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CRISIS RESOLUTION AND THE ASIAN FINANCIAL CRISES: USES OF THE PAST IN THE RESOLUTION OF FINANCIAL CRISES IN EMERGING MARKETS

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UPIER WORKING PAPER VOL 11

JULY 2019

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CRISIS RESOLUTION AND THE ASIAN FINANCIAL CRISES – USES OF THE PAST IN THE RESOLUTION OF FINANCIAL CRISES IN EMERGING MARKETS

Abstract

Financial crises in emerging markets have taken many forms during the previous four decades. In Latin America it was sovereign debt that led to financial crises in the 1980s, while in the 1990s Asian financial crises emanated mainly from debts in the private sector. In the 1980s, the IMF began to assume a new role as crisis manager: providing support to economic policies aimed at solving crises, stabilising the economies and coordinating funding needed to resolve crises. This was a period when financial markets were becoming both more global and more integrated—

shifts which changed the size and composition of lenders to emerging economies. As a result, crises became far more complicated to resolve and required far more funding. This paper examines uses of the past in crisis resolution programmes in Asia in the 1990s finding that issues raised in Mexico in 1995 had yet to translate into policy and practice.

INTRODUCTION

The Asian crisis in 1997-1998 took many by surprise. The miracle economies had seemingly done everything right: they had low government debts, fairly balanced budgets, and they had sustained high real growth rates based on exports for many years. Capital inflows were high and sustained by implicitly fixed exchange rates. However, in the years preceding the crisis, the current account imbalances increased suggesting that there were underlying weaknesses. The financial institutions in Thailand, in particular, began to show weaknesses suggesting that leverage was high. These issues were discussed in meetings between Thai authorities and IMF officials in 1996. In the reports of the Article IV consultations for Thailand and Indonesia the financial sectors were analysed, and weaknesses were discussed.[1] At the time, the signals were not strong enough to prompt decisive policy action. It was only in July 1997 that the pressure on the Thai baht made devaluation inevitable.

The crisis resolution led by the IMF led to Thailand, Indonesia and South Korea implementing tight monetary and fiscal policies. This crisis response attracted criticism from many quarters and it was suggested that the policies exacerbated the crisis before any recovery occurred.[2] According to the critics, the policy actions seemed to suggest that the IMF had misunderstood the crisis by treating it like a sovereign debt crisis similar to the Latin American crises in the 1980s when in fact this was a banking and currency crisis. This paper explores uses of the past during the crisis resolution of the Asian crisis and finds that issues raised the Mexican crisis in 1994 did not translate into the reform of IMF policy and practice before the Asian financial crises erupted.

The paper is organised as follows. First, the Latin American debt crises in the 1980s will be briefly recounted to provide the context for the Mexican financial crisis and its resolution in 1994-95. Then the run-up to the Asian crisis will be summarised and the resolution measures will be described and assessed.

[1] SM/96/148 Staff report on Article IV consultation with Thailand and SM/96/173 Staff report on Article IV consultation with Indonesia

[2] Eg Katz (1999), Krugman (1998), Sachs (1998),Wade (1999)

THE LATIN AMERICAN CASES

The IMF Articles of Agreement state that the purpose of the Fund is: to promote international monetary cooperation; to facilitate trade and payments; to promote exchange stability; and to provide resources to correct temporary balance of payments problems in order to ensure that the that international balance of payments is stable over time.[3] In order to do this, the Fund has established various financing facilities with slightly different purposes, terms and conditions that member countries can draw upon in different circumstances.

In the first decades of operation the IMF mainly pursued macroeconomic surveillance and it was not until the 1960s that member countries began to draw on Fund facilities. Those that did were mainly industrialised countries who were experiencing what appeared to be temporary difficulties. The end of the Bretton Woods system had led to the diversification of currency regimes and greater volatility. The 1970s proved to be a decade of crises and global adjustment. Thus the Fund became a forum for managing sovereign debt problems. While the formal mandate to act was not there, Sgard has revealed how the Executive Board was determined to stay involved as they believed that the expertise of the IMF was useful.[4]

However, the Fund could not lend into arrears, i.e. a de facto bail out of private loans. Instead it was made clear that arrears would be managed as part of the overall restructuring process. In the 1970s market participants seemed to treat the Funds' analysis as risk assessments and began contacting Fund staff in private to ask for their view on the economic situation in individual countries.[5] The Fund could thus be perceived as either a credit rating agency or a provider of risk assessments. This was not a role that the Fund should have assumed because it could limit its options when negotiating with countries and was not in line with its mandate.

