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After the Storm: A View from the IMF

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Introduction

It is a great pleasure to be invited once again to speak at an event organized by the Bankers' Association for Foreign Trade. Let me repeat how much we appreciate the Association's long-standing support for the IMF in promoting a strong and open global economy. In particular, we are grateful for your help in persuading Congress to support the quota increase, which finally came into effect early this year. With your help, the quota increase strengthened the global trading and financial system at a crucial time.

Nonetheless, I must confess to some trepidation on receiving the offer to speak here today. Let me explain why. When I spoke at your Midwinter Conference in January 1998, Korea was still struggling to reschedule its debts after a wave of financial crises had swept across South East Asia. And in February this year I was forced to miss the event altogether, having to fly instead to Brazil to negotiate a new economic program after the collapse of the country's exchange rate peg. My highly esteemed former colleague Alassane Ouattara was delighted to attend in my place.

With the crisis having subsided, I was sure all would be well this year. Then on Monday I was told that I had to attend the WTO talks in Seattle yesterday – and I feared that the curse of BAFT was about to strike for a third time. Fortunately, I made it here safely.

I will begin today by assessing the shape of the world economy – and the emerging markets in particular – after the difficulties of the last two-and-a-half years. I will then turn to some of the challenges that confront the IMF and other international institutions in the wake of those tumultuous events. The bottom line is that the outlook is brighter than it has been for some time, but – and you can rely on someone from the IMF to say this -- there is no cause for complacency.

[1] I am grateful to Robert Chote and Daniel Citrin of the IMF for their inputs. Views expressed are not necessarily those of the IMF.

From Bad to Worse to Better

When the financial crises began with the devaluation of the Thai baht in July 1997, it was reasonable to hope that this might prove to be an isolated event. No-one could have predicted the severity and speed with which the turmoil would spread. And then just as Asia started to recover, the Russian crisis erupted in August last year: the effects spread rapidly to Latin America, and to LTCM, and there was serious talk of a looming world recession.

That this apocalyptic outcome was averted is thanks in large part to a decisive response by policymakers across the world. The Federal Reserve cut interest rates promptly, and other central banks followed. Congress finally supported the increase in the IMF's capital base. Japan announced further fiscal stimulus and stepped up the restructuring of its banking system. And the Fund assembled a support package for Brazil that went a long way towards stabilizing not only Brazil, but also Latin America. Critics of course point out that Brazil eventually devalued in January this year. But the consequences would have been far worse had it done so earlier, at a time of unprecedented global financial fragility.

World recession may have been averted, but the crises still had a devastating impact in the countries most affected. After decades of outstanding performance – annual growth rates of 8 per cent or so in recent years – output and incomes fell in Indonesia, Malaysia, Thailand, Korea and Hong Kong in 1998. Unemployment rose, school drop-out rates increased and millions of people found themselves pushed into poverty. In Latin America, the tidal wave arrived a year later. By last summer we, as well as many market participants, were predicting output falls this year for Argentina, Brazil, Chile, Ecuador, Uruguay and Venezuela.

But in recent months the outlook has improved. Consider Asia first. Korea is expected to grow at 9 percent this year. Thailand has been growing at an annual rate of between 3 and 4 per cent, with factory output up by far more on a year ago. Growth has even resumed in Indonesia, where stabilization took longest to achieve. Market sentiment has been dealt a blow in recent months by the Bank Bali scandal and violence in East Timor, although there was a positive reaction to the outcome of the recent election. The return of Japan to positive growth is contributing importantly to the Asian recovery.

The resumption of economic growth in these countries reflects the adoption of sound macroeconomic policies and the beginnings of ambitious structural reforms. But if the improvement in the macroeconomic environment is to be sustained, then it should not be used as an excuse to slacken the pace of financial sector reform and corporate restructuring. It is no accident that every one of the recent crises, except that of Brazil, has been associated with serious weaknesses in banking systems. Through our newly instituted Financial Sector Stability Assessments (FSSAs), we and our colleagues at the World Bank will be helping emerging market nations to identify and repair weaknesses in their financial systems. But national policymakers in the crisis economies have a special responsibility: to keep up the momentum of reform efforts as the direct role of the international financial institutions is reduced.

