VI

Conclusions and Policy Considerations

The causes of the financial crisis in Asia are complex and will need to be thoroughly analyzed—both to reduce the risk of similar occurrences in the future and to identify appropriate lessons for economic policies. The May 1998 *World Economic Outlook* will provide an occasion for a more comprehensive assessment. For now, this Interim Assessment provides a preliminary analysis of the still-unfolding crisis.

Just two or three months ago, neither economic forecasts nor the pricing of assets in financial markets foretold the depth and breadth of the economic and financial difficulties that have engulfed several southeast and east Asian economies and that affect emerging market economies more generally. It may well be that such developments are inherently nonforecastable, as their occurrence and especially their timing are intimately linked to sudden changes in investor sentiment and financial market conditions. But the risks of financial market turbulence not only could have been perceived: they were perceived, and with sufficient lead time to have permitted constructive actions to limit if not avoid current difficulties. In this connection, although the IMF staff did not forecast the recent crises, and in retrospect was too optimistic in its baseline projections, recent issues of the *World Economic Outlook* have repeatedly warned about the risks of disruptive changes in investor sentiment unless policies were adjusted to address overheating and to reduce unsustainable external imbalances, about the excessive narrowing of risk premiums for emerging markets, and about the dangers associated with financial sector weaknesses. Such warnings have also been communicated through other channels of IMF surveillance. But when economic conditions remain generally good and when private foreign capital is flowing in at a record pace and on very attractive terms, it is easy to believe that the good times will continue and that the resolution of external imbalances and underlying structural deficiencies in the economic and financial system can safely be deferred to a more politically convenient time.

In the countries most affected by the crisis, the key domestic factors that led to the present difficulties appear to have been, first, the failure to dampen overheating pressures that increasingly had become evident in Thailand and many other countries in the region, pressures that had manifested themselves in large external deficits and property and stock market bubbles; second, the maintenance for too long of pegged exchange rate regimes that encouraged external borrowing and led to excessive exposure to foreign exchange risk in both the financial and corporate sectors; and third, lax prudential rules and financial oversight that led to a sharp deterioration in the quality of banks' loan portfolios. All of these factors eventually led to repeated attacks on the Thai baht and subsequently on other currencies in the region. As the crises unfolded, political uncertainties and doubts about the authorities' commitment and ability to implement the necessary adjustment and reforms exacerbated pressures on currencies and stock markets both in Asia and in other emerging market countries. In particular, reluctance to tighten monetary conditions and to close insolvent financial institutions has clearly added to the turbulence in financial markets.

In Korea, the difficulties in the financial system reflect a combination of weaknesses in the supervisory and regulatory framework together with a legacy of government-directed lending practices that has led to excessive leveraging in the corporate sector and delayed necessary restructuring efforts. To help finance Korean enterprises at home and abroad, large amounts of predominantly short-term foreign currency credit have been taken on by Korean financial institutions. With increased difficulties in rolling over this external debt, the won came under severe downward pressure from late October onward. The initial reluctance of the Korean authorities to raise interest rates to prevent a substantial weakening of the exchange rate, and their apparent willingness to allow official reserves to be used to permit private financial institutions to meet their foreign currency obligations, contributed to the downward pressure on the exchange rate and further undermined confidence.

Although the roots of the current difficulties lie mainly in the countries most affected, developments in the advanced economies and in global financial markets contributed significantly to the buildup of the imbalances that eventually led to the crises. Specifically, weak growth in Japan and Europe since the beginning of the 1990s has left attractive domestic investment opportunities falling short of available saving, while appropriately leading to accommodative monetary policies and low interest rates. Large private capital flows to emerging markets were driven, to an important degree, by these phenomena and by an imprudent search for high yields by international investors without due regard to potential risks. Also contributing to the buildup to the crisis were the wide swings of the yen/dollar exchange rate over the past three years. Initial spillovers from the crises were fairly well limited, but as the financial market turbulence has spread, international investors have reassessed emerging market risks more generally.