The 1970s oil crises affected industrialised and developing countries negatively but the recycling of petrodollars led to capital inflows in some developing countries contributing to investment and growth. The Mexican economy underwent a transformation in the 1970s from a predominately agrarian economy to a resource-based one. Towards the end of the decade, in the wake of the two oil crises, Mexico

[3] Article 1, Articles of Agreement (1944)
[4] Sgard (2016)
[5] Gold (1988)

developed its oil industry and benefited from higher oil prices. Oil production expanded by 15 per cent annually from 1977 to 1980.[6] Real growth rates averaged 8 per cent. Rapid growth led to wage increases. These, in combination with external developments, meant that inflation reached 28 per cent by 1981. Forecasts at the time anticipated an inflation rate of 100 per cent in 1982.

Nevertheless, the country benefited from the recycling of petrodollars via international banks. In 1979, USD 136 billion was lent to developing countries by internationally active commercial banks to governments and this amount had increased to USD 500 billion by 1982. Mexico alone had borrowed USD 81 billion by 1981.[7] Public sector spending grew and the public sector deficit equalled 15 per cent of GDP in 1981. The Mexican government increased its borrowing. By 1981, total debt was equivalent to 33 per cent of GDP rising to 53 per cent a year later. That number does not seem very high if it is compared to the criteria for membership of the European Monetary Union of 60 per cent. However, the debt service ratio as a percentage of exports was equivalent to total exports by 1980.

In the United States a decade long fight to bring down inflation culminated with the sharply raised interest rates in 1981 and the strengthening of the US dollar. Since Mexico had borrowed in US dollars this led to higher interest rates. At the same time, oil prices began to fall. This combination did not augur well. Banks had begun a shift to short-term lending in 1981 and this lead to substantial repayments due by August of 1982. By February 1982, it was clear that Mexico could not sustain the peg to the US dollar and the Mexican government withdrew efforts to do so. The peso promptly lost 40 per cent of its value, drastically raising the cost of repaying the international debt. By August 1982, when the repayments were due, the government was simply unable to pay or raise new funds. The crisis was a fact.

Initially, in the period from August to November, support was offered through various bilateral credit lines and swap lines. In December 1982, an IMF programme was approved. The financial support package amounted to USD 3.75 billion over three years and commercial banks entered into concerted lending amounting to USD 5 billion.[8] These loans were linked to an economic programme of tighter fiscal and monetary policies. The budget deficit was programmed to be reduced over a four year period to 3 per cent of GDP through cuts in public expenditure in all sectors and increased tax revenue to be achieved by

[6] Macroeconomic data from the World Bank
[7] Buffie and Krause (1987)
[8] EBS/82/208 Extended Arrangement with Mexico and economic programme, Boughton (1990) p 293

broadening the tax base. A tight monetary policy aimed to bring down inflation while keeping the exchange rate flexible.

The IMF handling of the Mexican debt crisis can be seen as a milestone. It was the first step towards the Fund becoming crisis manager and a spider in the web in numerous negotiations between private and official creditors, which involved devising complicated schemes to ensure continued access to external finance. These schemes were based on IMF lending or guarantees that in turn facilitated possible extensions of credit from commercial banks and official creditors. The legal aspects of the IMF's role in debt rescheduling and negotiations have been analysed at length in numerous papers and will not be dealt with here.[9] It is the underlying principles for resolving the economic crisis that are of interest. The Mexican authorities had not invited the IMF for missions between 1979 and 1981 so there had been a period without consultation at staff level. The 1982 Article IV report was prepared whilst the Mexican government was already implementing policies to try to contain inflation and bring down the public sector deficit. Nevertheless, it was clear that the one of the IMF's priorities was to ensure that Mexico was not cut off from international banking markets and, in order to achieve this the government finances and inflation had to be brought under control.[10]

In January 1983, Argentina requested a stand-by arrangement to deal with its crisis.[11] In the 1970s real growth had been uneven and it had turned negative by 1980. In the mid-70s the fiscal deficit and external debt had begun to increase rapidly reaching about 8 and 30 per cent of GDP respectively. By 1978, inflation had reached 170 per cent per annum. Measures taken to control it were only partially successful and inflation was only brought down temporarily through 1981 but it was forecast to rise to close to 200 per cent by 1982. An overvalued peso was devalued twice in 1981 but devaluation did little to improve the economy. In late 1981 new measures included floating of the peso, freezing of public sector wages and cuts in expenditure. The war with Britain, in May 1982, led to freezing of financial assets and trade support making debt-service extremely difficult. The war was over by June but by then arrears had built and a debt crisis became a fact.

