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Summing Up by the Acting Chairman
World Economic Outlook—Interim Assessment—Implications of the Financial Crisis in Southeast and East Asia
Executive Board Meeting 97/122
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Directors welcomed the opportunity provided by the staff's interim assessment to discuss the implications for the global economic outlook of the financial turmoil in Asia. With events in Asia still unfolding, Directors emphasized the unusually large uncertainties that necessarily attach to the present projections, and regarded them as being of a preliminary nature.

Directors generally concurred with the staff's analysis of the origins and evolution of the financial crises in several Asian economies. A number of factors had contributed to the buildup of recent difficulties. Those included some positive features of the economic performance in recent decades of the countries affected, which had helped to attract large-scale capital inflows during the 1990s. External factors had also played a role: in particular, low asset yields in industrial countries had encouraged those capital inflows, while the appreciation of the U.S. dollar and slower export market growth in the affected economies had adversely affected trade and growth performance in 1996-97, contributing to the disruptive shifts in market sentiment.

Directors agreed, however, that policy weaknesses in the countries affected had been most important. Most Directors noted that, in most of the crisis cases—Korea being the main exception—inflexible exchange rate arrangements had to a significant extent made it more difficult for monetary policy to play its role in containing overheating pressures. Directors generally placed most emphasis, however, on the role played by structural weaknesses, especially in financial sectors. Inadequate regulation and supervision of financial institutions, combined with weaknesses in the institutions themselves, had fostered imprudent lending, which in some cases had been boosted by unsustainable levels of short-term foreign borrowing. Moreover, market discipline on the allocation of resources and on the volume of capital investment had been to varying degrees impeded by excessive government intervention, thus further distorting not only the deployment of the financial inflows from abroad, but also the effective intermediation of domestic financial resources. Directors also noted that significant delays in confronting the seriousness of the problems and adopting the requisite monetary policy and structural reform measures had compounded the economic difficulties experienced by the affected countries and the attendant contagion effects. Directors also stressed that the recent experience amply demonstrated the importance of accurate and timely provision of information. The need for timely and complete data on financial and banking indicators, short-term external debt, and reserve-related liabilities was particularly emphasized.

Most Directors agreed that the staff's baseline scenario represented a cautiously optimistic assessment, and one that was subject to a wide margin of uncertainty. In particular, the baseline projections assume that, with appropriate and timely adjustment and reform efforts in the countries affected, together with the support of the international community, sentiment toward the emerging market countries in Asia will begin to turn around in the year ahead, although private external financing to the emerging markets in all likelihood will not return to the high levels seen in 1996. The drop in capital flows now being experienced will generate significant declines in the current account deficits of the countries affected, through weaker domestic demand and activity as well as the large exchange rate depreciations that have taken place. These adjustments, in turn, will feed through negatively to activity in trading partners. Growth in most Asian emerging market economies is set to slow significantly in the period ahead. Capital inflows and rates of expansion in emerging market countries of other regions are also likely to slow, but by less than in Asia. For the world as a whole, output growth seems likely to moderate to about 3 1/2 percent, a downward adjustment of 0.8 percent compared with the projection in the October 1997 *World Economic Outlook.*

Directors expressed concern, however, that there appeared to be significant downside risks to the central projection for global growth. In particular, the projected pattern of current account positions may not be sustainable, and it seems likely that the emerging market countries may have to undertake more adjustment in response to reduced capital inflows than allowed for in the baseline. This points to what Directors agreed is among the most important sources of uncertainty—the scale, distribution, and duration of the decline in capital flows. In this context, Directors considered that the alternative scenarios presented by the staff provide useful illustrations of the implications of larger financing shortfalls.

Directors emphasized that the outcome will depend on policies, and generally concurred with the staff's analysis of the policy actions needed to contain the crisis. They agreed that the main responsibility for taking appropriate action to limit the economic damage lies with the countries directly affected, and that hesitation in the implementation of the needed adjustment and reform measures can only worsen the crisis and exacerbate overshooting in financial markets and contagion to other countries. In this context, a number of speakers questioned the adequacy of the commitments of the authorities in some of the affected countries and argued that this had added to market turbulence. All Directors agreed that bold actions to address key policy weaknesses are indispensable for confidence to be restored and for the ground to be prepared for a solid rebound from the current difficulties. They particularly stressed four areas for action.

First, a priority in a crisis situation is to reassure domestic and foreign investors that macroeconomic stability will be restored. However, some speakers questioned the need for significant tightenings of fiscal policy, since the Asian economies in crisis generally do not suffer from fiscal imbalances. Directors agreed that the required degree and composition of fiscal adjustment needs to strike a balance between several objectives, including the need tocontribute sufficiently to the process of current account adjustment and to meet the costs of the restructuring of financial systems while avoiding excessive compression of domestic demand.

