ADB

EDRC Briefing Notes
Number 11

Policy Response to the Asian Financial Crisis: An Overview of the Debate and the Next Steps

Excerpted from the
Asian Development Outlook 1999

Economics and Development Resource Center

Asian Development Bank

POLICY RESPONSE TO THE ASIAN FINANCIAL CRISIS: AN OVERVIEW OF THE DEBATE AND THE NEXT STEPS*

May 1999

*Excerpted from the *Asian Development Outlook 1999.*

Foreword

The *EDRC Briefing Notes* are developed from notes prepared by staff of the Economics and Development Resource Center to brief Management and the Board of Directors. The *Notes* aim to provide succinct, nontechnical accounts of salient, current policy issues. They are not meant to be in-depth papers, nor intended to contribute to the state of current scientific knowledge. While prepared primarily for Bank readership, the *EDRC Briefing Notes* may be obtained by interested external readers upon request. The *Notes* reflect strictly the views and opinions of the staff and do not reflect Bank policy.

JUNGSOO LEE
Chief Economist

Contents

AN OVERVIEW OF THE DEBATE

The principal responsibility for dealing with the Asian crisis at an international level was assumed by the International Monetary Fund (IMF), the institution charged with safeguarding the stability of the international financial system. The IMF's goal was to quickly restore confidence in the three hardest hit Asian economies—Indonesia, Korea, and Thailand—through a combination of tough economic conditionalities and substantial financial support. In 1997 the IMF approved $35 billion in loans for these countries, and in addition, mobilized commitments worth $77 billion from the Asian Development Bank (ADB), the World Bank, and bilateral sources. In 1998 the IMF arranged further loans worth $6.3 billion for Indonesia.

The IMF's economic strategy had two key components. The first, in keeping with its usual practice, concentrated on macroeconomic policy, the main component of which was to be tighter monetary policy. Higher interest rates were designed to defend exchange rates, and so stem (or reverse) the capital outflows. Modestly tighter fiscal policy was designed to support current account adjustment and provide the funds that would be necessary to bail out sick banking systems. The second, complementary, component of the strategy was substantial structural reform. The IMF demanded deep reform of the region's banking systems, breakup of monopolies, removal of barriers to trade, and substantial improvements in corporate transparency. This marked a significant departure from past IMF practice, when conditionalities had been more closely confined to macroeconomic policies alone. The IMF saw the structural reforms as essential for a long-term solution to Asia's financial crisis.

Both components of the IMF's strategy have come under heavy fire. Some critics have gone so far as to argue that the policies the IMF initially imposed, far from ameliorating the situation, actually made the region's problems worse. Not surprisingly, such accusations have led to a vigorous defense of its actions by the institution and its supporters.

Two difficulties plague any evaluation of the IMF's policies. The first is the insoluble problem of the counterfactual. Knowing precisely what would have happened if the IMF had adopted a different approach is impossible. The second difficulty is that the IMF's targets and tactics changed over time. As the situation in Asia progressively worsened, the IMF eased its approach and required less fiscal contraction. In Indonesia, for instance, it relaxed its initial requirement of a budget surplus in 1997 to allow for a sizable budget deficit. Similar, if less dramatic, relaxation occurred in the cases of Korea and Thailand. The crucial question is whether these changes in policy were an implicit admission of initial misjudgments by the IMF, or whether they simply represented a flexible response to changing conditions.

Did Tight Monetary Policy and High Interest Rates Exacerbate the Crisis?

In crisis-affected countries, the IMF recommended a sharp increase in interest rates to restore confidence, stem capital outflows, and stabilize the currency. The IMF maintained that because of the time needed for other (structural) reforms to take hold, the only way to stabilize a crisis situation quickly was to raise interest rates with sufficient resolve.

Critics of the IMF argue that this approach was misconceived and counterproductive. They point out that high interest rates forced highly leveraged corporations into bankruptcy. Widespread bankruptcies in the corporate sector led to bank insolvencies as the banks' corporate customers failed to repay their loans. These bankruptcies weakened the financial system and encouraged capital flight, and thus caused a further decline in the exchange rate. All this had a tremendous negative impact on the real sector of the economy. Given this negative spiral, the critics claim that a more appropriate policy response to the crisis would have been a looser monetary policy, that is, a fall rather than a rise in interest rates. Lower interest rates would have made it easier for firms to maintain production, thereby restoring investors' confidence that the economy would recover quickly, and would thus have caused currencies to appreciate. That would have created a virtuous circle. Many of the critics point out that Japan followed just such a policy in dealing with its domestic crisis.

The IMF, however, feared that a lower interest rate policy would cause a vicious downward spiral. As currencies plummeted, so the real burden of debt denominated in foreign currency would rise. Because the Asian firms had high leverage ratios, a much higher foreign debt burden could have forced insolvencies and caused even larger collapses in production. Unlike Japan, which is a net foreign creditor, the size of foreign debts was a much greater concern in Asia's crisis-affected countries.

