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The Asian Crisis and the International Response

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Thank you, ladies and gentlemen. It is a great pleasure to be back again in Barcelona, and to be visiting the Institute of Advanced Business Studies (IESE) of the University of Navarra for the first time. Considering that my ancestors were subjects of the Kings of Navarra longer than they were subjects of the Kings of France, and that my path has frequently, at just four centuries' distance—a mere moment in eternity—crossed that of Francis Xavier on the shores of the Strait of Malacca, China and Japan, I am particularly pleased to have the opportunity to spend some time with you in trying to reach a better understanding of the world in which we live. It is a world that seems to be moving from crisis to crisis. Today, as we see, it is the turn of the countries of southeast Asia—where I am headed again tomorrow—countries that not so very long ago were considered models of orderly development.

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With that in mind, I would like to give you my perspective on developments in Asia and where we must go from here; on the requirements for sound economic management at the national level, something that will not surprise you coming from me; and, beyond that, on what more could and should be done to reduce the risk of such crises in the future. But I beg you to show a certain amount of intellectual prudence about what I am going to say to you. Although we are moving toward an understanding of what happened and are making progress in putting out this particular fire, the fire is still smoldering. We are not at the end of the story yet, and it doesn't take a great deal of imagination to see how regional problems, if left unattended, can become global ones.

I. Let us begin with a simple question: how could it happen?

How could events in southeast Asia unfold as they did, after so many years of such outstanding economic performance?

The region's problems began in Thailand, where there were numerous signs of impending crisis. Macroeconomic indicators pointed to substantial imbalances: the real exchange rate had appreciated substantially; exports growth had slowed markedly; the current account deficit was persistently large and was increasingly financed by short-term inflows; and external debt was rising quickly. These problems, in turn, exposed other weaknesses in the Thai economy, including substantial, unhedged foreign borrowing by the private sector, an inflated property market, and a weak and over-exposed banking system. Markets also warned of the unsustainability of Thailand's policies, as seen in lower equity prices and mounting exchange rate pressure. The IMF, for its part, was in continuous dialogue with the Thai authorities for 18 months prior to the floating of the baht last July, stressing these problems and pressing for urgent measures. But, after so many years of outstanding macroeconomic performance, it was difficult, if not impossible, for the authorities in Thailand—and other countries—to recognize that serious underlying deficiencies could jeopardize their track record. What we had here was an unprecedented "denial syndrome," which very quickly spread and which contributed to the delay in taking convincing policy action until, at last, the crisis broke.

If macroeconomic imbalances provoked the crisis in Thailand, how then did it spread to economies such as the Philippines, Indonesia, Malaysia, and Korea, the eleventh largest economy in the world? It may be some time yet before we have the complete answer to this question—and obviously my answer cannot be complete either—but some elements of the explanation are becoming clear.

To begin with, developments in Thailand naturally affected economic conditions in neighboring countries. For example, in expectation that the depreciation of the baht would erode the competitiveness of Thailand's trade competitors, other currencies in the region also weakened. And as these currency slides persisted, the debt service costs of the domestic private sector increased. Uncertainty about how far these currencies would decline and how much debt service costs would increase encouraged a rush to hedge external liabilities that only intensified exchange rate and interest rate pressures.

At the same time, problems in the Thai economy prompted markets to take a closer look at the risks in other countries. And what they saw—to different degrees in different places—were many of the same problems affecting Thailand, among them: overvalued real estate markets, weak and over-extended banking sectors, poor prudential supervision, substantial private short-term borrowing in foreign currency, and, frequently, relations between banks and businesses that bordered on the incestuous and that seriously jeopardized the overall quality of management, as here too the the separation of powers is the font of wisdom. Moreover, after Thailand, markets began to look more critically at weaknesses they had previously considered minor, or at least manageable in an orderly way, given time.

Two other factors also undermined market confidence. One was the lack of transparency about government and central bank operations, about the true state of financial sectors, and about the links between banks, industry, and government and their possible impact on economic policy, a problem that is particularly serious in Korea. In the absence of sufficient information, markets are entitled to fear the worst and to doubt the capacity of governments to take corrective action. The other factor was the controls—and threat of controls—on market activity, which not only made investments riskier, but tended to reinforce the view that governments were addressing the symptoms, rather than the causes, of their problems, and accelerated investors' run for cover and set back other efforts to restore confidence. This brings us to the basic challenge.