The IMF programme under the stand-by arrangement included tight fiscal policies with a combination of reduced spending and increased taxes. Regulated interested rates were introduced and exchange rate

[9] Eg. Gold (1988) ,Sgard (2016), Sachs (1989),
[10] Bouthgon (1990), Sgard 82016)
[11] Article IV Consultation and Request for Stand-by Arrangement and Supplement EBS/83/8

controls remained partly to manage the shortage of foreign exchange and to prevent (further) capital flight.[12]

Brazil had enjoyed comparatively high growth rates since the 1960s and it had been able to borrow from international banks. By 1980 the debt to GDP ratio was high but economic growth was still robust. Inflation, however, had risen to about 90 per cent and foreign reserves were low. International banks were generally becoming concerned about their exposure to developing countries. The Mexican crisis put Brazil on the spot as well. Negotiations began with commercial banks before a formal application was made to the IMF. A support programme was tentatively approved in early 1983.[13] The IMF programme was broadly similar to the Mexican and Argentinian programmes and aimed tobring down inflation through tight monetary policies and keeping government expenditure under control.

Although Mexico was the most severe case these three examples illustrate the steps taken to resolve the Latin American debt crisis in the 1980s. Despite the variations in the macroeconomic situation, the similarities are striking with large public sector deficits, comparatively high external debts, very high inflation rates and fixed exchange rates. External factors, including U.S interest rates and falling commodity prices, contributed to the economic woes. Exports growth was dampened and the exchange rates became more unsustainable. The IMF resolution measures aimed to bring government finances under control as well as brining down inflation and curbing debt.

THE CRISIS RESOLUTION QUESTIONED

The IMF's approach to handling crisis resolution in Latin America led to numerous discussions about the scope of the programmes and the conditions they included. Jeffery Sachs analysed them and focused on the issue of levels of debt and how to move forward.[14] He noted that in all three countries, with the exception of Brazil, growth had failed to recover by 1988. Growth in GDP per capita had contracted substantially since 1980, except in Brazil. By 1989, annual inflation was 99 per cent in Mexico and 640 per cent in Brazil. The economics were not on a path of sustainable recovery and growth. However, Sachs noted, these countries managed their debt payments through new lending. It was an outcome he

[12] EBS 83/8 Stand-by Arrangement and Staff Report Article IV Consultation 1983
[13] EBS/83/4 Brazil Request for an Extended Arrangement
[14] Sachs (1989)

questioned, and he recommended that debt relief should be undertaken instead. In his view, the agreed programmes were not helping the countries as long as debt was not reduced.

John Williamson made the case that institutions in Washington seemed to agree on ten policies that it was necessary to pursue in Latin American economies.[15] These policies were typically included in structural adjustment reforms in IMF programmes which seemed to suggest that there was a consensus of the right policies that borrowing countries should pursue in exchange for IMF lending. This would later be dubbed the Washington Consensus.

In a Q&A paper published in 1994, IMF historian James Boughton discusses seven points of criticism against the IMF and its handling of the Latin American debt crisis and answers each of them.[16] The first centres on the issue of liquidity crisis versus solvency crisis. The resolution was formulated as a response against a solvency crisis when it was perhaps not clear what type of crisis it was. The countries had sufficient real resources for it to have been treated as a temporary liquidity crisis he argued. The second strand of criticism was that the IMF appeared to be acting on behalf of the commercial banks. Boughton argues that the approach to ensure continued commercial bank lending was made with the view to sustain access to international capital markets and that there was a mutuality of interests between the foreign bankers and the Latin American authorities. If lending had ceased, the resulting defaults and bankruptcies could have contributed to a deeper economic crisis. It was thus justified for the IMF to support continued lending.

A recurring issue that was first raised in connection with the Latin American crisis was whether the IMF had the mandate to act as a crisis manager or indeed whether the Fund could request structural adjustments. Boughton says that the IMF programmes were within the mandate referring to the fact that the EFF facility used for Mexico was set up in 1974 and allowed the IMF to be a crisis manager.[17]

Structural adjustment became a feature of IMF programmes in the 1980s. The early programmes aimed for tight monetary and fiscal policies to contain inflation, rein in spending, and achieve fiscal balance. The

[15] Fiscal discipline, reorientation of public expenditures, tax reform, financial liberalisation, unified and competitive exchange rates, secure property rights, trade liberalisation, openness to FDI, privatisation and deregulation. Williamson (1990).

[16] Boughton (1994)

[17] The Extended Fund Facility (EFF) was established to support countries a) experiencing payments imbalances because of structural impediments or b) with slow growth and inherently weak balance of payments position, (IMF fact sheet)

addition of structural policies and conditions began to feature in 1984 with Brazil as the first case.[18] The argument was that in order to achieve price stability structural reforms were needed. These included efforts to eliminate distortive policies and other measures that had counterproductive effects, such as capital controls. In addition, the programmes included other measures aimed at removing distortions in the economy to facilitate trade and investment. Boughton notes that the advice given and conditionalities included in the programmes could be justified by analysing the IMF Articles of Agreement and the terms and conditions attached to the various financing facilities.

