How to Fix It

Just as the crisis did not arise from a single source, there is not a single silver bullet that will fix it. The main policy imperatives are summarized below.

Restructuring and Reform of Financial Sectors and Prudential Oversight in the ASEAN-4 Economies and South Korea

Because it was neglect of financial-sector reform that—more than anything else—got these countries into trouble, such reform has to be the centerpiece of the recovery package.

Each of these countries—with the assistance of the IMF and the World Bank—needs to evaluate to what extent its financial sector was subject to excess capacity prior to the crisis. The larger was this excess capacity, the stronger the case for encouraging the exit of firms as part of restructuring the financial sector. Banks and finance companies that are clearly insolvent should be closed down, while those that are undercapitalized should be recapitalized to meet international capital standards.

Foreign-ownership limits should be liberalized so that foreign financial-service companies can help to finance this recapitalization and contribute to better risk diversification and a strengthening of overall credit and risk management systems. A recent World Bank study by Claessens (1998) demonstrates that the emerging-market banking systems that exhibit relatively high levels of foreign participation (as measured by the ratio of the
number of foreign banks to total banks) are also the ones that show lower intermediation costs (as measured by the ratio of overhead costs to total assets) and lower levels of banking fragility (as measured by a Goldman-Sachs index of fragility). Stronger domestic firms should also be encouraged to take over weaker ones, so long as such mergers do not conflict with the need to eliminate overcapacity in the system.

Small retail depositors of failed banks should be paid off. As a quid pro quo for injection of public funds, equity holders of failed banks/finance companies should lose their stakes and the management of these failed institutions should be fired (and prosecuted, if found to have engaged in fraudulent practices). Large uninsured creditors of closed institutions (both domestic and foreign) should be placed at the back of the queue and should be paid off only to the extent that there is anything left over after the sale of the closed institutions’ assets is used to reimburse the deposit insurance fund or treasury (more on this later on in this chapter).

Each of these countries, likewise, needs to commit itself to *upgrading significantly its system of financial-sector supervision and regulation*. The emphasis here should be on making loan classification and provisioning practices stricter, adopting international accounting standards, privatizing state-owned banks and curtailing policy-directed lending, putting tighter controls on connecting lending, and instituting better monitoring and control of banks’ foreign-exchange exposure (including large currency mismatching by banks’ customers). The most efficient way to encourage this upgrading of prudential standards is to ask these countries to sign on to the Basle Committee on Banking Supervision’s “Core Principles of Effective Banking Supervision” (the Core Principles) and to assign the IMF and the World Bank the task of monitoring their compliance with these principles. The Core Principles are reproduced in the appendix.

Table 11 lists the major financial restructuring elements that are included in the IMF-led rescue packages for Thailand, Indonesia, and South Korea. At this point, the restructuring and reform process is still in a relatively early stage in each of the most adversely affected crisis countries. That being said, the design of the reform measures is clearly in the right direction, in the sense that some insolvent institutions are being closed, capital requirements are being increased, foreign-ownership limits and restrictions are being eased, and supervisory practices are being adjusted upward toward international standards. Bright spots over the past three to four months include the decision of the Thai authorities to close (and keep closed) 56 (out of 58) insolvent finance companies, the recent decision (early April 1998) by the Indonesian authorities to close

1. I have laid out the elements of what should be included in a minimum set of international banking standards in Goldstein (1997a).
### Table 11: Financial restructuring measures agreed upon with IMF

<table>
<thead>
<tr>
<th>Thailand</th>
<th>South Korea</th>
<th>Indonesia</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Measures</strong></td>
<td><strong>Dates</strong></td>
<td><strong>Measures</strong></td>
</tr>
<tr>
<td>Suspension of 58 insolvent finance companies.</td>
<td>8/97</td>
<td>New legislation governing supervision, deposit insurance, closure of financial institutions, and allocation of losses and equities write downs.</td>
</tr>
<tr>
<td>Tightened loan classification and bank licensing rules.</td>
<td>11/97</td>
<td>Closure of 10 (of 14 suspended) merchant banks.</td>
</tr>
<tr>
<td>Guidelines for assessment of owners, board members, and managers of financial institutions.</td>
<td>12/97</td>
<td>Submission of rehabilitation plans by remaining merchant banks; recapitalization plans required of commercial banks whose 1997 capital adequacy ratios fall below 6 percent based on full provisioning.</td>
</tr>
<tr>
<td>Amendment of bankruptcy laws; stronger loan classification and provisioning rules to meet international standards by 2000.</td>
<td>3/98</td>
<td>Establishment of units at Ministry of Finance and Economy and under Financial Supervisory Board to coordinate and monitor bank restructuring and provision of public funds.</td>
</tr>
<tr>
<td>Preparation of restructuring and privatization plan for intervened banks; review of banking supervision laws.</td>
<td>6/98</td>
<td>Initiation of consultations with banking community and outside experts on strengthening prudential regulations (regulations to be issued 8-11/98).</td>
</tr>
<tr>
<td>Memoranda of understanding with financial institutions on implementing stricter loan classification and provisioning rules.</td>
<td>8-9/98</td>
<td>Legislation to allow full write-down of existing share-holders' equity.</td>
</tr>
<tr>
<td>Revision of Bank of Thailand laws; completion of amendments to foreclosure laws.</td>
<td>10/98</td>
<td></td>
</tr>
<tr>
<td>Completion of disposal of assets of 56 (of 58 suspended) finance companies; new prudential regulations; stronger rules governing disclosure, auditing, and accounting practices; new deposit insurance scheme.</td>
<td>12/98</td>
<td></td>
</tr>
<tr>
<td>Development of plans for privatizing institutions undergoing state intervention.</td>
<td>nd</td>
<td></td>
</tr>
</tbody>
</table>


nd = no date specified.
14 more weak banks (they had closed 16 banks in November 1997), and South Korea’s commitment to upgrade its prudential and supervisory structure by signing on to the Core Principles. What remains to be seen is whether the restructuring and reform process will be sustained over the next two to three years, particularly as it faces resistance from industrial and family groups who will lose favored access to cheap credit, as consolidation forces layoffs in the industry against a backdrop of recession and slow growth in the economy more generally, and as foreign banks gain market share in the industry.