Speculators appear to have played a relatively limited role in the crises. Perhaps they determined the timing of the eruption of crisis in some countries, but investors who profited did so primarily by correctly perceiving unsustainable and inconsistent economic policies, financial sector fragilities, and overvalued property and stock markets. Some speculators, however, appear to have made large losses in some operations. More generally, foreign investors in Asian emerging markets have taken substantial losses.

Because there was never any reasonable basis for expecting that equity investors would be shielded from these substantial losses by government bailouts, it cannot be concluded that moral hazard associated with expectations of such bailouts played any significant role in motivating flows of equity capital to emerging markets. Equity investors may well have miscalculated their risks, but if they did so it was of their own accord. Similar miscalculation also, presumably, partially explains the very narrow spreads at which nonequity financing was made available to private enterprises and financial institutions in a number of emerging market countries. For this form of capital flow, however, there is greater concern with the possible influences of moral hazard. When pressures developed against the continued extension of credits to private enterprises and financial institutions, governments in several emerging market countries undertook to provide various forms of guarantees for these credits. The expectation that such support might be provided may well have encouraged some foreign creditors to lend larger amounts on more attractive terms and, correspondingly, encouraged domestic borrowers to undertake greater debt and foreign exchange risks than they reasonably should have done. To contain such moral hazard problems and to limit the sometimes enormous public sector costs of financial bailouts, it is essential to enforce rigorously the sound principle that private debts are private responsibilities, both for the debtor and for the lender. Moreover, besides properly managing their own indebtedness, especially their shorter-term foreign currency indebtedness, governments have a clear responsibility not to assume, or to place themselves in a position where they might be thought likely to assume, private sector obligations that would threaten their own solvency.

The crisis has led to a slowdown in private capital flows to emerging market countries in all regions, with the sharpest drop in Asia. Painful adjustments will need to be made as policies are tightened, domestic investment and consumption are compressed, imports decline, and economic growth slows or in some economies turns negative. As current account deficits are reduced in the emerging market countries, the rest of the world will feel the impact through trade flows, while losses on foreign investments may affect confidence. Much of this is unavoidable and is reflected in the revised baseline projections that show a downward adjustment to world growth in 1998 by ¾ of 1 percentage point, with the most significant revisions to projected growth being in southeast Asia and Korea. However, as the episode continues to unfold, there are clearly downside risks, especially in view of the vulnerability of banking systems in some countries and the powerful financial linkages that exist across countries. Policymakers will need to respond forcefully to forestall an unnecessarily deep, prolonged, and self-reinforcing downturn, which might seriously undermine support for an open world financial system and foster protectionist sentiment.

To contain the economic damage, the main responsibility for taking appropriate measures lies with the countries directly affected. Hesitation in the implementation of needed adjustment and reform measures can only worsen the crisis, cause markets to overshoot even further than they have done to date, and exacerbate contagion both to other emerging market countries and to the advanced economies. Conversely, bold actions to address key weaknesses will help to restore confidence and prepare the ground for a solid rebound from current difficulties.

- Fiscal policies, although not an important cause of the crisis in most countries, need to contribute to reductions in countries' reliance on external saving and, in some cases, to help offset the cost of restructuring banking systems. The required degree and composition of fiscal adjustment will vary depending on specific circumstances in individual crisis countries. It should strike a balance between different policy objectives, including the need to contribute sufficiently to the process of current account adjustment and to the correction of earlier excesses in the public sectors, while ensuring that private sector excesses also are corrected and that domestic demand is not unduly compressed. A priority in a crisis situation must be the need to reassure domestic and foreign investors that macroeconomic stability will be restored.
- Monetary policies need to be kept sufficiently firm to resist excessive exchange rate depreciation, its inflationary consequences, and downward pressures on partner countries' currencies. A failure to limit the extent of exchange rate depreciation through adequate increases in interest rates may well add to the sense of panic in a crisis situation and to the problems of domestic financial institutions and nonfinancial enterprises with large foreign currency exposure. Any attempt to avoid such increases in interest rates because of concerns about the impact on the private sector is likely to be counterproductive (Box 5). For countries with