Boughton does acknowledge that the IMF officially was slow to recognise the need for debt relief even though individual staff members had argued in favour of that earlier in the resolution phase.[19] It was not until 1989 that debt restructuring took place after an initiative from the U.S. The initiative, which included debt reduction, was name the Brady plan after US Treasury Secretary Nicholas Brady. The final two criticisms concerned the IMF's position as preferred creditor and its refusal to write down its claims which was said to contribute to the delay in debt relief. Finally, it was suggested that poor coordination between the Fund and other international agencies contributed to delays.

The Latin American crises in the 1980s had propelled the IMF into a new role of crisis manager, provider of policy advice and reform, and acting as the middle man for debt rescheduling negotiations. The major economies in Latin America recovered only gradually. Growth did not return to the high levels of the previous decade, debt levels remained relatively high. However, foreign investments recovered especially in Mexico.

"THE FIRST CRISIS OF THE TWENTY-FIRST CENTURY"[20]

In the early 1990s, the Mexican economy appeared to be robust by all accounts, so much so that after the discussion of the Article IV mission in February 1994 there was little contact with the IMF. While real GDP growth had slowed somewhat the outlook was mostly positive, since North American Free Trade Agreement (NAFTA) was expected to lead to an increase in trade and investments.[21] IMF staff noted that private capital inflows had increased. There was some concern about the stability in the banking system,

[18] ibid
[19] Dooley (1986, 1994)
[20] Karin Lissakers, US executive director in the IMF board meeting regarding approval of the Stand-by arrangement, 1st Feb.1995. It is not clear who coined the term though.
[21] Staff report Article IV consultation 1993

due to increasing levels of non-performing loans, but the situation appeared to be manageable. The peso had appreciated, and concern was expressed about what continued appreciation could lead to. The last point was discussed in the board meeting with the US Executive Director suggested that a depreciation of the peso might be in order.[22]

Economists outside the Fund were worried about signs of competitiveness being eroded and expectations of a devaluation began to surface. MIT Professor Rudiger Dornbusch was among those who called for a devaluation.[23] The current account deficit had also widened to 7 per cent of GDP. As part of its debt restructuring Mexico had issued dollar-linked bonds, *tesobonos*. These bonds were payable in pesos but denominated in US dollars. As the US raised interest rates in late 1994 the pressures on Mexico increased and capital outflows began.

In December 1994, the Mexican government decided to devalue the peso by 15 per cent. This was perceived to be too little and speculation continued, capital flowed out of the country and the crisis was a fact. This time the US Treasury became the main provider of funds utilising a special facility while negotiations with the IMF, the BIS and commercial banks were underway. USD 20 billion were made available by the US. This time there was not a big fiscal deficit to address, nor triple digit inflation, but there were rising debt payments and dwindling reserves.[24] A stand-by arrangement with the IMF was announced in February 1995 adding SDR 12 billion to the amount made available by the US. Eventually, the total resources made available through multilateral and bilateral channels amounted to USD 40 billion. The reform programme built on the government's existing economic programme to reach a primary surplus and pursue a tight monetary policy while letting the peso float.

When the IMF Executive Board approved a stand-by programme for Mexico, the US Executive Director said that "this was first crisis of the twenty-first century" noting that this crisis differed quantitatively and qualitatively from the crises of the 1980s.[25] She pointed out that the days were gone when creditors were few enough to gather in one room for negotiations. This time, securitised private international finance meant that there were far more investors to deal with, the size of the flows was considerably larger and the risk for spill-overs significant. In other words, this was a crisis on a scale that the IMF had not dealt

[22] EBM94/16 Minutes from the Executive Board meeting on Article IV consultation
[23] Dornbusch & Werner (1994) suggested that the peso needed to be devalued by 20 per cent, a figure that was widely cited and given credibility by Professor Dornbusch standing.
[24] Boughton (2012) and Geithner (2014) provide detailed accounts of negotiations from different perspectives.
[25] EBM95/11 Minutes from the Executive Board meeting on Stand-by Arrangement with Mexico

with before and was not properly equipped to deal with. Nevertheless, the Fund had to act in order to try to achieve stability for Mexico and emerging economies. It was deemed to be a liquidity crisis like previous crises, albeit on an entirely different scale than previous crises.