**Exchange Rate Policies in Asia and Trade Policies in the G-7**

For the foreseeable future, the crisis countries should not attempt a return to fixed exchange rates. Instead, they should stick with a managed float. Defense of a fixed exchange rate requires active use of interest-rate policy to squeeze short sellers during speculative attacks. But high interest rates—other than for a short period—will not be credible in countries where weak financial sectors are in the process of being restructured and where growth rates are well below precrisis levels; in these conditions, the costs of “holding on” (to the peg) become too large relative to the (credibility) costs of reneging. Markets realize this. This is likely to be the situation for two or three years—not two or three months. In this connection, Goldstein and Reinhart (forthcoming 1998) report that judging from earlier banking crises in emerging economies over the past 25 years, it takes about 2 to 3 years before growth rates in crisis countries return to the average of the two precrisis years. Hong Kong and Argentina have thus far fared better in the crisis than some of their neighbors not because they have currency boards but rather because they have gone farther in strengthening their banks and their liquidity defenses; so too with Singapore (which has a more flexible exchange rate regime).

This change in (emerging Asia’s) exchange rate regimes toward much greater flexibility will, however, bring with it certain threats that were not so pressing prior to the crisis. By now, there is wide-ranging evidence that volatility of real exchange rates is typically higher under floating than under fixed exchange rate regimes.\(^2\) Also, weak domestic demand and high shares of exports in GDP (see table 12) will put a lot of pressure on crisis countries to export their way out of recession. Given the size of devaluations in Asian-crisis countries, one should expect import penetration to rise sharply in some of the industrial countries contributing to the rescue packages—especially the United States, where, as noted earlier,

---

2. See Mussa (1986) for a summary of that evidence.
the 1997 current account deficit of roughly $170 billion is headed sharply upward this year. Thus far, the turnaround in the current account position of the Asian-crisis countries has come much more from a reduction in imports than from an expansion of exports (perhaps reflecting credit and debt-servicing difficulties on the part of exporters in the crisis countries), but the export expansion should gain momentum in the second half of 1998. Press reports suggest that some import-competing industries in the major industrial countries (e.g., Dynamic Random Access Memory [DRAM] producers) are already gearing up for antidumping complaints (New York Times, 1997).

In view of all this, it would not be surprising if charges of competitive depreciation and exchange rate manipulation begin to surface (both within emerging Asia and in the United States and the European Union). It is well to recall that such charges were a temporary feature of the post-ERM crisis landscape—the core countries (especially France and Germany) complained about the “excessive” depreciation of the lira, the pound, the Swedish kroner, the Spanish peseta, and the Portuguese escudo. Already, in this crisis charges have been made that Taiwan did not defend its currency forcefully enough in October 1997 and that its devaluation added unduly to the pressure on Hong Kong. The fact that no consensus presently exists over what kind of behavior constitutes competitive depreciation or exchange rate manipulation under today’s international monetary system only adds to the problem.


4. See Bergsten (1997, 3) who concludes that Taiwan’s action represented “a clear competitive devaluation reminiscent of the 1930s.”

Table 12  Asian export to GDP ratios, 1996

<table>
<thead>
<tr>
<th>Exports as a percentage of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Thailand</td>
</tr>
<tr>
<td>Korea, South</td>
</tr>
<tr>
<td>Indonesia</td>
</tr>
<tr>
<td>Malaysia</td>
</tr>
<tr>
<td>Philippines</td>
</tr>
<tr>
<td>China</td>
</tr>
<tr>
<td>Hong Kong</td>
</tr>
<tr>
<td>Taiwan</td>
</tr>
<tr>
<td>Singapore</td>
</tr>
</tbody>
</table>

| 30.2 |
| 26.8 |
| 21.9 |
| 78.8 |
| 24.4 |
| 21.2*|
| 117.3|
| 42.5 |
| 132.9|


This means that Asian countries along with the G-7 will need to consult and cooperate more closely on exchange rate policies than they have in the past. As recovery from the crisis takes hold and as domestic demand and exchange rates in the crisis countries strengthen, this threat will become less acute—but it will be important in the interim. This is an area where regional cooperation groups (APEC, Executive Meeting for East Asia Pacific [EMEAP], etc.), along with the IMF, can be helpful in defusing incipient tensions and providing a dialogue on exchange rates and supporting policies.

On the trade policy side, the major industrial countries likewise need to resist actions that would frustrate or handicap the adjustment underway in the Asian-crisis countries. In particular, as suggested by Bergsten (1998), the major industrial countries should not adopt any new trade restrictions in the wake of the Asian crisis.

**Japan’s Role**

*Japan has to become part of the solution to the crisis—not a tinder box that handicaps crisis management.* For that to happen, domestic demand in Japan has to resume satisfactory rates of growth, and Japan has to get its bad-loan problem behind it.

As the economic situation in Japan has continued to deteriorate over the past few months, a crescendo has been building for bold fiscal expansion. With interest rates (at both the short and long ends of the yield curve) at historic lows, with the standard cyclical indicators pointing in a recessionary direction, with aggregate price indices signaling zero inflation or deflation, with recent fiscal policy actually withdrawing stimulus from the economy, with a structural (cyclically adjusted) budget deficit less than half as large as the actual one and an extremely low ratio of net government debt to GDP, and with recession working strongly against a recovery of property prices and a decline in bankruptcies (both of which exacerbate the bad loan problem), it’s hard to imagine a conjuncture more favorable to strong fiscal policy stimulus.