Some of the critics who advocated lower interest rates to reflate the domestic economy and relieve the financial situation of heavily indebted firms acknowledge that a lower interest rate might not have strengthened the exchange rate or brought back departed capital. In that case, the only remaining alternative would have been for countries to suspend service on their external debts and impose exchange control measures. Such actions could have had an extremely detrimental and long-lasting effect on the countries' ability to access international capital markets. With the exception of Malaysia, which imposed selected exchange controls in September 1998, this option was not pursued.

Available empirical evidence does not necessarily support the view that interest rates were persistently high. Indeed, several of the crisis-affected countries pursued low interest rate policies well into the crisis. Despite continued worsening of the foreign exchange market, Korea maintained official ceilings on interest rates through December 1997, and Indonesia reduced its interest rates in September 1997 as the rupiah was declining. The real interest rate in Indonesia remained negative until mid-1998. Malaysia, another country that was affected by the crisis but did not seek IMF assistance, waited until December 1997, when its currency value had fallen by 40 percent, before it tightened its monetary policy. Supporters of the IMF's position further point to Indonesia as an example of the disastrous consequences of loose monetary policy. Indonesia manifestly failed to tighten its monetary policy in late 1997. The result was a collapse in the exchange rate, galloping inflation, and the bankruptcy of much of the corporate sector. Korea and Thailand, which eventually adopted a tight monetary policy (even though it was not extremely tight in degree or duration in relation to that in other countries elsewhere outside Asia in the past that were faced with exchange rate instability) succeeded in stabilizing their economies. In these economies interest rates began to fall during 1998 while exchange rates strengthened. Moreover, a recent IMF analysis (IMF 1999) indicates that the costs of tighter monetary policy may have been lower than many suggest. It estimates that in Korea and Thailand, the effects of the monetary tightening may account for less than a quarter of the expected decline in economic growth rates between 1997 and 1998.

Did the IMF Force Unnecessary Fiscal Adjustment?

Unlike many other crises that have required IMF intervention, the Asian crisis was not caused by profligate government spending. Thus fiscal imbalances were not a major concern in the initial IMF programs. Nonetheless, the IMF's approach in the crisis-affected countries was to demand a tightening of fiscal policy based on two arguments. First, it argued that in the presence of rapid capital flight these countries needed to reduce domestic demand in order to reduce their current account deficits. Tightening fiscal policy was an effective way to do this. Second, and more subtle, was the argument that government spending needed to be cut to make room for the expected expenditure necessary to bail out insolvent banks. Some estimates suggest that the cost of bailing out financial institutions in some crisis-affected countries could eventually reach 20 to 30 percent of GDP, which under reasonable assumptions about the interest rate would entail an annual cost of about 3.0 to 3.5 percent of GDP (see Table 1). Eventually, the Asian economies would need to run budget surpluses high enough to cover this cost. Therefore beginning a modest tightening of fiscal policy early on was prudent.

Critics, however, claim that the fiscal tightening simply exacerbated the enormous economic contraction already taking place in the region. In the face of collapsing output, they argue, fiscal expansion, i.e., a small budget deficit, would have been more appropriate. Even if the region's economies needed to run surpluses over the

Table 1: Cost Estimates by the IMF of Bank Restructuring in Asia, Selected Asian Economies

	Debt Issues		Interest Payments	
Economy	$ billions[a]	Percentage of GDP	$ billions[a]	Percentage of GDP
Indonesia	40.0	29.0	5.4	3.5
Korea	60.0	17.5	6.4	2.0
Thailand	43.0	32.0	4.0	3.0
Malaysia	13.0	18.0	0.9	1.3
Philippines	3.0	4.0	0.3	0.5

a. At the exchange rate of 30 November 1998.
Sources: IMF (1998a, b).

long run to pay for their banking bailouts, worsening a severe recession with immediate fiscal tightening was unnecessary. In short, they charge, the IMF failed to gauge the severity of the crisis and the fiscal conditions it imposed made matters significantly worse.

In hindsight, this is an easy criticism to make. Clearly the fact that the IMF relaxed its fiscal targets over time suggests that its priorities changed as the region's economic outlook worsened. However, it is hard to blame the IMF for failing to gauge the depth and likely persistence of the region's problems. Few policymakers or commentators foresaw the depths of the crisis.

Even if running a looser fiscal policy had made more sense for Asia's governments, fiscal flexibility was severely constrained by the lack of access to international credit at reasonable rates. If international institutions and industrial countries made more liquidity available, Asian countries' fiscal flexibility would improve significantly.

Did the Closure of Insolvent Banks Precipitate Runs on Solvent Banks?

Given the parlous state of the financial sector in the crisis-affected countries, there is little doubt that many banks in Indonesia, Korea, and Thailand needed to be restructured, merged, or simply closed. The IMF believed that speedy and concerted action in this direction would, by weeding out the bad financial apples, help restore investors' confidence. In all three countries, therefore, the operations of a number of clearly insolvent financial institutions were suspended or the institutions were closed early on. In Thailand 58 finance companies were suspended in July and August 1997, in Korea 14 merchant banks were suspended in December 1997, and in Indonesia 16 banks were closed in November 1997.