Box 5. Policy Responses to Exchange Market Crises

A number of Asian currencies have been subject to acute and prolonged downward pressure in recent months, resulting in large depreciations that have gone much beyond any reasonable judgment of what was initially needed to improve competitiveness. While the reasons for this are many, as discussed in the text, one key element has been the self-reinforcing nature of the crisis, whereby the failure of policymakers to address problems in advance of the crisis and to move with sufficient force and determination once the crisis had hit has tended to undermine confidence throughout the region. In this regard, the reluctance to tighten monetary policies with sufficient determination and persistence to underpin exchange rates has been a particularly important factor.

Even though tighter monetary policies may in the short term exacerbate some of the difficulties of economies with weak financial systems, experience indicates that when a crisis of confidence threatens or is under way, any effort to keep monetary policy relatively easy is likely to be both counterproductive at home and damaging abroad, because of its consequences for the exchange rate. For economies with substantial foreign currency debts, steep depreciation undermines the solvency of domestic firms and financial institutions as much as, or more than, temporary increases in interest rates. And, as confidence further erodes, the increase in interest rates ultimately necessary to stabilize the situation may well be larger than what would have been sufficient at an early stage.

This is a key lesson from experience in the "tequila crisis" of 1994–95 and from more recent experiences in Brazil, Hong Kong SAR, the Czech Republic, and Russia. A period of sufficiently tight money is essential whether to defend a currency peg effectively or to restore stability to a flexible exchange rate once confidence in the currency has been compromised. The question of how tight is difficult to answer generically. In Mexico, after confidence had been eroded in late 1994 and early 1995, nominal interest rates on 28-day *Cetes* (*certificados de tesorería*) had to rise to 70–80 percent for a couple of months to stabilize the exchange rate (*see figure*). Mexico's experience with macroeconomic instability and high inflation probably meant that interest rates had to go further than might otherwise have been needed.[1] However, the key element in the end was that the authorities showed the determination to do what was needed to stabilize the exchange rate.

Argentina held to its exchange rate peg in the "tequila crisis" and accordingly avoided the collapse of confidence that would have accompanied its abandonment, especially in view of Argentina's history of rapid inflation prior to 1990. While this success had unavoidable short-term costs in terms of high interest rates that cut deeply into domestic demand, it helped to improve the current account rapidly and restore confidence in the convertibility plan.

Both Mexico and Argentina faced significant banking crises in early 1995. In both cases, the sharp monetary tightening was accompanied by early actions to address the weaknesses in the banking sector, including liquidity support, recapitalization, and, particularly in Argentina, the exit of insolvent institutions from the system. And these actions made it possible to survive a period of tight monetary policy without serious damage to the financial system. In both Mexico and Argentina, firmer monetary policies and actions to deal with the financial sector were not the whole story. Despite the generally sound stances of fiscal policies prior to the crisis, moderate degrees of fiscal tightening were also appropriate to help reduce current account deficits, to support confidence, and to make fiscal room for the public sector costs of financial sector restructuring.

