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**THE ECONOMIC CHARACTERISTICS
OF THE ASIAN CRISIS AND THE
IMF ECONOMIC STIMULUS
RECOVERY PROGRAM**

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Abstract

Two years ago Asia's tiger economies were celebrating the Asian miracle, operating in an environment of relatively low inflation with a stable but cautious monetary policy. However, the rising wave of growth has suddenly turned into an Asian Tsunami. Rapid growth and *prudent* macroeconomic policies, therefore, do not guarantee a sustainable economic environment.

This paper examines the characteristics of the current economic storm in Asia and the IMF relief effort, which has been labeled as antagonistic and ineffective in the salvaging of stricken Asian economies.

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1. Introduction

For almost a decade, a phenomenal record of economic growth had been posted in the East Asian region. Countries such as South Korea, Hong Kong and Singapore, Malaysia, Thailand, Indonesia and the Philippines all achieved remarkable rates of growth, building high-quality manufacturing industries in a wide range of products, from clothes to computers. The region recorded GDP growth rates ranging from 10 percent in Singapore to 4.5 percent in Philippines (von Lefferen and Cheng, 1998). In addition, these economies also attracted almost half of total private capital inflows to developing countries, totaling over \$100 billion in 1996 alone.

This environment, however, was not sustainable as most assumed it to be. The broader financial crisis first erupted in Thailand in July 1997 with a series of speculative attacks on the baht, triggering a wave of currency depreciation and stock market declines throughout Asia. After the second half of 1997, the currency values of South Korea, Thailand and the Philippines, Malaysia had decreased by more than 40 percent while the Indonesian rupiah eroded by 70 percent. The stock markets of Bangkok, Kuala Lumpur, Jakarta and Manila lost approximately US\$370 billion (63% of the four countries' combined GDP). South Korea's stock markets alone shed 60% of its value.

As the crisis built, it inflicted substantial macro shocks to financial institutions in the region, many of which were not prepared for a financial disturbance of this magnitude. What had originally been perceived as a 'temporary adjusting process' within the financial sector and one that would last only for a short period of time turned into something far more serious and pervasive. Further, the turbulence in the financial markets has radiated further afield, and together with the ensuing acute recession in this part of the world, stands to drag down world economic growth, threatening to fuel an even wider crisis. This could generate a domino effect in the global financial markets.

Investors badly affected by Asia's wounded tiger economies and Russia's 'lumbering bear' have withdrawn funds from Latin America to cover losses in other markets or headed to the safety nets of U.S and European bonds. The results have been damaging. Stock markets from Sao Paulo to Santiago have fallen to their lowest levels in years while the Mexican peso has fallen to a record low, down about 20 percent against the greenback to this date. Since *then* Columbia has

devalued its peso by 9 percent and Venezuela may follow suit (The Nations, September 1998). The Brazilian real depreciated by nearly 8 percent in a managed devaluation and threatens to trigger another crash in financial market confidence and set back Asia's attempts at recovery (Guttsman, 1999). The biggest concern is if the managed devaluation fails, this could potentially pull down the rest of the Latin America with it, as during the Mexico peso crisis in 1994.

In response to the financial crisis and currencies plunges, crisis-hit countries like Thailand, Indonesia and South Korea (the world's 11th largest economy), have had to turn to the International Monetary Fund (IMF) for temporary bailouts. Even Japan, the world's second largest economy after the United States, looks susceptible to the Asian Tsunami. The role of the IMF in these crisis-hit countries has drawn severe and at times uncontested criticism from critics such as economists, politicians and journalists, all of whom held their personal views on how the crisis should be resolved. Instead of restoring financial confidence, the critics say the IMF prescription of high interest rates had dragged Asia into a deeper recession in the region.