At the Board meeting several directors noted that the Fund had to develop the most "appropriate instruments and procedure" to deal with a twenty-first century crisis. The Fund also needed to develop a better early-warning system and improve its analysis of financial sector developments and their implications. This called for a different type of analysis than the standard macroeconomic analysis that had been undertaken so far. The directors were not alone in this. Stanley Fischer, who joined the IMF as Deputy Managing Director in autumn of 1994, was concerned that there wasn't enough data collected and analysed in the Fund about ongoing macroeconomic developments in different countries.[26] The call from directors was made in early 1995. Within two years later the next crisis of the twenty-first century would begin to unfold.

THE ASIAN CASES

The East Asian Miracle report was published by the World Bank in 1993. The eight economies studied were lauded for their macroeconomic policies, their success in achieving stable real long-term growth, declining poverty rates and openness to the international economy.[27] The countries were also characterised by high savings rates, approaching 30 per cent of GDP, compared to the less thrifty emerging economies in Latin America. In 1996, the level of external debt to GDP ranged from 40 per cent of GDP in South Korea to 63 per cent in Thailand. Foreign direct investments were substantial in export-oriented sectors contributing to rapid industrialisation and high real growth. Inflation rates were below 10 per cent annually in the first half of the 1990s.

South Korea, Thailand, and Malaysia had slightly different formal exchange rates policies but were widely perceived to be implicitly pegging their currencies to the USD dollar thereby facilitating investments. Indonesia gradually depreciated the rupiah vis-à-vis the US dollar but it was a predictable policy. In the run-up to the Asian financial crisis these countries had opened their capital accounts for short term capital. Given the track record and the prospects for growth international banks lent large amounts in hard

[26] Boughton (2012)

[27] World Bank (1993). Japan, Hong Kong, Singapore, South Korea, Taiwan, Malaysia, Indonesia and Thailand were included, but in this paper Japan is excluded from all comparative data.

currency. Risks appeared to be low with the exchange risk virtually minimised. The flows were short-term into local banks and other financial institutions. European and Japanese banks had the largest exposure of international banks. Japanese companies also dominated foreign direct investment. Short-term funding was used for medium- or longer-term investments and, given the prevailing climate, credits were simply rolled over. Over time this financed long-term investments and maturity and currency mismatches built up in the banks. These went undetected by traditional macroeconomic analysis. While the macro data looked fine apart from worsening of the current accounts the economies appeared healthy and well run. However, there were warnings about overheating pressures in 1996-1997. In 1996 for instance, an IMF mission raised concerns about the exchange rate with the Thai authorities and there were discussions about a gradual adjustment.[28]

All four countries had financial sectors dominated by banks and consequently bank lending or retained earnings were the main sources of finance for domestic companies. South Korea had a history of directed lending to priority sectors. The main industrial companies were grouped into conglomerates that often contained a bank. Intra-group lending was thus facilitated. In Thailand and Indonesia, similar close connections between firms and banks existed. But there was far less direct intervention by the government in Thailand and Indonesia than in South Korea. Once the financial crisis had begun, these connections would be questioned. Malaysia had chosen a slightly different policy model with an active economic policy to promote businesses from different ethnic groups.

While there were similarities between the countries with the export-orientation, high savings, low debt and reasonably balances budgets, there were also significant differences. In Thailand the current account deficit was around five per cent of GDP and reached almost 8 per cent of GDP in 1996. The share of short-term debt to total was more than 40 per cent and debt service equalled 17 per cent of exports. Thus, the macro data clearly showed some weakness. In meetings in early 1997, the Fund made the recommendation to tighten fiscal and monetary policies and reform the financial sector but cautioned about changing the exchange rate regime at the time. The real problem was to be found in the private sector. The share of private non-guaranteed external debt was 43 per cent of total external debt. The debt-equity ratio for listed companies averaged 2.4 per cent suggesting high leverage and a reliance on external finance. In its Article IV consultation for 1996, IMF staff had noted overheating pressures, the sizeable current account deficit and the pressure on the exchange rate. In its discussion of the report the

[28] Staff report for the 1996 Article IV mission, SM/96/149, June 24, 1996.

Executive Board commended the Thai authorities on its economic performance and policies but expressed concern about the current account deficit.[29] A tighter monetary policy was supported and Board members like IMF staff recommended a more flexible exchange rate. The 1997, Article IV consultation was discussed by the Board in a restricted session in June, but the document is not available, thus neither the staff's position nor the views of the Board are publicly known. In July 1997 the baht was floated, and the crisis began.