The chorus of external and internal calls for bolder fiscal action elicited in March 1998 announcements from the Japanese authorities that they are prepared to go forward with a 16 trillion yen fiscal package. A useful assessment of this proposal—which I support—is contained in a forthcoming IIE study by Posen (forthcoming 1998). He notes that over the past decade the net stimulus associated with announced Japanese fiscal packages has typically been much smaller than meets the eye because, inter alia, previously planned expenditures are often simply moved forward from the next year’s budget and because asset purchases and transfers (which often loom large in these packages) have very small aggregate demand effects. If this package falls on the regression line, the 16 trillion

---

28  ASIAN FINANCIAL CRISIS
yen would really be half as large in net terms. Posen (forthcoming 1998) argues that, given Japan’s present output gap of about 3 percent, a net stimulus package of 16 trillion yen would be about the right size. When fiscal stimulus has been significant (as in 1995), it did have significant output effects (as in 1996). Furthermore, Posen concludes that most of the stimulus should take the form of personal tax cuts rather than further increases in public spending because: (1) consumption in Japan is particularly weak, whereas there is overinvestment and low efficiency in the areas typically targeted for public investment; (2) cuts in tax revenue will induce falls in public expenditure in the medium term (thus helping to deal with Japan’s longer-term fiscal problem); (3) overall resource allocation will be improved by moving resources from the public to the private sector; and (4) the difference in the multipliers as between expenditure increases and tax cuts is considerably smaller in the long run than in the short run. To sum up, a 16 trillion yen fiscal stimulus would be a big improvement over the previously announced 2 trillion yen package; it would be even better if it were really a 16 trillion yen addition to the status quo (rather than some fraction of it) and if permanent tax cuts (rather than expenditure increases) were the focal point of the package.

The good news on the bad loan problem is that the authorities have finally discarded the fantasy that they will be able to overcome widespread banking fragility without a sizeable injection of public funds and have indicated that they will increase their initial proposal of a 10 trillion yen injection to 30 trillion yen. The bad news is that much of this money may go to propping up insolvent or very weak banks, that earlier announced plans to implement rules-based “prompt corrective action” procedures may well be postponed, and that various “gimmicks” may be employed to artificially inflate regulatory bank capital and to offset the (welcome) move to more rigorous loan classification procedures. The risks here are that the problem of overcapacity in the banking industry will remain, that banking supervisors will continue to grant forbearance to undercapitalized banks (rather than compel them to implement corrective actions), and that accounting gimmicks will convey the impression that little has

5. Ito (1998b) comes to a similar conclusion, arguing that if the Japanese government had not implemented the fiscal packages of the past five years, real output growth, instead of being merely marginally positive, would actually have been negative.

6. Ito (1998b) also argues that a tax cut is preferable to increased expenditure on public works (because fiscal spending has been wasteful from the supply-side point of view and because a tax cut would boost consumer confidence). He argues further for temporary consumption tax reduction in housing-related expenditures because efforts to increase housing size would have positive feedback effects on consumption.

7. One such accounting gimmick is to allow banks to use the higher of book value or market value in valuing gains or losses on their equity holdings.
changed on transparency and disclosure—with predictable effects on market confidence.

The greatest contribution Japan can make to ending the Asian financial crisis is get its own house in order. It should do so with a sense of urgency. A domestic-demand-led recovery in Japan would allow it to absorb its fair share of exports from emerging Asia and would (cum higher Japanese interest rates) help to end the downward slide of the yen (which, in turn, exacerbates the situation of the Asian-crisis countries, makes it harder for China to resist a devaluation, and threatens to stoke later protectionist pressures in the United States). A significant reduction in the overhang of bad loans would not only feed back positively on Japan’s own performance (by easing the credit crunch and building confidence) but would also increase the room for maneuver in rescheduling the bad loans of banks in the crisis countries. At present, regional crisis management is severely handicapped by the constraint that any measures that add (directly or indirectly) to the already serious problems of Japan’s banks tend to be avoided—even if such measures would otherwise be helpful in dealing with the crisis.

China’s Role

*China can play its part in the broader crisis-management strategy by continuing to resist the temptation to devalue its own currency, at least until recovery from the crisis is more firmly established.* This should not require a large sacrifice on China’s part. China is not under strong immediate pressure to devalue. It has a sizeable stock of international reserves, has been running a small current account surplus, and has a very low ratio of external debt to GDP and to international reserves. Moreover, the low share of portfolio flows in its total capital inflows, the lack of capital account convertibility, and the absence of a deliverable forward market for the currency suggest that there isn’t an obvious “foreign fuse” to ignite a speculative attack. Also, given the likely negative effect that an immediate Chinese devaluation would have on confidence and exchange rates in the Asian-crisis countries (including the ability of the Hong Kong authorities to maintain their peg), the net effect of Chinese devaluation on its competitiveness is uncertain

8. Bergsten (1998) has characterized China’s behavior in the Asian financial crisis thus far as exemplary.

9. China holds approximately $145 billion of international reserves; it ran current account surpluses equal to about 1 and 2.5 percent of GDP in 1996 and 1997, respectively; and its ratio of external debt to GDP is below 20 percent. Perry and Lederman (1998) show that China’s ratio of external debt (owed to international banks) to international reserves in mid-1997 was much below that in the Asian-crisis countries.

but likely to be considerably smaller than the gross effect. Indeed, because of its spillover effects within the region, an early Chinese devaluation might even worsen China’s competitive position. In any case, China has not yet suffered a large deterioration in competitiveness because of the devaluations in the Asian-crisis countries. Liu et al. (1998) have estimated that roughly a 6 percent real devaluation of the renminbi would be sufficient to offset the balance of payments effects of the devaluations that have occurred in Asia since the crisis began—that is, to restore the status quo ante.