This paper examines the economic characteristics and the implosion of the Asian crisis, what the IMF has done to help contain it, and why the IMF prescribed bailout programs are being tagged as a failure to the impending crisis. The paper is divided into two sections. Section 1 addresses the economic characteristics of the crisis with special emphasis on fixed exchange rate, large currency and maturity mismatches, fragility of the financial institutions, government-business relationships, investors-lenders delusion and the panic-driven withdrawal of funds. Section 2 examines the role of the IMF in the crisis and discusses whether IMF intervention has made the situation better or worse. The paper ends with a summary and brief conclusion.

2. Economic Characteristics of the Asian Crisis

Until the crisis erupted, the region's economic success was attributed to its cultural values: a combination of a disciplined work ethic, conformity to principles of community and authority, and a tradition of a paternalistic outlook. These economies were achieving high growth rates in what was considered a stable economic environment, with relatively low inflation and outward-oriented policy regimes. Since the 1980s, the introduction of export-oriented foreign direct investment in the region stimulated exports and imports growth. The economic fundamentals

were substantially strong as the region enjoyed high saving rates, relatively low inflation, and sound fiscal policy (Kawai, 1998).

Why are these emerging tiger economies struggling with collapsing currencies and plunging stock markets, after so many years of outstanding economic growth and performance in a “disciplined market”? The answer is essentially a game of “global arbitrage”, where funds move from one market to another, seeking profit opportunities from the imperfect financial global markets by taking advantage of interest-rate differentials and short-selling in stocks (Bello, 1999). A disciplined financial market does not guarantee stability and the market is not always right.

3. Exchange Rate Stability

Prior to the crisis, many Asian countries had generally adopted exchange rate policies that were either explicitly or implicitly pegged to the US dollar in order to ensure the stability of their nominal exchange rates relative to the US currency. For example, the currency board in Hong Kong had its parity tied to that of the US dollar; the Thai baht was effectively fixed within a narrow band of 25.2 to 25.6 to the US dollar from 1990 to 1997; and the Malaysian ringgit moved within a restrictive range of 2.5 to 2.7 to the US dollar.

However, this carried with it two negative consequences. Firstly, the appreciation of the dollar relative to most world currencies following spring 1995 inevitably caused a rapid real appreciation of the Asian currencies which were pegged to the dollar, affecting the competitiveness of these countries and resulting in a less sustainable current account deficit following favorable trade balances. Using 1990 as the base year, Roubini (1998) reported that in early 1997 the real exchange rate had appreciated by 19% in Malaysia; 23% in the Philippines; 12% in Thailand; 18% in Singapore; 8% in Indonesia; 30% in Hong Kong. The degree of currency overvaluation also correlated with worsening current account deficits. Table 1 shows that the Asian countries experiencing the crisis are those countries that have a large current account deficit relative to their GDP growth. For example, Thailand’s current account deficit was as high as about 8 percent of its GDP growth for two consecutive years.

This occurred while the currencies in countries such as Taiwan and China, which followed a more flexible exchange rate policy, experienced a real depreciation, and at a time when there was a fall in world export prices. The world prices for semi-conductors, an important export product for the crisis-hit countries, dropped 20% between 1995 and 1997 after rising sharply in the early 1990s (Radelet and Sachs, 1999). Competitiveness of this region was threatened by this decline and a significant slowdown in export growth was observed by 1996.

Although a stable currency value assured a low exchange rate risk, favorable interest rate differentials attracted massive capital inflows; a situation which in itself partly caused the growing current account imbalances that were to come. Excessive capital inflow ended up in Thailand and South Korean commercial banks and non-bank institutions, and domestic corporate firms in Indonesia. This inflow of foreign capital was used to finance the consumption and investment boom in these countries. This was especially the case in non-tradeable sectors such as real estate projects, prestigious infrastructure projects and investments in speculative assets. This excessive accumulation of foreign liabilities by local financial institutions from the international capital markets fed a speculative asset bubble (in stock markets, land and real estate prices), which was not grounded in economic fundamentals.