By contrast, in Indonesia, the current account deficit was below 4 per cent of GDP. Short-term debt reached a maximum of 25 per cent in 1996 but the debt-service ratio reached 37 per cent. In both the 1996 and 1997 Article IV consultations, IMF Staff raised concerns about the stability of the banking system and the exchange-rate policies. However, the 1997 report discussed by the IMF Board in July 1997 expressed cautious optimism. Steps taken to improve banking supervision were lauded and the response to the Thai devaluation with a wider band for the rupiah was greeted favourably as well.[30] Yet Board members did express concern about potential overheating with rising inflation, widening current account deficit and debt levels that could adversely affect the banking sector.[31] Moreover, they supported ongoing reforms to strengthen the financial sector, monetary policy measures to bring down inflationary pressures and the adjustment of the exchange rate.

In South Korea, short-term debt reached more than 50 per cent of total debt but the debt service ratio hovered around 12 per cent of exports. The current account turned negative in 1990 and showed a dramatic deterioration from -2 per cent of GDP in 1995 to -5.5 per cent in 1996. South Korean listed firms had on average a debt-equity ratio of 3.4. Again, the warning signs were mainly in the private sector.

Malaysia, finally, had a short-term debt level of 20 percent but the current account deficit reached 9.8 per cent of GDP in 1995 before dropping a bit and then turning positive again in 1998. The debt service ratio in 1995 was 9 per cent of exports. In the Article IV consultation in 1996 demand pressures were highlighted and recommendations to tighten monetary policy were proposed alongside tighter fiscal policies.[32] A year later it was stated that pressures had abated. The current account deficit remained high, but policy

[29] EBM/96/68 Minutes from Board meeting
[30] SM/97/159 Staff Report Article IV Consultation.
[31] EBM/97/67 Minutes from Executive Board meeting, SUR/97/76 Summing Up of Board discussion
[32] SM/96/217 Staff Report Article IV Consultation

measures were undertaken and the Malaysian authorities' willingness to move towards greater exchange rate flexibility was noted.

On the 2nd July 1997, the bath was floated and promptly fell. Speculation had been rife for months that the peg was unsustainable, and that bank lending had fuelled an unsustainable property boom. Capital inflows had been strong for a number of years, and banks had lent to a number of sectors, but the property sector stood out. The Thai authorities initially sought to deal with the situation on their own but eventually turned to the IMF for help and a programme was agreed in August 1997. The programme aimed first to restructure the banking sector and second to strengthen the fiscal position.[33] While the IMF, as the lead agency, provided the largest amount of money other multilateral institutions contributed as well as several Asian countries. The total amount raised was USD 17.2 billion. This was too little to convince investors and capital continued to flow out.

The Indonesian rupiah had similarly been regarded as overvalued and the initial response was to devalue it a little at a time, beginning in July 1997, prior to letting it float. Across the banking system the capital position was so weak that 200 smaller banks had to close and the largest had to be nationalised. An IMF programme agreed in October 1997 contained a number of policy actions to be implemented.[34] Banks were to be recapitalised or closed. Fiscal policy conditions were to focus on tightening in anticipation of an economic contraction. This involved cuts in spending on infrastructure and development on the one hand and measures to raise revenues on the other. These included higher excise taxes and removal of VAT exemptions. As in Thailand, the IMF took the lead in coordination the crisis response. The total amount of financing reached USD 40 billion, more than twice the size of the Thai package.

Contagion spread quickly as investors started to withdraw funds from the region as a whole and speculative attacks began on other currencies that were implicitly pegged to the US dollar. The South Korean economy had initially seemed to be more resilient but towards the end of the year it was evident that the level of external private debt was unsustainable. An agreement was reached with the IMF in December which was similar to the programmes agreed for Thailand and Indonesia. The financial sector needed to be recapitalised and restructured and fiscal and monetary policies were to be tightened to meet the costs of restructuring in an attempt to keep capital in the country.[35] The initial amount provided

[33] Thailand Letter of Intent and Memorandum of Economic Policies August 1997
[34] Indonesia Letter of Intent and Memorandum of Economic Policies November 1997
[35] Korea Letter of Intent and Memorandum of Economic Policies December 1997

by the IMF and multilateral agencies was USD 35 billion, with more funds being made available through bilateral support.

The programmes in Thailand and South Korea had to be revised due to incomplete information about the level of foreign reserves at the time of the first agreement. The programmes in all three countries were also revised several times and each revision changed the target for government finances, from a surplus of about one per cent of GDP to a deficit in the range of two to three per cent of GDP.

By contrast, Malaysia chose not follow IMF advice, nor did they borrow from the Fund. Instead, the government pursued a set of policies to deal with the crisis. Chief among them was the imposition of capital controls in September 1998.

USES OF THE PAST IN CRISIS RESOLUTION?