But what is true in the short term is not necessarily so beyond that. China is facing a serious problem in downsizing and reforming its loss-making state-owned enterprises. These losses have increasingly been financed not through the budget but rather by relying on loans from the state-owned banks. As a result, China’s state-owned banks are now burdened with a share of nonperforming loans that matches or exceeds the worst cases among the Asian-crisis countries. As Lardy (1998) argues convincingly, failure to deal promptly and forcefully with this banking problem would seriously handicap reform efforts in other areas (ranging from establishing capital account convertibility to developing China’s bond and equity markets), would lower saving and hinder the efficient allocation of investment, and would run the risk of igniting a domestic bank run. But restructuring state-owned enterprises and recapitalizing the state-owned banks is likely to be expensive—both in terms of short-term employment losses and fiscal costs. As Fernald, Edison, and Loungani (1998) show, the Asian financial crisis has already increased the risk premium on Chinese sovereign debt and is likely to slow FDI flows into China. All of this is occurring against a backdrop of an already severe urban unemployment problem (with all its social repercussions) and a projected slowing of GDP growth for 1998. It would not be surprising therefore if China saw a no devaluation pledge as too costly beyond the next two years or so.

**IMF Rescue Packages**

Turning to the design and effectiveness of IMF-led rescue packages, much of the criticism that has surfaced in recent months is off the mark. Indeed, of the five most frequently voiced criticisms, three stand on very weak ground,

11. This issue is discussed more fully in Lardy (1998), Liu et al. (1998), and Fernald, Edison, and Loungani (1998).
13. The April 1998 IMF World Economic Outlook projects that China’s real GDP growth will slow from 8.8 percent last year to about 7 percent this year.
and one is a toss-up. The only criticism that really hits home is the moral hazard problem linked to bailing out large uninsured creditors of banks in the crisis countries (primarily in South Korea).

One critique says that the strong medicine prescribed by the IMF for the crisis countries is ill advised because these countries were well behaved before the crisis. They were merely “victims” of a marked and concerted shift in the sentiment of investors cum contagion. This argument ignores the serious financial-sector weaknesses and external-imbalance problems (outlined above) in the crisis countries. In short, banks and corporations let short-term and foreign-currency borrowing get out of hand to finance expansion, and they used the proceeds unwisely—this eventually came back to bite them. This interpretation does not preclude overshooting by the market once the crisis got started, but it rejects the “innocent bystander” hypothesis. The fact that the market did not see the crisis coming likewise does not indicate that fundamentals were fine. Empirical work by Goldstein and Reinhart (forthcoming 1998) on more than 120 banking and currency crises in emerging markets over the past 25 years reveals that interest rate spreads and credit ratings have typically been relatively poor predictors of these crises. In that sense, the Asian financial crisis is hardly unique.

A second line of criticism is that (with the evolution of the international monetary system to floating exchange rates) the IMF is really no longer needed to deal with such crises and that its intervention only serves to delay adjustment. This confuses the exchange rate regime with the IMF’s key purpose, namely, providing conditional financing so that countries can deal with balance of payments problems in a way that is less destructive of international prosperity. Without access to such financing, countries would respond to external deficits with larger deflations and greater resort to competitive depreciations and trade and exchange controls (as dramatically illustrated by the experience of the 1920s and 1930s). Even with a near $50 billion rescue package, Mexico underwent a 6 percent decline in real output in 1995—its deepest recession in 50 years. Prior to the crisis, 1998 growth in Thailand was projected to be 7 percent; it is now expected (even with the $17 billion rescue package) to come in between minus 3 and 4 percent. As documented in chapter 1, projected growth rates in the other crisis countries have likewise been downgraded

14. Sachs (1997) adheres to this view: “There is no ‘fundamental’ reason for Asia’s financial calamity except financial panic itself.” While acknowledging some vulnerabilities in the crisis countries, Radelet and Sachs (1998) also stress this theme; for example, they conclude that “The crisis is a testament to the shortcomings of international capital markets and their vulnerability to sudden reversals of market confidence.”

15. See Shultz, Simon, and Wriston (1998). They conclude (A22) that “The IMF is ineffective, unnecessary and obsolete . . . Once the Asia crisis is over, we should abolish the one [IMF] we have.”
The cushioning provided by official financing has to be accompanied by policy changes and reforms if the crisis is to be overcome. Who should administer that conditionality? Should it be administered by individual creditor countries, with all the political overtones that such bilateral negotiation would involve? Or does it work better if the party on the other side of the table is an international institution with a constitutional mandate to provide conditional financing and with a governing board on which borrowing countries sit and vote on the institution’s policies? As often concluded after earlier crises, if the IMF (warts and all) didn’t already exist, something a lot like it would have to be created.

Yet a third complaint is that the IMF has either been too intrusive in the policies it has recommended to the crisis countries, or alternatively, that it has not been intrusive enough. On the former count, it is argued that by making detailed recommendations about financial-sector reform and corporate governance, the IMF has moved away inappropriately from its mandate of balance of payments adjustment. But could market confidence and renewed access for the Asian-crisis countries be regained without these countries undertaking reform of banks, finance companies, conglomerates, and government monopolies? Could Thailand, for example, get out of its current predicament without closing insolvent finance companies and banks? Could South Korea regain the confidence of investors without altering the way in which the government, banks, and chaebols conduct business with one another and without reducing the extremely high debt-to-equity ratios of the chaebols? Could Indonesia recover without banking reform and without giving a concrete signal that it is prepared to curtail inefficient infrastructure projects and to rein in the worst cases of “crony capitalism”? When the fiscal costs of severe banking crises frequently wind up in excess of 10 percent of the crisis country’s GDP, does it make sense to set fiscal policy targets without bringing financial-sector restructuring and reform into the picture?

The charge that the IMF is not intrusive enough often surfaces in the debate over whether the conditionality linked to official rescue packages ought to include measures to safeguard labor standards, to protect the environment, and to prohibit abortion. As suggested by Feldstein (1998),

16. Feldstein (1998) has taken the too-intrusive position. He concludes that “The IMF’s recent emphasis on imposing major structural and institutional reforms as opposed to focusing on balance-of-payments adjustments will have adverse consequences in both the short term and the more distant future.” The view that the IMF is not intrusive enough—or is not intrusive about the right things—has been put forward by an array of groups promoting core labor standards, or environmental concerns, or antiabortion conditionality.