Further, most of these borrowings were short-term and their positions were left unhedged as firms and financial institutions expected the fixed exchange rate to be maintained. What followed were large maturity mismatches (using short-term bank loans to finance long-term projects), as well as big currency mismatches (borrowing short-term foreign currency liabilities to fund long-term projects with uncertain cash flows and revenues denominated primarily in local currencies) as evidenced in Thailand. Consequently, given the volatility of short-term capital movements in international markets together with over-inflated domestic asset prices and deteriorating loan quality, the current account became vulnerable to short-term capital outflow and market contagion, resulting from reverse expectations and the resulting decrease in confidence (Meltzer, 1998).

Table 2 shows that net private capital flows into the five most affected economies, namely Thailand, South Korea, Indonesia, Malaysia and the Philippines, leapt from \$37.9 billion in 1994 to \$97.1 billion in 1996. However, by the second half of 1997, due to the very short-term

maturities of these capital flows, they were able to leave the crisis-hit countries quickly. Thus, these inflows reversed as net private capital flows turned to an outflow of \$11.9 billion.

4. Financial Supervision and Moral Hazard

One major factor evidenced in this crisis was the lack of adequate resilience to a globalised environment while bringing about deregulation of financial markets and the liberalisation of capital accounts in the region (Kawai, 1998). In addition, deregulation of financial markets at the national level has not been replaced by reregulation at the global level because finance capital has accumulated tremendous political influences over the last two decades (Bello, 1999). Thus there are certain institutional lessons and reforms that developing countries should learn from this and the earlier Latin American crisis before moving to full financial deregulation – particularly the need to keep the banking system under a strict discipline

Unlike the crisis in Mexico in 1994 where the ‘tequila effect’ was the result of the difficulty for the Banco de Mexico to roll over the Mexican government’s excessive debt, the Asian crisis appears to be the result of fundamental weaknesses in the financial systems, masked by rapid growth fueled by private sector borrowings. Chan-Lau and Chen (1998) argued that while a somewhat established banking infrastructure existed in the crisis-hit economies, there were high operating inefficiencies, and such systems had been shown to give rise to both ‘capital inflow inertia’ and a sudden large capital outflow.

Financial sector liberalisation policies had been carried out in the crisis economies in the late 1980’s and early 1990’s, where stock and bond markets began to develop, new private banks mushroomed, and banks were given greater freedom in their lending decisions and raising funds offshore. This encouraged a significant buildup of offshore borrowings, which were financing the domestic investment and consumption boom.

However, local governments’ capacity to regulate and monitor did not keep pace with the rapid financial sector liberalisation. There was failure on the part of domestic regulators to strike a balance between short-term systemic instability and long-term moral hazard: “for years, lenders and depositors felt too safe for their own good” (The Economist, January 10, 1998). To promote

safe lending in the long-term, a trade-off must be struck, involving guarantees of one kind or another to the depositors on the one hand and prudent regulations to discourage excessive risk-taking on the other. In Thailand, for example, there was no effective mechanism or institutional structure in place to control the size and maturity of private debt and the lack of discipline led to private sector borrowings that greatly exceeded capital, a lack of consideration for exchange rate risks, too much short-term borrowing to finance long-term projects, and over-investment in sectors such as real estate and heavy industries (Sussangkarn, 1998). The lack of good corporate governance practices and a sound bankruptcy law turned private borrowings into moral hazard problem.

Ultimately, *imprudent* financial supervision, ineffective management of financial risk, and the maintenance of relatively fixed exchange rates led banks and corporations to borrow large amounts in foreign currencies, denominated in US dollars, marks, and yen – much of it short-term – without hedging to finance long-term loans. For example, the foreign liabilities of banks in Thailand increased from 5% of GDP in 1990 to 28% of GDP in 1995; while bank claims on the private sector increased by more than 50% relative to GDP in just seven years in Thailand, Korea and Malaysia (Radelet and Sachs, 1999). When the slowdown in economic growth led to the deterioration of the quality of the financial institutions' assets, net flows of foreign capital were curtailed. Hence, when foreign loans were not renewed, the banks and corporations were consequently faced with large defaults (Meltzer, 1998).