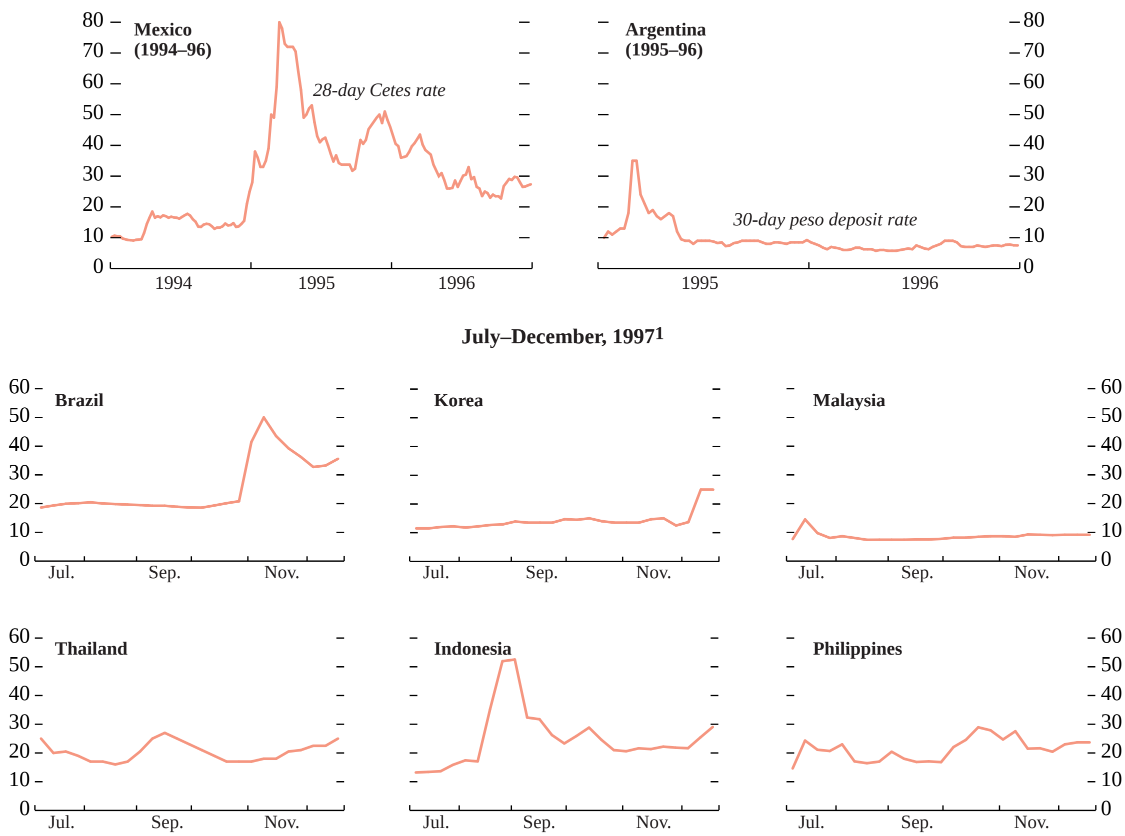
The recent experience of Brazil provides another good example. When the external environment for financing Brazil's substantial current account deficit turned sharply less accommodating in October, the central bank moved forcefully to double already high interest rates. This, however, was not enough to relieve pressures on the *real* because markets appeared to judge that weakness in the public finances, not lax monetary policy, was the fundamental problem. When the authorities moved to address this core problem, exchange market pressures eased further, despite continuing turbulence in Asia. The short-term cost of all of this, of course, will be a slowdown of domestic demand in Brazil, which will help to improve the current account.

For the east Asian economies, the fiscal situation was generally not problematic before the present crisis; but moderate fiscal adjustments are appropriate to contribute to current account adjustments needed in varying degrees in different countries, to bolster confidence, and to amortize the fiscal cost of financial sector reform. Firmer monetary policies have also been required to avert excessively large exchange rate depreciations. Here, judged by the extent of depreciations against the dollar and on a real effective basis, performance has been far from satisfactory. In contrast, Brazil with its policy measures has been able to maintain its exchange rate policy. The difference is at least partly explained by monetary policy. As previously noted, when exchange market pressures developed, Brazil raised its interest rates—which were already high in real terms—significantly and has subsequently kept rates quite high. Indonesia raised rates strongly at the outset of the crisis but lowered them quite quickly as stresses developed in the banking system; and with Indonesia's

[1]Since inflation in Mexico rose sharply in 1995 in the wake of the depreciation (to 35 percent for the year on average compared with 7 percent in 1994), the level of real interest rates rose much less during the crisis than implied by the rise in nominal interest rates.