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II. How to restore confidence

As developments have shown, confidence, once lost, is hard to regain. Restoring confidence must begin at the national level with a strong commitment to economic adjustment and reform demonstrated by the implementation of what are often painful measures. It also requires a free flow of timely, accurate, and comprehensive information from the national authorities so that markets can assess the extent of underlying problems and the seriousness of efforts to correct them. And, of course, restoring confidence takes time.

This process is now under way in southeast Asia. With the support of the IMF, Japan, and a number of other countries in the region, Thailand has launched a courageous and comprehensive program that addresses the problems of large external deficits and troubled financial institutions, which the new government that took office early this month has pledged to implement fully. The Philippines has taken necessary measures and extended its program with the IMF, under which a substantial amount of economic adjustment and reform had already taken place. Malaysia has also begun to adapt to changing conditions by announcing a tightening of the fiscal stance, a deferment of large-scale investment projects, and by strengthening prudential regulations and disclosure requirements.

Indonesia has strengthened its policy stance in continuous dialogue with the IMF and has recently reached agreement with us on a major program to strengthen fiscal policies, restructure the financial sector, and deregulate the economy. The IMF has agreed to support this program with a loan of $10 billion in a total package of $23 billion, of which $18 billion will consist of multilateral financing. In addition, an important group of countries have declared their readiness to provide additional financial support, if needed.

An IMF staff team is currently in Seoul helping the authorities address the economic and financial impact of the recent market turmoil through the implementation of a comprehensive adjustment program aimed at accelerating financial sector reform and restructuring, and strengthening macroeconomic policies. In fact, we are working day and night. This is no exaggeration if you consider that there is a 14-hour time difference between Washington and Seoul, and that, here in Barcelona, at 8 hours' remove from Seoul, I just spoke with my colleagues, for whom it was three in the morning and who were coming out of several hours of negotiations that were, I am pleased to announce here in Barcelona, very productive. We are reaching a consensus that I will ask the key political powers in the country to ratify, as presidential elections are coming up shortly, although I am confident that this can be achieved earlier. As in the case of the adjustment programs in Thailand and Indonesia, it is naturally expected that there will be a very substantial financial support package from the Fund and other, bilateral sources. With determined efforts to address the problems in the financial and corporate sector in Korea, I am confident that the situation will be stabilized and that, after a period of adjustment, Korea can return to the growth rates that it has enjoyed over the past two decades. But let me be frank. We are devoting all our energies to this, but the challenge is daunting, as the package of measures must provide sufficient guarantees that the same causes will not have the same effects tomorrow. What we are trying to do in our discussions is to remove a lot of dead wood and practices that are harmful to economic management, and especially to lay a solid foundation for recovery and for strong, more sustainable economic growth in the decades ahead. Naturally, it will take some time for these efforts to bear fruit. But developments in recent months have by no means wiped out the achievements of past decades. On the contrary, the region's longer term fundamentals—including its high domestic saving rates, strong fiscal positions, dynamic private sectors, and recent gains in competitiveness—remain favorable. Moreover, all of these countries still have a long way to go to catch up with advanced economies. Thus, if they pursue sound policies and rid themselves of hitherto hidden obstacles to high-quality growth, they should be able to sustain high rates of growth for an extended period to come.

In the less distant future, growth can be expected to rebound strongly after a relatively short, but sharp, weakening of economic activity and a rapid narrowing of external deficits. And as this process takes place, each of these countries will have the opportunity to strengthen its economy in fundamental ways. That is why I am confident that, after this period of adjustment, these economies will emerge stronger than before. Indeed, I believe that this crisis could be a blessing in disguise.

III. Some difficulties of the task

I am not suggesting that this process will be an easy one. Let me mention two issues that the countries must come to terms with and a third for the international community.

First, countries must exorcize the "denial syndrome." Even after so many years in my current position, it continues to surprise me that countries can deny the extent of their problems for so long, and only ask for international help at the last moment, when there is no other option open to them, and after wasting precious reform time and international reserves that are very difficult to rebuild. The human cost of this sometimes shocks me, as do all the stratagems used to leave the essential task of adjustment to future governments. What do these countries fear that they delay the inevitable so much? Is it the solutions that we propose? But these solutions are recommended by the entire world and have, moreover, been successful in other countries. Or is it mere change that they fear? This is more likely. It is difficult suddenly to abandon the comfortable, if suboptimal, equilibrium in which they have been living for some time, an equilibrium built on compromise between vested interests and political forces, at the cost of the poorest, the environment, and the quality of life of the majority of the population. Hopefully, these realities will become clearer in the future and politicians will understand that history will not easily forgive them for having contented themselves—in challenging times—with burying their heads in the sand.