In addition, foreign lenders did not monitor the total assets and liabilities of the borrowers nor showed any concern about making short-term loans that financed long-term domestic loans. Government guarantees, either explicit or implicit, and the response of the IMF to bailout liabilities made foreign lenders feel safe, and therefore, not accountable for their failures. This further exacerbated the moral hazard problem: “ Some argue that the true cost of the costless Mexican bail-out is today's crisis in Asia – because foreign lenders learned in 1995 that they would be rescued if their loans turned bad, therefore lent more than they should in Asia” (The Economist, January 10, 1998). Such guarantees hinder the governance of local financial institutions, increasing the incentive for unnecessary risk-taking, imprudent asset-liability management, fraud and undetected conflicts of interests. These guarantees also accelerate price inflation, reduce economic welfare, and weaken the financial system to near collapse.

5. Government-Business Relationship

The crisis was also aggravated by issues of governance, notably government involvement in the private sector and the lack of transparency in the provision of financial and economic data. The Asian region is said to be permeated with practices of personalism that range from mutual obligation between employees and employers in Japanese firms to the corruption of government leaders in Indonesia. Thus, heavy reliance was placed on connections and personal guarantees by borrowers rather than on project viability evaluation or their proven credit worthiness; hence, the term ‘crony capitalism’. This was another source of the moral hazard dilemma, as creditors felt secure that they would be repaid for lending to companies with strong links to the government.

This steady built-up of exposures of financial institutions - especially to real estate, infrastructure projects and stock markets, without due diligence to the ability of the borrowers to repay - invariably led to their vulnerability to economic downturn and any exogenous shocks, thereby generating excessive non-performing loans (NPLs). For example, the Thai government had allowed money to flood into building costly skyscrapers rather than investing in roads, telecommunications and education. The situation was worse in South Korea, where the entire economic system was based on the government encouraging banks to make cheap loans to conglomerates for continual expansion – regardless of world demand. A former executive of a South Korean bank rationalised the extension of credit to a steel company by asserting that steel was an important national industry. The steel firm subsequently went bankrupt. Thailand and South Korea were thought to be heading in the right direction in terms of the IMF recommended reform agenda. However, there is clear evidence of that chaebol restructuring, one of the IMF recommendations, has not materialized much and no meaningful improvement in key economic indicators in Thailand (The Bangkok Post, January 22, 1999).

6. Uncertainties

The continuing economic weakness of Japan, the major economy in the region also did not help. Compared to the Mexico crisis in 1994, when the US, the regional economic power and its biggest export market, was in a strong cyclical upswing, Japan continued to experience economic recession. This kept their interest rate low and hence, the yen continued to depreciate against the US dollar, and this worsened the real appreciation caused by the other regional currencies. The condition of Japanese financial institutions, which hardly recovered from the burst of the asset bubble in the 1980's and the recession of the 1990's, worsened still further because they had also lent heavily to the regional economies. The problems in the Japanese financial institutions will continue to have a negative impact as they withdraw credit from the region (The Bangkok Post, January 22, 1999).

Financial problems faced by firms and financial institutions were also repeatedly discovered to be worse than initially reported – creating a level of uncertainty about the magnitude of the problems faced by these institutions. This uncertainty reinforced the worsening financial conditions and validated further weakening of the currencies.

Another uncertainty is the immediate threat that China could devalue its yuan if its 8 percent economic growth is not sustainable under current conditions and is masking the fact that price deflation has intensified (Guttsman, 1999). There is an underlying fear that China will resort to devaluing the yuan in an attempt to increase export competitiveness with its neighboring crisis-hit countries

The gravity of the crisis has been worsened by the ensuing political uncertainty in the region. Examples include the student unrests and racial riots which continued even after the collapse of President Suharto's regime in Indonesia, governmental weaknesses in Thailand, and the highly controversial dismissal of Malaysia's once heir to Prime Minister Mahathir. These events generated a lack of confidence among foreign investors (delaying a much-needed capital inflow into this region).

