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The International Financial Crisis and the IMF

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When the world's finance ministers and central bank governors gather in Washington this week-end for the annual meetings of the IMF and the World Bank, the global economic crisis will dominate the agenda. The current and future roles of the IMF, which has been at the center of action and controversy for over a year, will come in for close examination. I take up three subjects that will feature prominently: the design of IMF-supported programs in Asia and Russia; the international financial architecture; and the critical question of how to deal with the immediate crisis without doing further damage to the international system.

IMF-Supported Programs in the Asian Crisis Countries

The IMF-supported programs in Thailand, Indonesia and Korea were designed both to restore macroeconomic stability and economic growth, and to address structural weaknesses that lie at the heart of the crisis in each country.

Early in each of the programs in Thailand, Indonesia, and Korea, interest rates had to be raised *temporarily* to stabilize currencies which had depreciated excessively. *That has been achieved in Korea and Thailand*, whose currencies are now stable in ranges about 35-40 percent below their pre-crisis levels, with short-term interest rates of around 8-9 percent, below pre-crisis levels. The critics who argue that high interest rates worsened financial problems fail to recognize that the further depreciations implied by lower interest rates would also have exacerbated these problems by increasing the burden of dollar-denominated debts on firms and banks. And while the burdens imposed by higher interest rates were temporary, those caused by bigger devaluations would have been permanent.

Thailand began its program with a current account deficit of eight percent of GDP. To help shrink the balance of payments deficit, the program included an increase in the budget surplus of three percent of GDP. Fiscal contractions in Indonesia and Korea, were much smaller, designed to cover the expected interest costs of the necessary financial sector restructuring.

If it had been clear when the Thai program was signed in August last year that Asia, including Japan, was heading for a major economic slowdown, less fiscal contraction would have been recommended. As growth in Thailand, Indonesia and Korea declined, so the programmed fiscal deficit in each country has been widened, and each of the crisis countries is now running a sizeable fiscal deficit. Further fiscal expansion, including more social spending to cushion the impact of the crisis on the poor, would make sense.

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The inclusion of structural measures in these programs has drawn criticism. Financial and corporate sector inefficiencies were at the epicenter of the macroeconomic crisis, and have to be dealt with to restore durable growth -- indeed, the priority now is to accelerate banking and corporate sector restructuring. Some argue that because structural problems will take a long time to resolve, it was a mistake to attempt to move on them so rapidly. Delay does not make banking sector problems go away. It makes them worse, as the Japanese delay in dealing with its banking sector problems shows.

Why have the programs worked less well than hoped? Two factors are critical. First governments in the crisis countries were initially reluctant to implement the programs. In each of Thailand, Korea, and Indonesia, the program only began to take hold and the currency to stabilize after a new government committed to the program took office.

And second, the external economic environment for the crisis countries has worsened markedly, especially because of the Japanese recession. The result is most visible in exports. Rapid export growth to the United States helped bring Mexico out of its crisis. In this crisis, the value of exports from Thailand, Indonesia and Korea to Europe and the United States increased between the second quarter of 1997 and the second quarter this year, while the value of exports to Japan declined sharply, by about 25 percent. Exports have thus not so far served as a source of growth.

[Another criticism of the IMF-supported programs is that private creditors were not bailed in quickly enough. In Thailand, there was an implicit agreement with the Japanese banks that interbank lines would be rolled over, and the agreement has broadly held. In Korea, funds continued to flow out after the announcement of the program, and within three weeks the process of bailing in the banks began, and was concluded successfully. In Indonesia, the program started in November and the formal bail-in process in late January. In each case, there was great concern about possible contagion, the fear that an attempt to bail in the creditors of one country would lead to their withdrawal from others. The question of how to bail in the private sector without creating contagion remains high on the architectural agenda.]