As in Asia, Latin America's largest economies – Brazil and Mexico – have also fared better than expected in recent months. Brazil, which in February was expected to suffer negative growth of nearly 4 percent this year, will probably show slightly positive growth, while Mexico's economy seems to have expanded healthily in the third quarter. Argentina's deep recession appears to be bottoming out and there are good reasons to be confident about an upturn in Chile next year. But again there are reasons to be cautious. Emerging market bond spreads have fallen from their peak at the time of the Russian default, but they remain relatively high at over 900 basis points. Bond issuance and loan commitments to emerging markets both dropped sharply in the third quarter, with Latin America bearing the brunt. The last thing we need is a return to the indiscriminate capital inflows of mid-1997, which helped create the problems from which emerging markets are only now recovering. But some improvement in financing conditions would certainly help to nurture these upturns.

Sustained recovery in the emerging markets will also require continued growth in the industrialized world, which produces two-thirds of global output. Fortunately – and it is not only good luck but also good policies that we need to thank -- the world economy is doing much better now than anyone dared hope 12 months ago. Growth in the US remains strong. As we say year after a year, a slowdown in U.S. growth is inevitable. The modest tightening of monetary policy put in place by the Federal Reserve is a welcome response to potential inflationary pressures, and it should help ensure that this remarkable upswing continues at a sustainable pace. But Europe and Japan will inevitably have to take a greater share of the momentum of the world economy. Fortunately, European growth is perking up, and Japanese growth is continuing. Monetary policy in Japan should remain expansionary – indeed it should become more expansionary -- until the recovery there is on firmer ground and remaining deflationary risks have passed.

The revival of economic growth in the crisis economies should also give the critics of IMF policy advice pause for thought. In the midst of battle, we were taken to task for asking the affected countries to tighten fiscal policies, and raise interest rates, and for pushing vigorously for financial sector and corporate debt restructuring. With the benefit of hindsight, we did ask for more fiscal tightening than was needed. But as soon as the extent of the slowdown in Asia became clear, we urged fiscal expansion on countries with IMF programs.

We were especially harshly criticized for insisting on interest rate increases to stem capital flight, stabilize the currency, and restore investor confidence. No-one would deny that there is a difficult trade-off here: when a country has a plummeting exchange rate and a weak banking system, the cure for one problem can make the other worse. But as we argued at the time, the interest rate increase would be temporary, the currency decline and its impact in raising the burden of dollar-denominated debts, permanent.

Raising interest rates as currencies came under pressure was the right thing to do. Even more so is that true of the insistence on early attention to financial sector and corporate debt restructuring. And the results in the Asian crisis countries bear that out – IMF advice worked.

Reforming the Architecture

Many other lessons have been learned from the traumatic events of the last two-and-a-half years. As the crisis has receded, there has been less public attention to reform of the architecture of the international financial system. But let me assure you that we have made significant progress since Mr. Ouattara talked on this topic at your conference earlier this year.

First, work is continuing on the development of international standards and principles. As you know, the IMF has itself developed standards for monetary and financial policy transparency, data dissemination and the transparency of fiscal policy. Other standards are completed or under way on banking supervision, securities market regulation, accounting, auditing and corporate governance.

Of course developing and publishing standards is much less than half the battle. The greater challenge is ensuring that they are implemented and monitored effectively. To this end, in collaboration with others, the IMF prepared a number of experimental "transparency reports" during the spring and fall. These included independent assessments by IMF staff of the extent to which national practices meet international standards. This experiment will continue, with other bodies undertaking assessments in policy areas that are not primarily the responsibility of the Fund. We will also seek both to explain the purposes and limitations of these reports to potential users, and to obtain feedback from the private sector to gauge the usefulness of the approach.

Second, the Financial Stability Forum (FSF) was set up in April this year to bring together G7 finance ministries, central banks and financial sector supervisory bodies, as well as representatives of the international supervisors, the IMF, BIS and World Bank. By bringing together these various supervisory bodies, it should be possible to improve the coordination between them. The forum already has working groups investigating some important issues, for example offshore financial centers, and the implications of highly leveraged institutions.

Third, as you know, the Fund is stepping up its surveillance of national policies and their international ramifications. We have been focussing more on capital account and financial sector issues, the sustainability of exchange rate regimes, and debt and reserve management practices. This effort has been given further momentum by the preparation and publication this summer of an independent report on the Fund's surveillance activities, compiled by a team led by John Crow, former Governor of the Bank of Canada. We are acting on a number of its recommendations, including greater emphasis on vulnerability analyses, cross country comparisons and regional developments.

Fourth, transparency. National authorities are being given greater incentives to heed the advice they receive. Most governments now publish summaries of the executive board's Article IV assessment of their policies and prospects. A pilot project has also been set up allowing countries to publish the Article IV staff reports themselves, and over 50 countries have agreed to do so, with more than 20 reports already available. Countries are now regularly publishing letters of intent, the documents in which they set out the policies to be implemented under IMF programs.