7. Herd Behaviour

Another significant characteristic of this crisis, one that is arguably the prevalent factor in explaining the contagion crisis effect, is the self-fulfilling herd behaviour of market participants. For example, risk spreads on emerging market debt were very narrow in early 1997 but were huge following the collapse of the Russian economy. This observation points to a lack of differentiation among borrowers as well as a swing in collective sentiment which was out of line with changes in the underlying prospects of countries hit by the crisis (Mann, 1999).

During the turbulent 1920s, a French economist, Albert Aftalion, introduced a psychological theory of foreign exchanges – one that held that exchange rates were dominated by sentiment, more so than by long-term economic fundamentals. The continued support of an exchange rate, by drawing down reserves to satisfy the private sector's excess demand for foreign exchange, could only invite speculative activities as market players anticipate currency devaluations. As a consequence, central banks would be forced to abandon their efforts to support the par value of their currencies more and more rapidly. In the Asian crisis, although most analysts initially did not place much emphasis on the panic-driven factor, it is now a more widely recognised contributor to the crisis (Krugman, 1999). The above characteristics, though explaining the vulnerabilities of the financial sectors in the pre-crisis economies, are short of rationalising the abruptness and the depth of the crisis, which affected so many countries simultaneously.

8. The Roles of IMF in the Financial Crises

Despite its continuous intervention as the financial architect in the Asian crisis, the International Monetary Fund (IMF) remains a puzzle on the international scene. Some observers, confusing it with the World Bank or another aid institution, are under the impression that the IMF exists to subsidise economic development in the poorer nations. To the crisis-hit countries IMF also implies different meanings: in Indonesia "IMF" means "Inject More Funds", in Thailand it means, "I'M Fired", and in Malaysia it means "International Monetary Fiasco" (Luther, 1998). Still others view the IMF as an institution of great authority and independence which decides the best economic policies for its members to comply with (Driscoll, 1998).

The IMF is neither a development bank, nor a world central bank, nor an agency that can or wishes to compel its members to do exactly what they are told. It is rather a cooperative institution that 182 countries have voluntarily joined because they see the advantage of consulting with one another in this forum to maintain a stable system of buying and selling their currencies so that transactions of foreign payments in foreign money can take place between countries smoothly and without delay (Driscoll, 1998). The IMF is also able to advise on monetary and fiscal policy, banking and financial reform and other structural reforms.

The IMF encourages all members to pursue sound economic policies and to foster liberalised trade and investment. It seeks to prevent economic crises by monitoring closely member countries' economy and warning them when trouble threatens. When a crisis does strike, the IMF has been willing to act in accordance with its purposes to deal with major problems confronting the international economy. For example, during the energy crisis in 1973-74, the IMF established a mechanism for recycling the surpluses of oil exporters and helping to finance the oil-related deficits of other countries. In 1994-95, the IMF intervened to help prevent Mexico's financial collapse - and to prevent the crisis from spilling over into other markets, which could have forced other countries to resort to exchange controls and debt moratoria, and might have caused a dramatic disruption in private capital flows to developing countries (Driscoll, 1998).

As the crisis erupted in Asia, the IMF became almost a household name overnight. It is playing the roll of a doctor to Asia illnesses. Over US\$100 billion has been committed to the region under the IMF endorsement bailout program since the crises began. However, its role in Asia and more broadly in the world economy is not widely understood. A main responsibility of IMF is safeguarding the stability of the international monetary system. Thus the key role for the IMF in resolving the Asian financial crisis was to help restore confidence to the economies affected by the crisis with a mixture of massive loans and strict policy recommendations to go with them (Driscoll, 1998).

Since financial weaknesses were a central cause of the crisis, the major recommendations of the IMF bailout programs have been comprehensive reforms that embrace a number of elements that are vital for economic growth and financial stability. The reforms called for the closure of insolvent and unsound financial institutions, the recapitalisation of undercapitalised institutions,

close supervision of weak financial institutions, increased foreign participation in domestic financial systems and higher and more cost-effective spending on primary health care and education, and adequate social protection of the poor, the unemployed, and other vulnerable groups and environmental protection (Driscoll, 1998; IMF, 1998; Feldstein, 1998; Meltzer, 1998).