Where do these countries stand today, about a year since the start of their programs? Recall that the average recession in the United States lasts about a year, and that nearly a year after the Mexican devaluation, there was a period of severe jitters about the sustainability of that program. There are important signs of progress in both Korea and Thailand, in the stabilization of their currencies, the decline in interest rates, and the start of bank and corporate debt restructuring. It was originally anticipated that growth in each country would resume in the second half of this year. That could still happen, though the outcome will depend not only on their own efforts, but also on the external environment. Most likely, a year from now each will be growing, each will be further along in dealing with its structural problems than its neighbors, and thus closer to sustainable growth.

The problems in Indonesia are more profound, for the civil unrest that accompanied the

end of the Suharto regime led to massive capital flight and a loss of investor confidence that will take time and careful political and economic management to repair. Critics often blame the closing of sixteen banks at the start of the Indonesian program for the collapse of the rupiah and investor confidence. A careful look at the timing of the decline of the rupiah suggests it has far more to do with President Suharto's illness at the end of November, perceptions that the government would not carry out the IMF-supported program, and excess creation of liquidity by the central bank, than with the closing of sixteen small bankrupt and suspect banks.

Indonesia has made some progress in recent months. The rupiah has strengthened as foreign assistance has started flowing. However attempts to keep food prices below world levels have become increasingly less successful and rice prices have risen. Accordingly the government, with the assistance of the World Bank, is removing generalized subsidies on food and moving to target the provision of subsidized rice and other essentials to the poor. Although an important start has been made in dealing with the interlinked problems of internal and external corporate debt and the banking sector, more rapid progress is urgent.

Russia

Since 1992, the IMF has been the international community's main vehicle for assisting Russia and promoting Russian economic reform. The process was difficult from the start, for the reformers never had full control over economic policy. Nevertheless, the international community's stake in Russian reform was too critical not to make the effort.

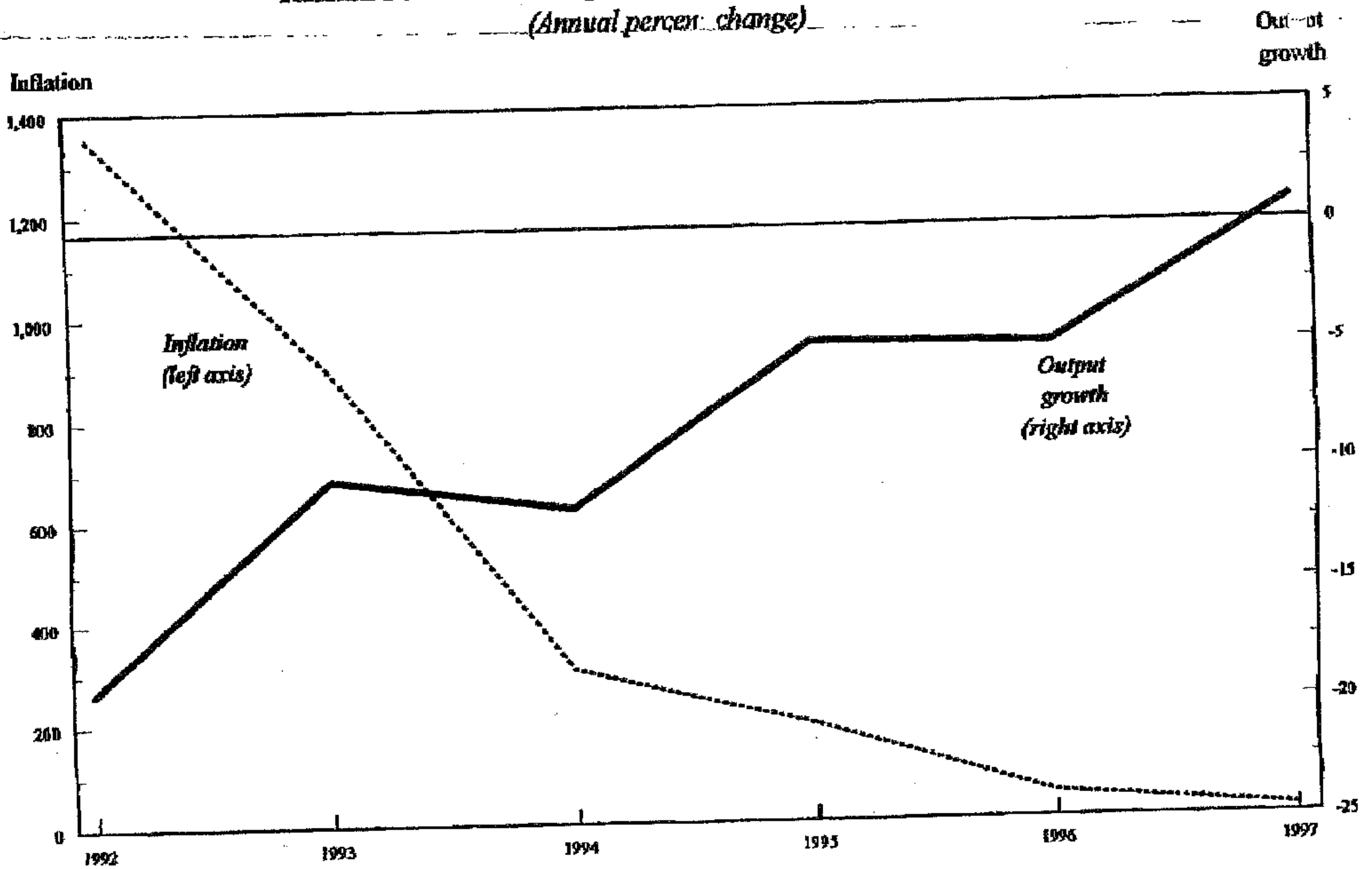
Gradual progress was made in restoring macroeconomic stability: the ruble was stabilized and inflation was reduced below 40 percent in 1996, and positive growth was recorded in 1997. [Chart?] On the structural side, and with the assistance of the World Bank, there has been progress in privatization. But little progress was made in restructuring the military-industrial complex, and the government, unable to collect enough revenue, was frequently in arrears on wage and pension payments. The banking system was ill-regulated and heavily exposed to the risks of a devaluation. And continued corruption created major problems for the economy and foreign investors.