Second, Directors emphasized that monetary policies need to be kept sufficiently firm to resist excessive depreciation, its inflationary consequences, and spillovers on partner countries' currencies. A monetary tightening up front is essential to restore market confidence quickly, while the requisite banking and other structural reform measures are getting under way. Several Directors observed that monetary policy alone cannot restore confidence and stability and that the extent and duration of the monetary tightening needed to stabilize markets would depend on the signals country authorities give markets about their willingness and resolve to accomplish the necessary reforms and the speed with which such efforts are pursued. They agreed that as confidence is restored, monetary conditions should be allowed to ease to help support activity, but emphasized the danger of premature easing. Directors particularly stressed the importance of providing adequate incentives for financial institutions and corporations to roll over short-term loans in cases in which the repayment of such loans risks exacerbating downward pressures on the exchange rate.

Third, Directors agreed on the key priority of addressing weaknesses in the financial sector that had been exposed and exacerbated by the recent difficulties. They emphasized that bold and comprehensive measures are essential to dispel uncertainties in the financial sector. While it is necessary to ensure adequate protection for small deposit holders, insolvent institutions need to be closed to facilitate an early restoration of confidence, and weak but viable institutions need to be restructured and recapitalized in ways that are fully transparent and do not inappropriately shield creditors and equity holders from losses or exacerbate problems of moral hazard.

Fourth, Directors stressed the need to strengthen public and corporate governance, to enhance transparency and accountability, and to provide on an accurate and timely basis data, especially on financial and banking sector indicators. These issues appropriately had received a high degree of attention in the policy programs supported by Fund arrangements in Thailand, Indonesia, and Korea.

Directors noted that the prolonged crisis in Southeast Asia and East Asia had raised the prospect that other emerging market countries, which had already experienced some spillovers, could witness an intensification of financial market pressures. While reform efforts have been strengthened considerably among the developing countries in recent years, Directors cautioned that a number of countries remain vulnerable to reversals of market sentiment, especially in view of the general reappraisal of emerging market risks. Directors considered that the policy requirements in those countries are similar to those that apply to the countries that have already been affected.

In addition, several speakers thought that some countries would need to consider whether greater exchange rate flexibility might help to reduce the risk and cost of speculative attacks on their currencies. Directors agreed that, whichever exchange arrangement countries choose to follow, the arrangement can provide protection against currency market turmoil only if it is fully supported by strong macroeconomic policies and robust financial systems.

Directors agreed that the imposition of capital controls during a crisis might well worsen confidence and add to turbulence in financial markets. At the same time, a number of speakers argued that the emerging market countries should not liberalize their capital accounts prematurely and that, especially in light of the extension of the Fund's mandate to the capital account, there was a need to better understand the preconditions for an orderly liberalization, among which undoubtedly was a strengthening of the financial system. Several other speakers suggested that the weaknesses in financial sectors that had been exposed by the recent crises in Asia could be attributed in part to the failure to liberalize the financial markets in those countries, which had impeded resource allocation. Directors generally agreed on the critical importance of prudential regulations to limit banking system exposure to currency market turmoil.

Directors also discussed the role of the international community in helping to contain the crisis. They noted the substantial financial support that is being provided by the Fund, in collaboration with other international agencies and bilateral sources. In this context, several Directors expressed concern about the possible moral hazard implications of the current crisis resolution mechanisms, and stressed that it was important to the maximum extent to ensure that Fund financing did not serve to bail out private creditors. They noted that the burden of financial support should not be assumed by the Fund, other international financial institutions, and the official sector alone, but that private sector creditors should play a part as well.

A number of speakers emphasized that, while financial market conditions remain unsettled, authorities in the major industrial countries should be cautious in considering any further tightening of monetary policy. Most Directors felt it would be appropriate to put further tightening on hold for the moment, particularly given the prospect in most cases of continuing subdued inflation. Some Directors felt, however, that domestic monetary policy should be aimed solely at dealing with the condition of the domestic economy.

Several speakers felt that the situation in Japan was of particular concern for the country itself, for the rest of Asia, and indeed for the global economic outlook. The importance of Japan in the global economic and financial system, as well as its role in Asia, made it critical that uncertainties about the health of its financial system be resolved. To this end, Directors called for resolute action to address the strains in the Japanese financial sector, including the closure of insolvent institutions and the well-targeted use of public funds to assist in the restructuring that is urgently needed. In this regard, Directors welcomed the planned introduction of measures to facilitate financial sector restructuring, and expressed the hope that those measures would be adequate to the needs of the occasion.

Most Directors also called for modest expansionary fiscal measures to help avoid any further withdrawal of fiscal stimulus until recovery is re-established. Directors also emphasized the need to speed up the process of deregulation to enhance domestic investment opportunities and, thereby, reduce Japan's persistently large external surplus.

Despite the seriousness of the issues confronting many of the Asian economies, Directors took comfort from the fact that growth in North America and Europe has been well sustained recently and is likely to provide support for the global economy during the period ahead. This suggests that the economies now experiencing difficulty will be able to benefit from a relatively favorable external environment. Speakers stressed that, given the medium-term growth potential of the countries at the center of the crisis, they could expect to regain market confidence once their structural weaknesses, especially in the financial sector, had been addressed.