To address the governance issues, greater transparency and accountability in government and corporate affairs are needed both as regards economic data (on external reserves and liabilities in particular) and in the fiscal and corporate sectors, as well as in the banking sector (Driscoll, 1998; Feldstein, 1998). In addition, the bailout program advocates stronger banking system that protect the savings of small depositors and that must be freed from government intervention in the allocation of credit so that they will not be funnelled just to a favoured few, but to those who will use it productively. All of these reforms will require a vast change in domestic business practices, corporate culture, and government behaviour.

9. Did the IMF Make It Worse?

Whether or not the Asia crisis turns out to involve a full-scale contagion effect, one question about the IMF bailout packages remains: did the IMF prescribe the right dosage of medicine or did it make the situation worse? Many critics, particularly from the Asian region have asserted that the IMF's current resolution on major structural reforms has tightened economic conditions to the point of strangulation, threatening to kill or paralyse the patient. They argue that the IMF should not have told countries to raise interest rates, or at least not by as much. Higher interest rates have certainly slowed the economies down, threatening some healthy companies and causing financial distress. For example, in South Korea, the IMF hoped to see interest rates doubled to more than 15 percent (Oxfam, 1998; IMF, 1998). This led to the collapse of (or at least crippled) many companies, resulting in lost of production and increasing unemployment.

The Prime Minister of Malaysia, Datuk Dr. Seri Mahathir Mohammad criticised IMF's tight monetary policies through high interest rates that choked and hindered economic recovery of the affected countries. High interest rates compensate the holders of debt instruments for country risk but may force borrowers into bankruptcy and are likely to suffocate investment (Weber,

1998). Thailand recently raised questions over whether prescriptions commissioned by IMF may be the right medicine for the ailing economy, and asked for more flexibility in response to changing circumstances. Such repercussions reflect growing disillusionment and disenchantment among affected countries with the IMF prescriptions.

The Asian crisis represents new challenges and a sense of confrontation to the IMF. Because in recent years, the IMF has focused its attentions on the poor in Africa; those making transition from communism (mostly in Eastern Europe) and those wobbling under the foreign debts of bad governments policies (mostly in Latin American) (The Economist, December 13, 1997), the IMF may underestimated the depth of and risks involved in the Asian crisis and probably did not anticipate the kind of blow-out that followed (IMF, 1998). Insufficient background analysis has been paid to the specific problems and issues in the Asian countries, so that the IMF concentrated on disciplining countries (as it had during the Latin America crisis of the 1980s) when it should have concentrated instead reassuring stability in financial markets. Massive deflation, increased interest rates and cuts in government spending were not only inappropriate, given the underlying economic conditions of the region, (in contrast to the 1980s Latin American crises, for example, most of the countries in the region have a high level of savings and a stable and cautious monetary policy, Oxfam, 1998), but also threatened to turn the regional recession into a full blown depression.

The use of IMF assistance to bail out a country in financial and currency trouble is considered by some to be a threat to the stability of the world financial system (Calomiris, 1998; Vasquez, 1998). The loans were given by the IMF and the foreign government at subsidised interest rates. However, the loss in terms of subsidised rates that are paid by the taxpayers in the U.S. and other developed countries is less than the loss borne by the taxpayers in the recipient countries. In most cases, the IMF and U.S. treasury are repaid. The loans however, provide strong justification for the increased taxes. The risk takers, who are wealthy and politically powerful, therefore gain at the expense general taxpayers.

Without government or IMF bailouts, both the creditors and debtors would renegotiate the debts or enter into bankruptcy procedure if they were illiquid or insolvent. As both the creditors and debtors predict that they are able to claim the public resource to bail themselves out, they lack

the incentive to minimise loss. Therefore, bailouts undermine the underlying concept of the laissez faire system pioneered by Adam Smith (Vasquez, 1998).