Second, countries in the region need to maintain some perspective about global markets, and not go from one extreme to the other. Certainly, there are risks in tapping these markets to which no country is immune. At times, markets can be slow to react to changes in economic conditions and then react sharply; and in some instances, herd instinct seems to prevail. But the fact remains that markets also provide tremendous opportunities to accelerate growth and development, as southeast Asia's experience in earlier years has shown. The key to reaping the benefits of global markets, while minimizing their risks, is to approach them in a responsible manner—with strong macroeconomic fundamentals and sound structural policies that give markets confidence and therefore encourage long-term investment; with respect for the signals that markets provide; and with transparent and market-friendly policies that allow markets to allocate resources efficiently. But it is true that sometimes the herd instinct of the markets generates all kinds of unfounded suspicions, as well as accusations—hitherto unsubstantiated—of widespread manipulation and conspiracies. What is worth doing, and what we have undertaken to do, is to ask ourselves about the structural changes that may have gone unnoticed in the money markets, the role of hedge funds, and the possible need for a regulatory change to promote more orderly and transparent operation of these markets. At the request of the G-15 countries, the IMF has been looking into this question, talking to market participants and central banks about how hedge funds are set up and regulated, and what role they may have played in the most recent crisis. Let me say this, however. From what we know so far, it would be a mistake to blame hedge funds or other market participants for the turmoil in Asia. We will be making our conclusions and suggestions public in a few weeks.

Even more important than this is the topic I am coming to now: What more can be done to prevent such crises in the future? What, first of all, are the appropriate lessons to be drawn from this crisis?

IV. Preparing for the future

The first lesson is the most obvious one: the necessity of taking early action to correct macroeconomic imbalances and strengthen domestic financial sectors before they precipitate a crisis. Unfortunately, for themselves and for other countries, this did not happen in Thailand, despite timely and vigorous warnings.

The second lesson is that countries must recognize is that in this globalized world they are more vulnerable to crises in other markets than their own economic fundamentals would suggest. Consequently, they need to take preemptive actions to strengthen their policies. Several suggestions come to mind as to where such action might be needed:

- one, maintaining an appropriate exchange rate regime. Clearly, there is no single "right" choice of exchange system that would fit every country and every circumstance. Yet the evolution of these crises has underscored the heightened risks of some common errors of exchange rate policy, such as trying to sustain an exchange rate peg that is out of line with economic fundamentals or trying to exercise nonmarket interference in a floating exchange rate system. In a financially integrated world, these errors carry swifter and more serious consequences. But regardless of the exchange rate arrangement and policy, appropriate macroeconomic policies are essential to ensure its success;

- two, maintaining an appropriate macroeconomic policy mix to ensure that fiscal positions do not lead to unduly high domestic interest rates, which, in many cases, have contributed to excessive amounts of short-term capital inflows;

- three, strengthening structural policies—especially the policies and institutions, such as prudential supervision, needed to underpin a sound financial system. In particular, it is important that fragilities in the financial system are not allowed to become so acute that the authorities are unwilling to use the interest rate instrument in times of international financial instability;

- and four, carrying out other supporting reforms—what we call "second generation" reforms—to promote domestic competition, increase transparency and accountability, improve governance, help ensure that the benefits of future growth are widely shared, and otherwise strengthen the foundations for future growth.

What else can be done to avoid future crises? One promising avenue is to complement the IMF's global surveillance over countries' policies with regional surveillance. As we have seen in Asia, spillover and contagion effects can be so rapid and so costly to countries with basically sound policies that every country has a strong interest in seeing that its neighbors manage their economies well. As EU members know, the scope for improving policies increases when neighboring countries get together on a regular basis to encourage one another—and, at times, to exert some peer pressure on one another—to pursue sound policies. Thus, it is encouraging to see that a number of countries of the Pacific rim are developing a mechanism for more intensive surveillance and dialogue among participating finance ministries and central banks, to complement the IMF's global surveillance. Of course, to be effective, regional surveillance has to be based on sound economic analysis. The IMF stands ready to contribute to regional surveillance in Asia, as it already does in the G-7 and other fora.

Let me also say a few words about the benefits of openness and transparency in preventing crises. When economic policies are transparent, policymakers have more incentive to pursue sound policies. If I may cite one pointed example among many, would the Central Bank of Thailand have accumulated such large forward liabilities if the public had had regular access to information on central bank operations? On the contrary, the authorities would have had to face the problem of Thailand's dwindling reserves much sooner; and most likely, they would have taken corrective action before reserve losses became so large.