17. See Goldstein (1997a) for a list of the fiscal-policy costs of banking crises in emerging economies.
the test here should be whether these measures are necessary for the crisis
countries to overcome their currency and banking problems. Labor and
environmental standards and anti-abortion measures do not pass that
test; financial-sector reforms do. Proponents of the former should push
their agendas primarily in other forums—not via the IMF. If the US
executive director in the IMF were obligated to vote against any IMF
program that did not contain conditionality dealing with labor and envi-
ronmental standards and/or with anti-abortion measures, the United
States would become isolated and much less influential within the IMF.
This does not mean that the US government should not candidly express
its views on these matters within the IMF—but such support should stop
short of making these policies a part of IMF conditionality.

IMF-led rescue packages should not become a Christmas tree on which
various groups (from the creditor countries) hang their favorite legislative
aims. This point does not apply only to social objectives. Large creditor
countries should not use such rescue packages to obtain bilateral trade
and investment concessions that are not crucial to achieving the program’s
broader objectives. For example, while eliminating foreign-ownership
restrictions on banks may be intrinsic to financing recapitalization of
those institutions, lifting a trade restriction on say, car imports from one
supplier, is harder to justify. Also, the more these rescue packages are
loaded up with extraneous side conditions, the harder it is going to be
both to conclude these agreements in a time frame relevant to crisis
management and to sustain them against political attack in the pro-
gram countries.

Criticism number four is that the IMF has exacerbated the Asian crisis
by prescribing excessively tight monetary and fiscal policies (cum high
interest rates) and by mandating the closure of some banks and finance
companies. Because the crisis countries did not have serious fiscal imbal-
ances before the crisis and because bank closures can lead to a credit
crunch, the IMF’s recommendations have made the contraction deeper
than it needed to be. Some would go further and argue that it is because
of this faulty policy mix that the rescue packages have not produced a
quick turnaround in currency and equity markets.

While the critics have a point, they take it too far. It is true that it is
harder to implement a successful restructuring of the financial sector if
growth is slow and interest rates are high. It is also true that very high
interest rates (in a context of a weak banking system and/or a recession)
can be ineffective in stabilizing a falling currency if market participants

---

18. Having an adequate social safety net is more likely to pass the test. This is because the
absence of a safety net may prevent the necessary monetary, fiscal, exchange rate, and
structural policies from being implemented long enough to be effective.


34 ASIAN FINANCIAL CRISIS
are pretty sure that such rates are sustainable for only a week or two; recall, for example, Sweden’s unsuccessful effort to use 500 percent overnight rates to stabilize the kroner during the 1992 ERM crisis. Likewise, a credit squeeze can prevent domestic firms from getting the working capital they need to respond to the improved export opportunities created by a depreciated exchange rate. And the solution to overcapacity in an economy is unlikely to be contractionary fiscal policy.

But there’s another side to that story. When market participants lose confidence in a currency and attach a high probability to further falls, it is difficult to induce them to hold the currency without higher interest rates. For example, it took nominal interest rates of 70 to 80 percent (for 28 day cetes\(^{20}\)) for several months in early 1995 to stabilize the Mexican peso.\(^{21}\) Moreover, halting a free fall of the currency takes on added importance when banks or corporations in the crisis country have large foreign-currency obligations coming due in the short term. Once the currency begins to stabilize, it may be possible to bring interest rates down substantially (so that the economy does not have to deal with them for too long). Besides all this, as Krugman (1998b) notes, for countries that are seeing their exchange rates in near free fall and are practically out of reserves, there isn’t much choice: raising interest rates is the only way to support the currency.\(^{22}\)

The case against closing banks in crisis countries is anything but convincing. If clearly insolvent banks/thrifts are allowed to continue operations, they are likely to “gamble for resurrection” by taking on even higher risks, adding significantly to the ultimate public-sector tab. This lesson was driven home forcefully in both the US saving and loan crisis and the ongoing Japanese banking crisis, as well as in a host of developing-country cases.

Also, not all bank runs are undesirable. Informed runs, where depositors shift funds from weak to strong banks, are a desirable element of the adjustment to banking problems. Between December 1994 and March 1995 (during the “tequila effect” of the Mexican peso crisis), some 16 percent of total deposits were withdrawn from the Argentine banking system. But an analysis of those bank runs indicates that depositors did discriminate quite sharply between weak and strong banks, punishing in particular banks that did not maintain high reserve liquidity.\(^{23}\) It is only

---

20. Cetes are treasury bonds (denominated in domestic currency) issued by the Mexican government.
22. Krugman (1998b) also derides the notion that lowering interest rates will strengthen the economy and actually cause the currency to appreciate—characterizing such a currency/interest rate Laffer Curve as “as silly as it sounds.”
when depositors and creditors run from sound banks that problems occur. And here, too, it has to be recognized that after a period when bank credit grew at an unsustainably rapid rate, some slowdown in credit expansion is to be expected; indeed, one doesn’t want bank credit going to finance the same uneconomic projects that contributed to the crisis. One key to keeping a credit contraction under control is to see that relatively stronger banks have sufficient capital so that they don’t need to engage in a fire sale of assets to meet regulatory capital requirements.

Like the use of interest rate policy during a crisis, the decision of how many insolvent banks to close in a crisis is a judgement call and not a foregone conclusion (with the outcome depending in good measure on how skillfully the closures are carried out). If the IMF made an error in closing 16 banks during its initial agreement with Indonesia, it was that it did not close enough banks—not that it closed too many. There were at that time over 270 banks operating in Indonesia; the 16 banks that were closed accounted for only about 5 percent of total banking assets. The trick to restoring confidence is to convince the public that all the bad banks have been resolved, and that the ones remaining open are solid.24 In Indonesia, it is very unlikely that the first cut of bank closures took care of the bulk of the weak banks (14 more Indonesian banks were closed recently);25 also, the prompt reopening of a closed bank owned by one of President Suharto’s sons did little to buttress the claim that bank closure decisions were being made without regard to political influence.