Thus, perhaps the IMF was short-sighted in not recognising the compounding moral hazard issues after the 1994-1995 Mexican bailout. Without IMF patronage, Mexico would have learned to implement better policies, would have fewer debts and would have made more progress. Government and business in many countries continue to assume excessive risk; international support for bank bailouts will only accelerate the risk-taking and bring instability to the financial system. The IMF intervention in the Asian crisis reinforced this moral hazard situation, allowing international banks to avoid the risks they undertake by imprudent lending (Meltzer, 1998). To prevent an even larger future financial crisis, the IMF should not subsidise nor insulate borrowers but instead charge a severe penalty and require healthy collateral. This will reduce financial risk and encourage safety and solvency of financial institutions.

The IMF is not a charitable organisation and has limited financial capital as well as limited political capital. It is not an institution set up as a full-scale lender of last resort; nor can it offer an open-ended credit line to liquidity constrained countries. The IMF has no political authority over the domestic economic policies of its members. It does not force its members to clean up the mess they have created. It can only recommend members to make the best use of scarce resources by refraining from unproductive military expenditures or by carefully targeting its spending on health, welfare programs and education. The provision of IMF funds should not reward careless lending and excessive risk taking by any member country nor should it assume the bad debts of any member country.

10. IMF Admits Mistakes in the Economic Stimulus Package to Crisis-Hit Countries

The IMF rescue programmes involve consolidating crisis-hit countries international debts and, lending fresh money in order for all debts to be repaid. Without the IMF help, these countries would have to declare a moratorium on their debts. However, the IMF rescue programme has been blamed for the recession and social crisis in countries such as Thailand, Indonesia and South Korea. It is accused of neglecting structural problems while placing too much emphasis on fiscal and monetary policies. The programme assumed similarity between the Asian crisis and the Mexico Tequila Effect, although the latter was limited to one country without any contagion effects. The IMF did not expect the Asian crisis to expand into a full regional crisis. Some critics argued that the IMF should have left the markets alone and more banks would have failed, more international lenders would have taken losses but currencies would have suffered less.

Hubert Neiss, the IMF director for Asia and the Pacific admitted that the IMF bailout program had underestimated the severity of the contagion from the crisis dragging Asia into a deeper recession. However, he defended the policy of high interest rate in order to slow down further competitive devaluations of the Thailand, South Korea and Indonesia currencies that would have deepened the crisis. The policy is unavoidable and put added stress on banking institutions and private enterprises. A lower interest rate regime would have led to the weakening of financial institutions. However, a prolonged high interest rate policy was not helpful especially for Thailand and Indonesia as tight credit measures enforced on banks reduced private investment. Without a tough austerity programme the potential risk of moral hazard would increase – the idea that crisis hit countries or investors act irresponsibly because they know someone will bail them out.

The IMF prescribed policy of high interest rates did not take into account unemployment and its social consequences in the affected countries. For example, IMF prescribed a US\$17.2 billion rescue package for Thailand in August 1997 requiring it to tighten both monetary and fiscal policies, which led to massive contraction and unemployment. In addition, IMF recommended that Thailand raise the value-added tax from 7 to 10 percent, which led to price inflation and

affected the general public immensely. In Indonesia the rescue package required the Indonesian government to end food and oil subsidies, which triggered social unrest in the country. Critics argue that IMF placed too much emphasis on monetary and fiscal restraints without much flexibility on the bailout package to crisis-ridden countries, which results in an overkill of economic activity. The IMF has recently revised its restrictive prescribed policy to allow Thailand to adopt an expansionary fiscal policy, to allow subsidies on food and oil in Indonesia and fiscal expansionary programme in South Korea to address massive unemployment problems. However, the question remains as to whether such new dose of treatments will speed up the recovery process?

11. Conclusions

There is nothing new about lenders imposing conditions on borrowers. Lenders usually impose conditions on borrowers to reduce the probability of defaults. Likewise IMF loans are not grants and have to be repaid with interests. Thus better crisis management programmes are needed in future in dealing with financial crises of this magnitude. . International focus should be on long-term responses to the crisis in achieving sustainable development and priority should be given to measures addressing deficiencies in the institutional and legal framework of the financial sector. Past experiences from the Latin American debt crisis should not be used as a template because every case is different. Social policies should not be isolated from economic considerations. The social impact of the crisis has been the dominating deficiency in the IMF rescue programme.