Fifth, the Fund agreed in April this year to further encourage sound policies by offering Contingent Credit Lines (CCLs) to countries that feel threatened by the sort of contagion witnessed in the recent crises. These will only be available to countries that have good policies, that are attempting to meet international standards, that manage their external debt sensibly and that are making an effort to secure credit lines from private sector lenders. The CCL is there to protect innocent bystanders. The stringent criteria for qualification and access should ensure that they are seen as a vote of confidence in the qualifying country's policies.

Sixth, the most difficult challenge we face in reforming the international financial system is the need to involve the private sector in the resolution of financial crises. Private sector involvement is necessary in part because we do not have enough money to resolve crises entirely with official financing. But, more importantly, we need to limit the moral hazard problem associated with official lending, so that private sector institutions do not undertake excessively risky investments simply because they believe that the official sector will bail them out. By doing so, it should be possible to reduce the frequency and severity of future crises.

This outcome is easier to describe than to achieve. One problem is to ensure that creditors feel they are being treated fairly in relation to others with comparable claims. Another is how to recognize circumstances in which a country cannot in practice meet all the claims on it, and how then to deal with the situation. Questions like these are at the forefront of current IMF programs in Ukraine, Pakistan, Romania and Ecuador. Each case is different and we are working with each government to develop an appropriate approach. As the lessons become clearer over time, we should be able to develop more general rules in this area.

These architectural reforms – promoting transparency, developing international standards, strengthening financial systems and involving the private sector in crisis resolution – are focussed primarily on those emerging market countries that enjoy access to global capital markets, with all the risks and rewards that this implies.

Spreading the Benefits

The other big challenge that confronts the international institutions as the millennium looms is to spread the benefits of globalization to those countries that have so far been left behind. Let me talk briefly about two priorities which can help achieve this: debt relief for the poorest nations, and a successful conclusion to the latest round of trade negotiations getting under way in Seattle.

On debt relief, it is three years since the IMF and World Bank first launched an initiative to reduce the external debt burdens of poor countries with good policies to sustainable levels. By removing the overhang of unsustainable debt, our objective was to kickstart investment, boost economic growth and thereby reduce poverty.

But the experience of the early beneficiaries demonstrated that our original estimates of sustainability were too conservative, not least because unexpectedly big falls in commodity prices depressed export revenues. So the initiative is being expanded, increasing the number of likely beneficiaries from 29 to 36 and more than doubling the net present value of debt relief involved to $27bn. The benefits will also be front loaded to a greater degree, providing more relief, more quickly, freeing government revenues to spend on urgent social priorities.

In their work on the new HIPC initiative, the IMF and the World Bank will have to work more closely together than ever before, each concentrating on those activities in which it enjoys a comparative advantage. This means that the IMF will focus on macroeconomic policy, while the Bank will take the lead on structural policies and the implementation of anti-poverty programs. But the Bank and the Fund should not be in charge: the success of the new initiative requires the country itself to be the driver of its own development strategy.

Lifting the burden of unsustainable debt can make an important contribution to poverty alleviation. So too could a successful conclusion to the Seattle round of trade talks. The evidence is persuasive that countries which are open to trade and investment grow more rapidly over time than those which shut themselves out of the global economy. Every country that has sustained rapid growth in living standards since the Second World War has done so by integrating itself more deeply into the world economy, exporting more and opening itself to imports from overseas. We must therefore hope that the new round succeeds in giving the poorest nations greater access to industrial country markets, so that in time they can benefit in the same way.

And if the battle over international trade intensifies, we must never cease to point out the truth – that trade is essential for growth and better living conditions, and that to oppose trade liberalization is to oppose growth and its potential benefits – at the same time as we seek ways of helping those who may be hurt by some of the dislocations associated with the ongoing process of globalization.

Conclusion

Anyone doing business in the emerging markets over the last two-and-a-half years is bound to have picked up a few gray hairs along the way. But we can safely say that the worst of the storm is over. World growth is picking up. Economic activity is recovering in almost all the countries affected by the crises.

Of course vigilance will be required to ensure that the momentum is maintained. Everyone has a part to play. The emerging market economies will have to persist with structural reforms, particularly the strengthening of financial sectors and corporate finances. The industrial countries will continue to pursue stable, non-inflationary growth, without which the world economy as a whole cannot prosper. We in the international institutions will contribute too, by encouraging the right policies at a national level and pressing ahead with our efforts to reform the international financial system.

And as the Seattle Round gets under way, we must all redouble our efforts to bring on board those billions of people so far excluded from the global economic system. They are the emerging markets and industrial countries of tomorrow.