The financial crisis that was triggered by the devaluation of the Thai baht in July 1997 subsequently spread to Indonesia and South Korea later affecting other countries in the region.[36] The IMF led the crisis resolution and additional multilateral support was provided by the Asian Development Bank and the World Bank. The crisis resolution programmes were seemingly modelled on those from the sovereign debt crises of the 1980s. The resolution programmes included measures that sought to stem capital outflows, while keeping budget balances from deteriorating too much. Since these were banking crises rather than sovereign debt crises the programmes also called for restructuring the financial sector by closing unviable institutions and recapitalising others (in addition to nationalisation). This expansion of government funding which would lead to increased government debt would be undertaken while maintaining a budget surplus, implying cut-backs of other government spending. Higher government debt was not considered to be a problem since the debt was so low; the anticipation of higher debt service was seemingly not an issue. The monetary policy of keeping interest rates high, in an effort to keep capital in the country, is understandable, but this was a policy that was bound to increase defaults and hamper investments. It was imperative to find ways to manage the debt and not be shut out of international markets.

[36] See Agenor et al (2000) Corsetti el al (1998), Goldstein (1998), Radelet & Sachs (1998) Kumar & Bibek (1999) for details about causes and progression.

The IMF actions in Asia were questioned almost immediately by a number of economists since the economies experienced severe contraction, more severe than anticipated, before there was any sign of recovery. Indonesia experienced the sharpest reversal with GDP contracting by 14 per cent in 1998. Stanley Katz provided an early assessment of how the IMF programmes contained intuitively misguided actions and how these were revised.[37] The goal to maintain a budget surplus while expanding fiscal spending for banking resolution was criticised, as were the high interest rates aimed at keeping money in the country but obviously contributed to defaults. Paul Krugman, who had been critical of Asian economies, arguing that their rapid growth was mainly due to labour surplus in traditional sectors and crony capitalism, was equally critical of the IMF.[38] Robert Wade and Frank Veneroso drew on historical experience and argued that inflation would solve the debt issues in a less costly manner for the economy.[39] Sachs argued that the IMF acted as if the 1994-1995 crisis in Mexico had not happened and no lessons had been learnt.[40] He referred to the number of crises in Latin America and Eastern Europe and argued that the IMF programmes contained excessively tight monetary and fiscal policies that led severe economic contractions before economic growth returned.

Stanley Fischer, then Deputy Managing Director at the IMF, defended the IMF programmes in Asia arguing that systemic banking crises – as they had become – required government intervention and the government would have to shoulder the cost.[41] In order to prevent debt from growing too much spending had to be contained. The spending cuts consisted partly of public investments, deemed unnecessary at the time, or the type of spending that would crowd out more urgent government spending. Interest rates were kept high to keep capital in the countries and also in an effort to limit inflation.

Can one trace uses of the past in the crisis resolution programmes in the Asian crises with respect to the policies required? The critique aimed at the IMF in the Asian crisis at the time was that the programmes contributed to, and maybe even exacerbated the economic contraction. The IMF programmes appeared to be carbon copies of the solutions in the Latin American crises as far as fiscal and monetary policies went. The objective in the Latin American crises of the 1980s was to handle excessive government debt and prevent further build-up of the same through tight fiscal policies. Tight monetary policy was pursued

[37] Katz (1999)
[38] Krugman (1996 and 2008)
[39] Wade and Veneroso (2002?)
[40] Sachs (1999)
[41] Fischer (1998)

to prevent inflation from spiralling completely out of control. Restraining wage increases added to the effort to contain inflationary pressures.

The 1980s debt crises represented a new type of crisis for the IMF to resolve and manage. These crises, while slightly different in different economies, were sovereign debt crises, but they were treated as liquidity crises and the resolution programmes aimed to bridge a liquidity problem.[42] Debt-repayments should be made through bridging loans initially and then the governments should pursue tight monetary and fiscal policies. Inflation was rampant before the crises started and it was recognised that the devaluations would be likely contribute to even higher inflation and thus a tight monetary policy was deemed necessary. Government spending had to be controlled to keep deficits from becoming unsustainable as government spending and debt increased as a result of the crisis. Expenditure had to be cut in order to keep deficits below a certain threshold and debt levels from growing beyond manageable levels. Exchange rates linked to the US dollar through crawling pegs or firmer pegs contributed to a false sense of security for lenders. Higher US interest rates made floating rate debt more expensive and exchange rate adjustments were necessary.