The extent of the fiscal problem is hard to overstate. In 1997, federal tax receipts amounted to 9.7 percent of GDP, *less than $4 billion per month.* The budget deficit was 6.9 percent of GDP. In essence, since 1996 the Russian government was in a race between the need to collect more taxes and the rising interest bill on its growing debt.

In 1998 tax collection began to improve. In the second quarter of this year, for the first time, federal government revenues covered non-interest expenditures. But at the same time, declining oil and commodity prices reduced export revenues, interest rates rose, and the government had to roll over about $1 billion a week of GKOs, short-term ruble-denominated debt.

Russian Feder ion: Output Growth and Inflation, 1992 to 199

(Annual percen change)



Source: IMF *World Economic Outlook* database.

In June and July the international community faced a difficult choice, whether to help Russia try to prevent devaluation and financial collapse by providing a large loan. The adverse consequences of a devaluation were clear, the reformist Kiryenko government was making progress on taxes and in other areas, and the decision was made to help -- recognizing that this was a calculated risk. At the same time as an official package of $22 billion was assembled, on condition the Russians undertake major tax reforms with the support of the Duma, a voluntary debt restructuring scheme to allow GKO holders to switch into longer-.term dollar obligations was introduced. However the takeup on this offer was small.

The new program would have been financially viable if GKO holders had been willing to roll over their maturing holdings. When, after the Duma rejected two tax measures (it passed most of the legislation submitted to it), and in the face of growing concerns about the ability of the government to meet its policy commitments, this did not happen, the government was faced with the unenviable choice among devaluation, a debt restructuring, or both. It chose both, with the GKO restructuring being unilateral, and also imposed a temporary moratorium on private debt payments -- and the second round of the global crisis was under way.

In the event, the contagion following Russia's actions has been greater than expected and feared. The realization that Russia was not too big to fail economically shook investor confidence -- though it is hard to believe that sophisticated investors who had earned an average of 50 percent a year on GKOs since 1994 can have believed that these investments were safe. Investors were also concerned that other countries might follow suit in unilaterally restructuring debts. The Latin American countries and the official sector have emphatically rejected this approach.