Likewise, when timely, accurate, and comprehensive data are readily available, markets adjust more smoothly. Thus, countries are less vulnerable to market reactions when problems eventually come to light, as indeed they always do. Especially when governments are trying to rebuild confidence, a free flow of information allows markets to assess the extent of underlying problems and the seriousness of efforts to correct them. Of course, transparency about government operations and decision-making also limits the opportunities for corruption, which can otherwise distort resource allocation, undermine investor confidence, and inhibit growth. For all of these reasons, openness and transparency can make a substantial contribution to better policies, more stable markets, and hence, more sustainable growth. To promote greater transparency, the IMF is actively encouraging all countries to provide more accurate, timely, and comprehensive economic and financial data to the public. To this end, the IMF has developed a set of standards regarding the quality, coverage, frequency, and timeliness of the data that countries release to the public. Procedures have also been put in place to permit countries to inform the public of the IMF's views on their economic policies and situation.

V. Dealing with crises when they emerge

First, the world must ensure that it has the means to deal quickly and decisively with the crises that do arise. For this, it looks to the IMF as the central institution in the international monetary system.

Part of our mandate is to provide members with temporary financial support so that they can correct balance of payments problems in an orderly way. Since time can be of the essence, the IMF has established an emergency financing mechanism so that it can provide financial assistance more speedily when countries facing external crises are willing to take strong corrective action. This mechanism was used to expedite the recent programs for the Philippines, Thailand, and Indonesia, and we are using it now with Korea. But in order to restore confidence in the face of massive capital flows, the Fund must, in some cases, provide very large amounts of financing.

This brings us to a very hot topic for the international community, namely, how to strike an appropriate balance in the amount of official financing provided to these countries, without creating a moral hazard problem by making the lives of the most irresponsible participants easier. How much is the "right amount" of IMF support? The IMF must not do "too much" or "too little." If it appears to be doing "too much," this would raise the specter of a "bailout" of the borrowing government or the most irresponsible private creditors and the associated moral hazard problems. The fact is, however, that no government would deliberately pursue unsound policies solely to give itself the luxury of drawing IMF resources, because our financing is only provided in support of sound, and often painful, adjustment programs. As for private creditors, if they think that our programs will allow them to pursue unsound management practices with impunity, they may wish to ask the shareholders and creditors of the 16 banks in Indonesia that recently suspended operations at our request whether they feel particularly "bailed out."

On the other hand, the IMF must not do "too little" either. To begin with, we have to do our job. Our Charter stipulates that one of the basic purposes of the Fund is "to give confidence to members" by providing temporary financial support so that they can correct balance of payments problems in an orderly manner. To fulfill this task in an era of massive capital flows, the IMF must be prepared to provide exceptionally large amounts financing, in some cases, in order to give confidence to policymakers and market participants. Likewise, the IMF must put enough money on the table to give confidence to other lenders. It requires a delicate balance. As you can imagine, this leads to lively discussions in our Executive Board, and, knowing the Spanish Executive Director as you do, you can be sure that some snippets of Catalan wisdom filter down to us.

This leaves us with one last problem to be discussed: how to maintain our financial credibility? More specifically, what steps can we take to increase our resources when confronted with challenges of this magnitude?

As you may know, the membership has recently agreed to an increase of about $90 billion in the IMF's capital. This will raise the capital base of the institution to some $290 billion. The Fund has also taken steps to augment its financial resources through the agreement on the New Arrangements to Borrow. Under these arrangements, participants would be prepared to lend up to the equivalent of some $47 billion when additional resources are needed to deal with an exceptional situation that poses a threat to the stability of the system.

Finally, agreement has been reached on a special one-time allocation of special drawing rights, equivalent to about $30 billion, that will equalize the ratio of SDR allocations to quotas for all members, thereby doubling the amount of SDRs allocated to date. These resources will supplement members' reserves, giving countries more flexibility in economic policies and a cushion against adverse developments, and also bring to a successful conclusion the major battle that we have been waging since 1994 in Madrid. All of these initiatives will require ratification by individual member governments, including in many cases, parliamentary approval. Thus, there is still a considerable amount of work to be done to ensure that the IMF will continue to have the necessary resources to play its key confidence-building role.

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I do not have time for lengthy concluding remarks, but I would just like to reiterate my pleasure in having had the opportunity to share with you my modest reflections on the upheavals that have taken place in so many countries as they face the new world horizon at this turn of the century, a horizon that has been Catalonia's since its earliest times. Thank you.