In a study of 24 countries that experienced systemic bank restructuring, Dziobek and Pazarbasioğlu (1997) found that the countries that were quickest to diagnose the problem, assess the losses, and restructure their banking systems were generally the ones experiencing the better recovery patterns from the crisis. In short, if there is an issue on bank closures, the critics seem to have gotten the argument backward.

In any event, it looks increasingly doubtful that the original targets for monetary and fiscal policy in the official rescue packages are the main reason why the market reaction to the IMF programs was initially so disappointing. Suppose, for example, that the fiscal targets in the Indonesian and South Korean programs called for a fiscal deficit of 1 percent of GDP rather than a surplus of the same amount. Would that have produced


25. I have been told that at the September 1997 Annual Meetings of the IMF and World Bank in Hong Kong, lists of unsound Indonesian banks were circulating widely and that such lists had many more than 16 entries.
the market confidence necessary to buoy currency and equity markets in the crisis countries? Surely not. It needs to be recognized that when a country is undertaking a wide-ranging structural reform that promises to alter the way banks, corporations, and the government have conducted business over several decades and when the implementation of that program is scheduled over a several-year period, it is going to take some time before market participants become convinced that reform efforts are "serious"—especially if there is a false start or two. In addition, the decline in currency and equity prices has been sharpest when uncertainties about the political will and ability to implement the program have been most severe (e.g., in South Korea, in the immediate run-up to the presidential election; in Thailand, prior to the change in government; and over the first four months of 1998 in Indonesia, particularly after the health of President Suharto came under question, after rumors and then confirmation of Jusuf Habibie’s appointment as vice president, and after submission of a less than realistic budget.26

The IMF has also made it clear that it is willing to revise the monetary and fiscal targets in these programs if growth appears to be weaker than expected at the time the programs were agreed. In short, on traditional Keynesian grounds, I suspect that an easier fiscal stance would have been appropriate, but this is not the crux of the problem. Rather, it is convincing market participants both that the structural weaknesses that played such a key role in motivating the crisis have permanently changed for the better and that the overhang of short-term debt of banks and corporations can be resolved in a satisfactory and reasonably expeditious way.

The fifth criticism is one that merits the most attention, because it affects not only this crisis but the probability of getting into similar financial crises in the future. It goes under the broad heading of moral hazard, that is, the provision of insurance by the official sector that acts as a subsidy to risk taking and, thus, results in too many resources being channeled into the insured activities.

After the Mexican crisis, the G-10 countries undertook a review of how to deal with sovereign liquidity crises (G-10 1996; executive summary reprinted in Kenen 1996). The emphasis was on sovereign liquidity crises, because Mexico’s debt crisis involved sovereign bonds and because it was implicitly assumed that private-sector debt rescheduling presented fewer unresolved problems than did rescheduling of sovereign debt.

Among the relevant conclusions of the G-10 report, the following merit explicit mention (Kenen 1996, 74–75): (1) "[N]either debtor countries nor their creditors should expect to be insulated from adverse financial consequences by the provision of large-scale official financing in the event of a crisis;" (2) "[T]here should be no presumption that any type of debt

26. See Ito (1998c) on these political factors in the crisis countries.
will be exempt from payments suspensions or restructurings in the event of a future sovereign liquidity crisis;’’ and (3) ‘‘[N]ote was taken of the current policies of the IMF that provide, under exceptional circumstances, for lending in support of effective adjustment programmes prior to full and final resolution of the sovereign borrowers’ arrears to private creditors. It would be advisable for the IMF Executive Board to review existing policy in this area and to consider whether the scope of its application should be extended to other forms of debt not covered.’’ In identifying a broad set of principles and features that should guide the resolution of future sovereign liquidity crises, the report also urged: ‘‘[I]t should minimize moral hazard for both creditors and debtors;’’ and ‘‘it should strengthen the ability of governments to resist pressures to assume responsibility for the external liabilities of their private sectors’’ [emphasis added].

One might then ask: well, if these were the principles that were to guide the (post-Mexico) resolution of future liquidity crises and if the Thai, Indonesian, and South Korean crises dealt primarily with private debt (rather than the tougher case of sovereign debt), how did the United States wind up with nearly $120 billion in official rescue packages—particularly since US Treasury Secretary Rubin has indicated on a number of occasions that he wouldn’t be willing to ‘‘spend a nickel’’ on bailing out private creditors?

To be fair, several things should be recognized at the outset. First, the rescue packages go primarily for purposes other than to prevent rescheduling of debt to private creditors; namely, they go to cushion the (inevitable) recession in the crisis countries, to help to rebuild international reserves, and to help to recapitalize the banking system. As noted above, I would argue that these are indeed legitimate uses of IMF resources. Second, in at least the Thai and Indonesian cases, the IMF probably acted in the direction of restraining national authorities in the crisis countries from engaging in even larger bailouts of large, uninsured creditors of banks and corporations. For example, the Thai authorities announced a blanket guarantee for depositors and creditors of Thai banks and finance companies. After 58 finance companies were closed in Thailand, the original (Thai) plan was to give the large creditors of these finance companies bonds at market interest rates in exchange for their existing claims; the IMF apparently fought successfully to make these bonds carry a below-market rate of return (2 percent)—so that large creditors took a nontrivial hit. Similarly, I understand that language was written into the Indonesian program to try to limit the diversion of IMF funds for bailing out the creditors of large corporations. Third, there is a good case for bailing out small retail depositors of banks (because they are apt to be less sophisticated and efficient at judging the soundness of banks).27 Fourth, through-

out the crisis, equity holders and bond holders have “taken a hit.” It is probably the case that they would have taken even a bigger hit without IMF involvement, but they certainly have paid a significant penalty. The main problem is with large, uninsured creditors of banks.28