Much of the contagion was caused by technical factors. Highly leveraged investors have had to realize assets to meet margin calls; and investors seeking to move out of emerging markets have sold in the most liquid markets to raise cash. And the shocks are now reaching into industrial country markets.

The new Russian government faces an extremely difficult situation. In the short run it may employ a mixture of money printing and more controls. But these approaches will not work, and sooner or later a Russian government will have to return to the task of reforming the economy. At that point the international community will be able to reengage financially.

In the meantime, we should maintain the dialog, and encourage the authorities to meet with their creditors, as well as the steering committee of private sector creditors, to try to agree how to restructure the GKOs, and how to lift the 90-day moratorium on private payments. Success would not only bring Russia closer to future market access, it would also offset some of the tensions in the global markets caused by the original debt restructuring.

What went wrong in Russia? Fundamentally, and although important progress was made over the years, the Russian government was too weak to implement its desired policies. The

international community, through the IMF, was right to try to support reform in Russia. And the IMF was right from early on to emphasize the need to fix the budget. Eventually, as a weak internal situation combined with external shocks, the crisis came. Its effects will take time to overcome, but the story of Russian reform is not yet over.

International Financial Architecture

There is no shortage of suggestions for fixing the international financial system. I will concentrate on a few key points: the need to strengthen national banking and financial systems; mechanisms to reduce contagion; capital controls; the need to deal with the moral hazard problem; exchange rate systems; and reform of the IMF.

Banking system weaknesses have either caused or sharply worsened all the recent crises. Most of these weaknesses were identified in advance by the IMF, but efforts to get countries to take action before crisis struck were not successful. The development of international banking standards, the Basle *Core Principles*, is an important advance. At present we have no way of ensuring that national banking systems meet best international standards. An effort is now starting to strengthen surveillance of banking systems. But we lack enforcement mechanisms. These could for instance take the form of differential provisioning requirements against loans to different countries, depending on the standards met by their banking system (and also on standards in other areas, such as corporate accounting and information provision).

Second, the virulence of the recent contagion raises troubling questions. Admittedly, contagion is rarely baseless: the markets generally treat countries in better shape better than those in worse shape. Nonetheless, the fact that technical factors have contributed to the recent contagion implies that it has been excessive, and that a way has to be found to moderate such excesses. The task will fall in the first instance to financial sector regulators in the industrialized countries, who will need to ensure greater transparency of the positions being taken by international investors, and to consider whether leverage has in some cases been excessive.

Better information should also help increase the efficiency of international capital flows. Through the *Special Data Dissemination Standard*, the IMF is encouraging countries to move toward greater transparency. It will be necessary to strengthen the standard, for instance by providing more timely data on foreign reserves and complete data on forward transactions by central banks. We also need better and more timely data on short term debt, an area in which the Bank for International Settlements is working hard.

Third, Malaysia's decision to impose controls on capital outflows, and support by some academics, raise the question of whether these controls will once again become widespread. The IMF's position has been that capital account liberalization should be undertaken in an orderly way: countries that have controls on outflows should lift them gradually as the balance of payments strengthens; liberalization of inflows should start at the long end and move gradually to

the short end as the banking and financial systems, and macroeconomic balances, are strengthened. The IMF has not opposed Chilean-style, market-based measures to regulate capital inflows at the short end, but we recognize that they need to be considered on a case-by-case basis, and that Chile has recently eased its controls.

Long experience shows that whatever short-term benefits controls on outflows may produce are likely to be outweighed by their long-term disadvantages, as they encourage domestic evasion and capital flight, and discourage foreign investors. Following Malaysia's imposition of controls, other Asian countries firmly rejected them, as have Latin American countries. We should though recognize that the appeal of cutting the country off from the international system, will increase unless international financial turbulence declines.