Short-Term Interest Rates in Selected Crisis Episodes

(In percent a year)



[1]One-month interbank rates except for Korea (15-day interbank rate) and Brazil (30-day deposit rate).

inflation rate being higher than Brazil's, there has been much less of a sustained increase in real interest rates. In Korea, Malaysia, and Thailand interest rates have been raised by less and more slowly following their exchange market crises. In the Philippines, the response was relatively quick and comprehensive; associated partly with this, the crisis has been less severe.

The short-term effect of the needed policy adjustments in east Asian economies would normally be to slow the growth of domestic demand and, to a lesser extent, of output, as current account deficits are brought into line with reduced external financing flows. Unfortunately, the crisis having been prolonged, the extent of the economic slowdown is likely to be greater than would have been the case if monetary policy had been tightened more forcefully. This result is not the intended effect of recommended policy measures; it is the consequence of a collapse of confidence that reflects inadequate policy responses at an earlier stage, as well as unreasoned panic in financial markets.

large amounts of short-term external liabilities it is particularly important that monetary conditions provide adequate incentives for the private sector to roll over short-term foreign loans in the face of the increase in risk premiums that result from the crisis. In the absence of such incentives, the private sector might seek to pay off its short-term debt, which would exacerbate the downward pressure on the exchange rate. As fundamental policy weaknesses are addressed and confidence is restored, interest rates can subsequently be allowed to return to more normal levels, which would help to support activity, but experience suggests that premature easing can exacerbate a crisis.

- In many cases, weaknesses in the financial sector require particularly urgent attention. Insolvent institutions need to be closed to facilitate an early restoration of confidence and prevent the collapse of already weak financial systems. Weak but viable institutions will need to be restructured and recapitalized. Reforms of prudential regulation and supervision are needed to strengthen banking practices and enforce discipline on individual institutions. Blanket provisions of public guarantees to domestic or foreign creditors of financial institutions—including those already known or suspected to be insolvent—would unnecessarily raise taxpayer costs, inappropriately shield creditors and equity holders from losses, and exacerbate problems of moral hazard.
- It is also important to strengthen public and corporate governance and enhance transparency and accountability. Those objectives have been particularly emphasized in policy programs supported by IMF arrangements with Thailand, Indonesia, and Korea.

A sharp slowdown in economic growth is an unavoidable consequence of the type of crisis affecting a number of the Asian economies. And the effects of some of the measures needed to contain the crisis may well tend to slow growth in the short term. However, the fundamental purpose of these measures is to limit the risk of a deeper and more prolonged crisis and to promote an early and sustainable recovery. The experience in Latin America following the "tequila crisis," and more generally the experience of countries in similar situations, demonstrates that this objective is realistic and feasible.

As the crisis has deepened and spread, the prospect has increased that additional countries will be exposed to pressures similar to those experienced in Asia. It is true that reform efforts have been strengthened considerably during the past decade or so throughout the developing world and among the countries in transition. At the same time, however, many countries are vulnerable to reversals of market sentiment, especially in view of the general reappraisal of emerging market risk. It is therefore critical that countries take the necessary steps to reduce their vulnerability. The policy requirements in such cases are very similar to those that apply to the countries that already have been affected by the crisis. In addition to appropriate measures to contain external deficits and strengthen banking systems, some countries will need to consider whether it would be desirable to introduce greater flexibility into their exchange rate arrangements to help ensure that exchange rates do not become misaligned and to reduce the risk of speculative attacks. Where it is appropriate to introduce greater flexibility, exit strategies from pegged or fixed exchange rate regimes will need to be carefully managed to help to avoid excessive exchange rate volatility. In other cases, it may be decided that the longer-run benefits of the successful defense of a relatively fixed exchange regime outweigh the shorter-run costs. In any case, as recent events illustrate, exchange rate flexibility does not protect against currency market turmoil unless the exchange arrangement is fully supported by macroeconomic policies and robust financial systems that do not raise doubts about the authorities' resolve to tighten policies in response to unwarranted downward pressure on the exchange rate.