IMF/G-10 attitudes seem to have shifted by the time of the South Korean rescue. By that time, the depth and contagion of the Asian crisis were more serious. Also, as in the Thai case, the South Korean authorities, in an effort to stem the crisis, had indicated (in August 1997) that they were prepared to guarantee the liabilities of all South Korean financial institutions and overseas subsidiaries.29 Presumably, a decision was made that attempting to reschedule the short-term debts of South Korean banks (that is, impose a hit on the creditors of these banks) would risk spreading the crisis further. Perhaps there was also a concern that there was no easy way to do this in a nonconfrontational way, without going the full monty of a “debt moratorium.” By late December 1997, when a short-term rescheduling (default) on South Korean debt was closer at hand, the official sector was apparently even more concerned about the spillover effects of a rescheduling on South Korean bank debt and opted to increase the speed of official disbursements and to lean on bank creditors to roll over the debt coming due over the next month.

While none of us can confidently know the counterfactual, I would argue that the decision not to rely more heavily on rescheduling of short-term bank debt in December 1997 was a mistake and, in concert with mega-IMF rescue packages, risks sending us down the road to an approach to crisis management that cannot be sustained.30 My view rests on the following arguments.

Operating exclusively on the borrower to limit moral hazard is not apt to be effective. In this connection, two characterizations of the cost of borrowing from the IMF have often been advanced over the past few years. Neither of them is correct.

The first characterization is that the IMF lends money to countries at highly subsidized rates, thereby encouraging these borrowers to under-
take excessive risk taking. Indeed, one proposed bill in the US House of Representatives would compel the IMF to offer loans at rates “comparable” to those in private financial markets (adjusted for risk).

The interest rate that countries pay for borrowing from the IMF depends on which borrowing facility (facilities) they make use of. While the IMF operates one significant concessional facility, the Enhanced Structural Adjustment Facility (with an interest rate of 0.5 percent per year and repayments that begin 5.5 years after and end 10 years after the date of each disbursement), the facilities most relevant for situations akin to the Asian crisis are the IMF’s regular facilities (standby arrangements and the Extended Fund Facility [EFF] arrangements) and the newly created Supplemental Reserve Facility (SRF). As shown in table 13, about 90 percent of the use of IMF credit in 1997 was accounted for by its regular facilities.

Countries that enter into standby and EFF arrangements with the IMF pay an interest rate (called the rate of charge) that is a weighted average of the short-term interest rates in the G-5 countries (where the weights are the same as those used to construct the Special Drawing Rights [SDRs]),

difference between the financial crises of the 1990s and the Latin American debt crisis of the 1980s. Much more limited official assistance was forthcoming in the earlier episode.”

plus a small surcharge.32 Reflecting the fact that G-5 interest rates (particularly in Japan) have recently been unusually low, the rate of charge averaged 4.7 percent in 1997.33 The SRF was put in place in December 1997. It aims “to provide financial assistance to a member country experiencing exceptional balance of payments difficulties due to a large short-term financing need resulting from the sudden disruptive loss of market confidence reflected in pressure on the capital account and the member’s reserves.”34 With the SRF, there is an expectation that the correction in the balance of payments can be accomplished within a short period of time. As such, repayment periods under the SRF will normally be one to one-and-a-half years after the date of each disbursement; also, during the first year of the loan, SRF borrowers will pay an interest rate of 300 basis points above the rate of charge on regular IMF loans, and this will increase by 50 basis points at the end of that period and every six months thereafter until the surcharge reaches 500 basis points.35 South Korea was the first country (in December 1997) to draw on the SRF, receiving SDR4.1 billion (roughly $5.5 billion) of the total amount of SDR15.5 billion (roughly $21 billion) approved under the standby arrangement.

Because developing countries—especially when they are encountering difficulties—cannot access international financial markets on terms that are nearly as favorable as those available to the G-5 countries, it is certainly accurate to say that such countries pay interest rates on their borrowings from the IMF that are lower than they might obtain from the markets. Cline and Barnes (1997), for example, calculate that average eurobond spreads (relative to US Treasury bonds) for 11 major emerging market economies ranged from 315 basis points in late 1995 to 118 basis points in September 1997, before rising to 230 basis points at the end of October. Radelet and Sachs (1997) report that the spread on Thai sovereign bonds was 39 basis points in the second quarter of 1996 and was still only 79 basis points in August, a month after the crisis had begun. In early April 1998, South Korea placed 5-year bonds (cum a government guarantee for

32. These weights are as follows: United States, 43 percent; France, 10 percent; Germany, 17 percent; Japan, 17 percent; and the United Kingdom, 13 percent. Standby arrangements cover a one to three year period, drawings are normally phased in on a quarterly basis, and repayments are made within 3.25 to 5 years of each drawing. EFF arrangements normally run for three years (and can be extended for a fourth), have phasing comparable to those of standby arrangements, and repayments are made within 4.5 to 10 years of the drawing. EFF arrangements are designed to remedy balance of payments problems that originate largely from structural problems and require a longer period of adjustment; they generally also provide larger amounts of financing than standby arrangements.