The Asian countries, by contrast, had as noted a much stronger fiscal position, with almost balanced budgets and low public debt, and inflation levels nowhere near the levels seen in Latin America. The Asian crises were essentially banking crises and in this sense they were different from the Latin American crises. While the sovereign debt required bridge financing and ultimately debt restructuring, the Asian cases showed the need to deal with systemic financial instability. This situation was clearly different and required policy actions and government funding to stabilise the banking systems. Private sector debt became a public finance issue through the resolution programmes.

With respect to the macroeconomic situation the Asian countries shared greater similarities to Mexico in 1994 with large current account deficits but no sizeable budget deficits. Furthermore, like Mexico in 1994, there were numerous investors involved.

With respect to external finance and the need to negotiate (or initiate negotiations) with creditors to governments in Latin America in the 1980s, to calm private investors in the case of Mexico in 1994, and to respond to instability in Asia, all three crises required a credible economic adjustment programme to

[42] Boughton (2002)

convince creditors and investors that measures were underway to stabilise the situation and that the governments' economic policies were credible.

In the Mexican crisis in 1994 it was evident that the scale of the crisis was different, both in terms of amounts, and in number of creditors. Furthermore, the financial markets were far more integrated globally in 1994. The financing package needed to be much larger to restore confidence and ensure continued access to external capital. This experience was clear in Asia in that it was evident once discussions with the IMF were underway to put together a programme. There was a need to signal to the markets that firm actions were being taken so investors could be confident that the imbalances would be dealt with. In Asia, the announcement of the programmes and amounts of the financing packages failed to calm markets as investors and speculators seemed to question the stability of all the economies in East Asia regardless of fundamental data. There were speculative attacks on the Hong Kong dollar and the Taiwanese dollar as well.[43] The programme targets had to be revised when they proved to be too rigid and the economies continued to contract.

With hindsight, the proscribed fiscal and monetary policies seem overly tight, even if the general argument to raise interest rates in order to keep capital in the countries and to contain inflationary pressures was logical. The recapitalisation of banks and financing of deposit guarantees implied increased public commitment and therefore there would certainly be a need to carefully assess government expenditure. While it can be argued that government spending is often misdirected in an emerging economy, e.g. defence spending that diminishes spending on health and education, and that funds need to be redirected, or be put to better use, the surplus target is puzzling as government spending – necessary spending – had to increase. It is not clear why such a surplus was agreed upon from the available formal documentation.

It was, of course, not possible to estimate just how severe the banking crisis was going to be in Asia and the consequent effect on the economy. It is clear that the financial sectors were a main problem that needed to be solved though a range of measures spelled out in the Memorandums of Economic Policies and time-bound action plans in the Letters of Intent. The uncertainty at the time of the agreements can perhaps explain the initial targets. Still, the recent experience in Mexico should have suggested that less rigid targets could have made the contraction less severe.

[43] Ito & Hashimoto (2005)

At the time of the 1994 crisis directors made the case for better analysis and early warning. In 1999, the Fund began to undertake financial sector assessment programmes which thoroughly analysed the sector providing data for more in-depth analysis of the financial sectors.

The role that the IMF could – or should – have had in resolving banking crises was not clear then and the debate about the mandate of the Fund has continued. In the early 2000s, two proposals on crisis resolution were put forward under IMF guidance. These included the proposal of a (internationally managed) sovereign debt restructuring mechanism where countries could initiate restructuring in an orderly manner before reaching a critical point. The second proposal concerned the introduction of collective action clauses into bond contracts to facilitate restructuring. The purposed of the clauses was to ensure that all bondholders abide by restructured terms and conditions. The former proposal did not lead anywhere but it is revived it from time to time. The latter has become more common. These two proposals build on past experience with resolution of sovereign debt crises. The use of the past in the resolution of other types of financial crises has yet to lead to any similar proposals.

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Acknowledgements

The author would like to thank Prof. Catherine Schenk, Prof. Mats Larsson and the two anonymous referees for their very helpful critical comments.

This project has received funding from the H2020-EU.3.6 – SOCIETAL CHALLENGES – Europe in a Changing World – Inclusive, Innovative and Reflective Societies under grant agreement no. 649307. The project UPIER is financially supported by the HERA Joint Research Programme (www.heranet.info) which is co-funded by AHRC, AKA, PT-DLR, CAS, CNR, DASTI, ETAG, FCT, FNR, F.R.S.-FNRS, FWF, FWO, HAZU, IRC, LMT, MIZS, MINECO, NCN, NOW, RANNÍS, RCN, SNF, VIAA, VR and The European Community, SOCIETAL CHALLENGES – Europe in a Changing World – Inclusive, Innovative and Reflective Societies under grant agreement no. 649307.

HERA
Humanities in the European Research Area

Published by the UPIER project

Address University of Oxford

Website www.upier.eu

ISSN 2514-4960