The international community is also helping to contain the crisis. Substantial financial support has been provided by the IMF for the affected countries, reinforced by contributions from bilateral and other multilateral creditors. In addition, the major advanced economies should seek to maintain supportive conditions in international financial markets. In particular, in Europe and North America, in view of satisfactory inflation performance, as well as the moderately dampening effects of the crisis on exports and activity, it would be appropriate to put further monetary tightening on hold for now. Of course, monetary conditions will need to tighten if the very strong U.S., U.K., and Canadian expansions do not slow to a sustainable pace and as the recovery in continental Europe gains momentum. In this context, the recent buoyancy of many indicators do point to some upside potential both in North America and in Europe. However, policymakers in North America and Europe also should be alert to the possibility that the financial crisis in Asia could deepen further, with global ramifications for capital flows, trade, and growth. In such a scenario, there could be a need for timely monetary easing to arrest an escalating downturn.

The key near-term risk for the advanced economies involves a possible intensification of the slowdown in Japan, which could aggravate the already serious problems in the financial sector, with potential spillovers to other countries. The present fragilities in Japan's financial system are significant, but relative to the size of the Japanese economy they are substantially less severe than in some other Asian economies. These problems have their roots in the asset price bubbles of the late 1980s, which left the banking system with a large volume of problem loans. With the renewed weakening of the Japanese economy in 1997 and the problems prospectively arising from developments elsewhere in Asia, hope for recovery of deeply troubled institutions faded, and one of the twenty largest banks and two of the ten largest brokerage houses have been forced to close. Unfortunately, the persistence of difficulties in Japanese financial institutions and the failure to face up forthrightly to the magnitude of these difficulties and to implement the measures required for their resolution appear to have undermined confidence to a greater extent than is justified by the actual situation. Decisive actions to address strains in the financial sector, including the closure of insolvent institutions and the well-targeted use of public funds to assist in the needed restructuring efforts, are crucial to restoring confidence. The plans for financial sector restructuring announced by the largest party in the governing coalition on December 17 are an important step in the right direction. While there is little scope for further monetary easing in Japan, the recent announcement by Prime Minister Hashimoto of an income tax cut and new public investment spending will provide a moderate injection of fiscal stimulus in 1998 following the substantial consolidation in 1997.[12] The process of deregulation to stimulate growth in the nontradables sectors of the economy also needs to be accelerated. This will help to enhance profitable investment opportunities at home and to reduce Japan's persistent external surplus.

Fortunately, as a number of emerging market economies in Asia and around the world are experiencing difficulties and as the Japanese economy is struggling to regain forward momentum, growth in the industrial economies of North America and western Europe appears likely to be well sustained in the period ahead. This implies that the threat to global growth from the present crisis is reasonably limited, and it suggests that those economies now experiencing difficulty will be able to benefit from a generally favorable external environment to assist their adjustment and recovery. A favorable external economic environment is particularly important because the adjustment process for many emerging market economies necessarily entails significant improvements in current account positions in response to declining capital inflows. For the global expansion to be reasonably well-sustained while this adjustment is occurring in a number of emerging market economies, growth of domestic demand in other countries needs to be sufficiently robust, and some deterioration in the current accounts of these other countries needs to be accepted. To some extent, this will reverse the pattern seen earlier in the decade when strong domestic demand growth and widening current account deficits in a number of emerging market countries, particularly in Asia, helped to sustain global growth when demand was weak in a number of industrial countries. In this way, global economic stability is enhanced; some countries help to absorb adverse shocks occurring elsewhere at one time, and at another time receive this benefit in return, so that at the world level fluctuations are damped owing to the lack of synchronization of disturbances across national economies and the partial absorption of disturbances by external imbalances.