34. See IMF (1998c).

a few those years) at a spread of 345 basis points above US Treasury bonds and 10-year bonds at 355 basis points.36

One has to be careful, however, not to compare apples with oranges. The big difference between IMF (upper-credit tranche) programs and loans from the private sector is that the former always come with strong policy conditionality. As noted above, the IMF-led rescue packages with Thailand, Indonesia, and South Korea, in addition to conditions on monetary, fiscal, and exchange rate policies, carried a large helping of structural policy commitments, especially in the financial sector. From the point of view of the national policymaker, a loan agreement that strongly circumscribes his/her room for maneuver—and that might be used by political opponents to argue that the national authorities have surrendered the steering wheel to foreigners—is likely to be viewed as more “costly” than one that does not carry such conditionality.37 In other words, when valuing the cost of borrowing from the IMF, one ought to think in terms of the conditionality-equivalent interest rate, not just the nominal interest rate on the loan—the former will be higher than the latter. In fact, if IMF loans carried the huge subsidy that many of the IMF’s critics claim, then one would expect to see countries tripping over themselves in a rush to come to the IMF as soon there was a balance of payments need and before they turned to (higher-cost) private lenders. But this is exactly the opposite of what we in fact observe. Countries with serious payments problems usually come to the IMF late in the game, after their external problems are quite severe and only after they’ve exhausted their access to other lenders. The recent behavior of the Thai, Indonesian, and South Korean authorities in the run-up to the Asian financial crisis is a case in point. All of this should send a signal that one cannot easily capture any subsidy associated with IMF borrowing by reference to a simple interest rate comparison of IMF programs and loans/bonds from private creditors.

The second characterization is that the cost of IMF borrowing—inclusive of the costs of IMF conditionality—are so high as to deter sovereign borrowers from counting on the IMF as a backstop in case of a crisis. For example, it was sometimes said that after the costs Mexico incurred during the peso crisis, no rational borrower would allow itself to get into that kind of trouble again. Clearly, whatever the costs and coinsurance associated with IMF policy conditionality, the demonstration effect of Mexico was not sufficient to deter overborrowing in Southeast Asia and South Korea (as indicated in chapter 2).


37. To take but one recent example, when South Korea signed its standby arrangement with the IMF in December 1997, some South Korean opposition leaders referred to it as a “day of national humiliation.” Loans obtained from the private capital markets are not described in such terms, although it is clear that private capital markets also force policy changes on errant sovereign borrowers.
In my view, a better approach to reducing moral hazard in IMF-led official rescue packages would be to operate also on private lenders. Specifically, the only thing that will deter their excessive risk taking is a nontrivial probability of incurring a significant loss, which in turn requires that they occasionally actually do suffer a loss.

If the G-10 and the IMF want their pronouncements on official bailouts to be credible—particularly in the wake of the bail out of tesobono38 holders in Mexico—they need to act in accord with those pronouncements when push comes to shove in a crisis. The efforts that went into avoiding an earlier rescheduling of the debts of insolvent South Korean banks seem inconsistent with the principles laid out in the G-10 report (as cited above). Clearly, if the official safety net becomes wider and wider over time (based on the case law of actual rescues), we can expect private lenders to increasingly channel international capital flows into the debts of those borrowers and lenders who are deemed “too large to fail”—no matter what G-10 reports say. What sense then will it make to complain about excessively narrow spreads on emerging-market paper (especially bank debt) and to emphasize repeatedly in official reports that the first line of defense against crises is good risk management by banks and corporations if the official sector “blinks” whenever a large borrower is in trouble?

It is not obvious that a rescheduling of South Korean bank debt could not have been undertaken earlier on in the crisis without exacerbating it; nor is it clear that the first round of rollovers that did take place (in New York, Frankfurt, and Tokyo) would not have happened anyway in the absence of a promise of accelerated disbursements from the official sector. The argument that creditors are too numerous and disbursed to make such discussions feasible did not seem to apply in this case. If the rescue package for South Korea were smaller (say, $30 billion instead of $58 billion) and disbursements were not accelerated, a larger amount would have had to be rescheduled. But it is not clear why the smaller amount is to be preferred to a larger one. After all, this is private bank debt and the lenders have been compensated with risk premiums that reflected some probability of nonrepayment. In contrast to the 1982 situation, US and European banks were not in danger of being made insolvent by a hit on their loans to Asia. Admittedly, taking such a hit would have been a bigger problem for Japanese banks, but a large public injection is already needed there (see discussion above) and the Japanese economy is rich enough to afford it. Yes, there could have been larger spillovers to other emerging-market borrowers, but the IMF could have been prepared to extend liquidity to those countries whose solvent banks were adversely affected by South Korean rescheduling. Moreover, the G-10 report cited above spoke approvingly of the IMF’s “lending into arrears” policy, at

38. Tesobonos are US dollar indexed treasury bonds issued by the Mexican government.
least for extreme circumstances. So long as South Korea was carrying out its adjustment program and bargaining in good faith with its private creditors, why was an acceleration of disbursements crucial? And if South Korea can obtain an acceleration of official disbursements (before meeting the earlier agreed on performance criteria), what will be the message to banks, corporations, and national governments in other emerging economies? In the end, it’s possible that moving ahead with a nonconfrontational rescheduling of private bank debt (in which the official sector lends its good offices to the proceedings but doesn’t rush in with additional funds) may be less anxiety raising than making a sharp zero-one distinction between default and rescheduling. Little of what went on in debt negotiations involving South Korean banks was totally voluntary anyway—as officials leaned on their banks to undertake the initial one-month rollover. Nor is the oft-made distinction between illiquidity and insolvency so clear-cut here either. I suspect that many crisis-country banks were insolvent even if their assets and liabilities were marked to market at precrisis prices.

Bailing out large uninsured creditors of private banks also makes it harder to sell the principle of equitable burden sharing. Because of the expected contraction of economic activity and the higher cost of living, ordinary citizens in the crisis countries will need to make substantial sacrifices to overcome the crisis. It will be harder to convince them to do so if large lenders (domestic and foreign) escape their share of the burden. Similarly, if the IMF and the G-10 wish to maintain support for the funding of these packages, G-10 countries should not put their legislators in the position of trying to justify an outcome where governments put up the funds but a certain class of private investors (who made bad lending decisions) walks away whole.

Fortunately, there are policy and institutional changes that can be implemented to reduce (albeit not eliminate) the moral hazard associated with official rescue packages. These are best discussed, however, within the broader context of efforts to improve the international framework for crisis prevention and crisis management, to which we turn next.