The role of IMF in muscling crisis-hit countries in Asia may diminish as it faces dwindling amounts of funds available for rescue programmes. The ability of the IMF to steer the reform strategies as they see fit will begin to diminish and the leverage with other countries will reduce also. This creates concerns among the broader international community on the substantial economic, political and social reforms agenda some crisis-hit countries still have to implement, for example, the banking reform in Indonesia, the enactment of bankruptcy proceedings in Thailand and the reform of South Korea's chaebol. These reforms will not be completed by the time the fund runs out. The Russian crisis provides the best example of a country where reform stopped after absorbing some US\$4.8 billion of IMF funds. It devalued the ruble and defaulted

on its debt. The question remains as to whether market discipline is capable of replacing IMF discipline

Some critics argued that the markets appreciate having IMF involvement in bailing out crisis-hit countries but markets won't necessarily be upset if the government of these countries assume full accountability to the IMF reform agenda. For example, the Thailand and South Korea governments are very much reform-minded and need to confront domestic political challenges in their own ways. Both countries understand the need to total commitment to reform backed up by measurable results as prerequisites for winning back investors. Nevertheless, the region is unlikely to recapture its 1990s growth vitality until the Japanese economy is healthy because Japan accounts for about 70 percent of production in Asia. Perhaps, therefore, the IMF should revisit its role in the era of abrupt capital movements and turn from a crisis fighter into a crisis prevention agency, because political systems are national while financial markets are global.

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Table 1
Asian Economic Indicators

	Devaluation (% 1997)	FX Reserves (\$ Billion)	Current A/C (\$ Billion 1996)	Foreign Debt (\$ Billion)	GNP Growth (\$ as of)
China	0.0	134	7.2	110.0	9.0 (97)
Hong Kong	0.2	92	(2.6)	N.A	-6.4 (97)
Indonesia*	129.0	19	(7.9)	133.0	8.0 (96)
Japan	12.7	227	87.6	700.0	1.0 (96)
Malaysia	53.7	24	(4.4)	27.0	7.4 (97)
Philippines*	52.3	9	(3.8)	59.0	4.9 (97)
Singapore	20.2	74	14.0	0.0	7.6 (97)
South Korea*	101.0	24	(13.3)	160.0	6.3 (97)
Taiwan	18.0	83	9.3	62.0	6.9 (97)
Thailand	81.7	30	(10)	102.0	6.7 (96)

*IMF program

N.A. (not available)

Source: von Leffern, E., and Cheng, K.Y. 1998, 'The Asian Economic Crisis: Causes and Impact', *The Journal of Lending and Credit Risk Management*, Vol. 80, No. 7, March, pp.50-6.

Table 2
Five Asian Economies: External Financing

	1994	1996	1997e	1998f
Current account balance	-24.5	-55.2	-27.1	30.6
External financing, net	45.2	95.2	18.1	25.9
Private flows, net	37.9	97.1	-11.9	-0.3
Equity investment	12.1	18.7	2.1	16.4
Direct equity	4.7	6.3	6.4	6.9
Portfolio equity	7.4	12.4	-4.3	9.5
Private Creditors	25.8	78.4	-14.0	-16.8
Commercial banks	23.4	55.7	-26.9	-19.8
Non-bank private creditors	2.4	22.7	12.9	3.0
Official flows, net	7.3	-1.9	30.0	26.2
Resident lending/other, net**	-15.2	-21.6	-30.5	-4.6
Reserves excl. gold (- = increase)	-5.4	-18.4	39.5	-51.9

e = estimate, f = IIF forecast

The five countries are South Korea, Indonesia, Thailand, Malaysia and the Philippines.

**including resident net lending, monetary gold, and errors and omissions.

Source: Institute for International Finance, Capital Flows to Emerging Market Economies, 30 April 1998.