An open world trading and financial system facilitates this desirable cushioning of asymmetric economic shocks. It needs to be sustained—both now that the pattern of shocks is shifting, and for the future when, for example, some of the current account deficits that will widen in the present episode will need to diminish. But the open trading and financial system cannot, by itself, deliver global or national economic stability, and no country can rely on the rest of the world to solve its economic problems. Indeed, sometimes a country's difficulties originate in part from external disturbances, including irrational optimism or unwarranted pessimism in global financial markets. Even when this is partly the case, however, the situation is best addressed by focusing on what can constructively be done, at home, to improve economic performance and enhance confidence in the country's economic policies. And, as experience earlier in this century amply demonstrated, the global system that, despite its deficiencies, undoubtedly serves the longer-term interests of all participants can be threatened by efforts to deflect needed economic and policy adjustments on to other countries through trade restrictions or competitive devaluations.

Rather, the effort must be to strengthen and improve the global trading and financial system to the benefit of all its participants. Trade in goods and services benefits both exporters and importers; capital flows generally enable savers to earn higher returns (for a given level of risk) while the users of these flows are better able to pursue profitable investments; and risks are better diversified and more effectively spread by efficient global financial markets. Capturing these benefits necessarily implies an important degree of interdependence among national economies, and this carries with it a strong mutual interest in good economic performance, sound policies, and reliable institutions throughout the world economy. In pursuit of this mutual interest, in a world of increasingly integrated financial markets, recent events clearly demonstrate the crucial importance of strong financial institutions operated in accordance with established principles of sound banking and of rigorous transparency in the provision of economic and financial information. In this context, the emerging market countries need to move as quickly as possible to adopt the core principles on

[12]These measures were announced subsequent to the finalization of the projections in this Interim Assessment.

banking supervision.[13] The crisis also demonstrates the need more generally for sound macroeconomic policies and acute attention to signs of emerging financial tensions and economic difficulties before substantial crises become unavoidable. With such institutions, transparency, policies, and attention, the open system of global trade and finance will be better able to serve world prosperity with less risk of disruptive crises.

The financial difficulties in Asia are likely to stimulate renewed interest in the question of whether capital controls (on inflows, outflows, or both) may help to moderate the buildup of external imbalances and reduce the risk of financial crises. Experience shows, however, that the imposition of controls on outflows during a crisis may well worsen confidence further and add to turmoil in financial markets, and that the effectiveness of controls in general tends to erode quite quickly. Moreover, countries that have maintained extensive or partial controls, such as Korea, have clearly not been immune to financial crises when a failure to address serious policy weaknesses eventually triggers adverse shifts in investor sentiment. At the same time, the crisis has clearly strengthened the case for prudential measures that could help limit the banking system's exposure to currency market turmoil. These issues, and the preconditions more generally for an orderly liberalization of capital flows, will need to be considered carefully in the context of the ongoing preparations for the extension of the IMF's jurisdiction to the capital accounts of its members.

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The strong growth record of the Asian countries most affected by the recent turmoil and their commitment to outward-oriented policies suggest that these economies have the potential to regain the confidence of investors at home and abroad. As confidence returns, growth can also be expected to recover, with good prospects of the resumption by these countries of the impressive process of catching up with living standards in the industrial countries witnessed in the past. This will require some important changes in policy strategies and in the structure of the Asian economies. It is particularly critical to strengthen the financial sector's capacity to allocate financial resources efficiently on the basis of market principles and its ability to withstand shifts in market sentiment. This important lesson applies to all economies, particularly those that are seeking closer integration with world capital markets.

[13]See David Folkerts-Landau and Carl-Johan Lindgren, *Toward a Framework for Financial Stability* (Washington: IMF, 1998).