Fourth, we need to address the moral hazard issue. It is hard to see evidence of moral hazard on the side of policymakers. All the evidence is that countries do their best to avoid going to the Fund. Nor have individual policymakers whose countries end in trouble generally survived politically. The thornier issues arise on the side of investors. Economists tend to point to investors taking excessively risky positions in the presence of an IMF safety net; others are more concerned that some investors who should have paid a penalty may be bailed out by Fund lending. These concerns should be mitigated by the facts that most investors in the Asian crisis countries, and investors in Russia who bet on the so-called moral hazard play, have taken very heavy losses.

Nonetheless, we still need to find ways of balancing valid concerns over moral hazard with the costs for the system of exacerbating instability by failing to assist countries in need. This issue is closely tied to the question of how to bail in the private sector, in ways that minimize contagion. The IMF will be examining this issue in the months ahead, drawing on a forthcoming report by a G-22 working group. One promising possibility is the type of contingent financing that has been arranged by Argentina and Mexico.

Fifth, we will need once again to appraise the choice of exchange rate systems for emerging market countries. (Although many would put a target zone scheme among the major currencies high on the reform agenda, that is not likely in the next few years.) The recent crises have all taken place in countries that had fixed or semi-fixed exchange rates. Yet several countries, including Argentina, have benefitted from having a fixed rate; and currency crises are quite possible in countries with flexible rates. The argument has been made that there are ultimately only two stable exchange rate systems: a freely floating rate; or the adoption of another country's currency. With the expected success of EMU, we may see more currency blocs developing -- and a key to their success will be banking system regulation. In the meantime, we are in an uncomfortable in-between world in which floating rates are sometimes excessively volatile and fixed rates sometimes too vulnerable to attack.

And sixth, reforms are needed at the IMF. Many of the architectural changes will affect the role of the Fund. There is also general support in the industrialized countries for more transparency in Fund operations. The management of the Fund supports greater transparency,

and there has been a great deal of progress in that direction in recent years, as a visit to the Fund's website (www.imf.org) will show. More can be done, but only with the support of the membership, some of whom fear they are far more vulnerable to Fund criticisms than are the industrialized countries.

It is sometimes argued that the Fund is not accountable. That is not true. The Fund is fully accountable to its membership, through the 24-member Executive Board which represents the 182 member countries. No Fund loan or decision of any importance takes place without the approval of the Board. Overall Fund policies are set by the 24-member Interim Committee, made up of finance ministers and central bank governors, which meets twice a year. Most of the complaints about accountability turn out to relate more to transparency -- if more details of Fund operations were published, there would be more room for their appraisal by academics and others. That would be to the good.

Immediate Steps

While work on the international financial architecture gets under way to deal better with the next crisis, we need to focus on containing the present crisis. There are four main steps.

First, as the balance of risks in the international economy has shifted, so should and has the likely stance of monetary policy in the United States and Europe, on whose continuing growth the world economy now depends. The Fed has indicated a shift towards monetary easing. [***If they cut rates tomorrow, please say**: The cut in the Fed discount rate is welcome news indeed.] It is also good news that European central bankers have indicated that other European rates will converge to the low levels of France and Germany rather than meet in the middle.

Second, while Japan has played a constructive role in providing financial assistance in Asia, its recession is a continuing problem not only for Japan but also for other countries. Rapid action on the banking sector, and further fiscal stimulus would go a long way to help Japan and the rest of Asia recover from the crisis.

Third, the key to stopping the further spread of the crisis is Latin America, and within Latin America it is Brazil. Latin American countries have made real progress in structural reforms in this decade. They have generally reacted courageously and appropriately to recent financial pressures by tightening monetary and fiscal policies. President Cardoso in his speech last week sent a clear signal that he will take fiscal action after the election. Countries willing to help themselves, willing to play by the rules, deserve the support of the international community if they need it. The IMF will do what it can, within the limits of available funding.

Fourth, for the IMF to do its part, it will need the support of its member governments, and it will need the quota increase. The world economy is at a critical point. If this crisis is not arrested in Latin America, we will face an even larger problem, one that would likely result in a different and worse world economy.