surveillance, the continuing appropriateness of exchange rate regimes in light of changing fundamentals.

- Provide full and clear financial information, on both public and private sectors, to the market on a continuous basis so as to minimize the possibility of negative surprises.

- Strengthen regulatory and prudential regimes in all countries.

- Adapt institutions and regulations in creditor countries so as to better ensure an appropriate pricing of risk and to inhibit "bandwagon" behavior. Promote actions to reduce the systemic risk associated with financial market turbulence through, inter alia, strengthening disclosure requirements for all investors, including highly leveraged institutions.

Issues related to program design and implementation:

- Base programs on macroeconomic projections that take full account of the likely regional spillovers associated with a crisis and the effects of a crisis in curtailing countries' access to private external financing.

- Undertake further analysis of the particular issues arising in debtor countries from severe banking and financial sector weaknesses in the context of financial crises--including bank closures, government blanket guarantees, moral hazard concerns, and the extent and form of regulatory forbearance in these situations.

- Encourage the authorities to take decisive actions at the outset to demonstrate adequate ownership of, and public leadership in, the programs.

- Communicate and explain to markets and the general public, in the closest possible coordination with the authorities, the full content of the program, while avoiding eliciting unrealistic expectations.

- Exercise flexibility in adapting programs to changing circumstances.

- Secure early agreement with the authorities and other international financial institutions on a comprehensive strategy of structural reform, particularly as regards financial and corporate restructuring, with due attention to their timeliness and proper sequencing.

Issues related to financing of programs:

- Promote greater involvement of the private sector in forestalling and resolving financial crisis.

- Examine further the issue of the appropriate level of official financing and enhance the credibility of official financing packages, in particular by establishing clear understandings on the conditions for disbursement.

A number of these points are being intensively explored further, in particular in the context of discussions of the international financial architecture and of the Fund's conditionality guidelines.

Finally, Directors expressed their high appreciation for the staff's untiring efforts amid often unprecedented difficulties.