The IMF's critics charge that this abrupt closure of insolvent banks panicked the public and precipitated a run on sound banks. Concerned that their banks might be closed next, depositors withdrew their money from healthy banks in a classic banking panic. Although only Korea had a formal deposit insurance scheme prior to the crisis, the general perception in all three countries was that government guarantees covered most of the deposit base. When this perception turned out to be false, panic ensued.

Indonesia is the most dramatic example of this. The closure of 16 banks—which between them contained less than 3 percent of total deposits—led to a near collapse of the entire banking system as investors switched funds from private banks to the state banks, which they considered to be safer. Thus, the critics argue, the IMF's policy made matters much worse.

Clearly in Indonesia the decision to close banks did precipitate a public panic. However, the IMF's supporters argue that the lack of clear government policy caused the panic, not the bank closures themselves. The Indonesian government promised only a small deposit guarantee, did not publicize it widely, and did not explain publicly how depositors in banks that had not yet been closed would be treated. Similarly, the IMF's defenders point out, the closure of banks in Korea and Thailand did not result in such severe runs. That is true, but it is also true that the financial institutions that were closed in these countries were mainly merchant banks that did not take personal deposits.

Was the IMF too Intrusive?

Some critics question the IMF's insistence on far-reaching structural reforms in Asia's economies. They have suggested that the

IMF went well beyond its mandate of ensuring prudent macroeconomic policies. Instead it was intervening excessively in the domestic affairs of sovereign governments by demanding large-scale restructuring in the corporate and financial sector, as well as improvements in governance, labor markets, and competition policy.

The IMF's proponents argue that this critique does not sit well with the facts of the Asian crisis. If reckless monetary and fiscal expansion was not at the root of the Asian financial crisis, as those who view the IMF as being too intrusive also accept, devising a response focusing on these areas made no sense. However, if, as is widely acknowledged, structural weaknesses in corporate governance and the financial system lay at the core of Asia's problems, then the IMF's loan programs would have had little chance of success if they had not addressed structural reform. Providing large-scale financial assistance to support the region's currencies would have been irresponsible if the root cause of the problem was left unaddressed. Continued financial and corporate weakness would have undermined macroeconomic policy, investors would have continued to flee, and the IMF's ultimate goal—a quick return to economic growth—would have been impossible. The IMF's demands were intrusive, but necessary.

Did IMF Bailouts Increase Global Moral Hazard?

While much of the criticism directed at the IMF has focused on its strategy in Asia, some criticize the very existence of IMF support. This argument is based on the concept of moral hazard. Moral hazard implies that investors and borrowers behave imprudently because they believe they will be bailed out if their investments go sour. IMF loans, argue some critics, exacerbate moral hazard in two ways: they absolve governments from the consequences of profligate policies, thereby encouraging them to continue the profligacy in the future, and they reward reckless investors. Because the IMF's loans to the crisis-affected Asian countries were unusually large, the critics argue that they set a dangerous precedent that will increase moral hazard worldwide.

Although multibillion dollar support packages clearly run some risk of changing investors' incentives, three reasons support the view that the critics have exaggerated the moral hazard argument. First, most investors in Asia, whether foreign or domestic, suffered substantial losses. Typical investors in Asia have seen the value of their investments reduced to a third or a quarter of their precrisis value. Second, it is hard to believe that governments relish the tough conditions the IMF imposes on them. Many governments that turn to the IMF later lose power, as they are forced to implement politically unpopular changes. Third, the costs of not intervening in Asia's crisis would have been extraordinarily high. Investors would have fled even more quickly, countries would have been forced to default on their debts, and the region (and perhaps the world) could have been plunged into an even more serious crisis.

THE NEXT STEPS

As the region's economies began to stabilize during 1998, the full impact of the crisis on corporate and banking sectors gradually became apparent. Large parts of the corporate and financial sectors in the crisis-affected countries were either insolvent or in deep financial trouble. Statistics provided by private sector analysts paint a considerably gloomier picture than official estimates. Analysts at the Deutsche Bank, for instance, have estimated that the ratio of nonperforming loans to total loans is as high as 60 percent in Indonesia and is above 30 percent in PRC, Korea, Malaysia, and Thailand (Deutsche Bank Research various issues). At these levels, if nonperforming loans were written off against bank capital the net worth of the whole banking system would be negative. To recapitalize these banks in order to reach the minimum 8 percent capital adequacy ratio recommended by the Basle standards would cost between 20 and 30 percent of GDP (World Bank 1998b).

A simulation analysis on the effect of the devaluation and of credit and interest rate shocks undertaken by the World Bank (1998a) shows that on average, firms in the crisis-affected countries lost about half of their equity value. One firm in three had loans that exceeded its equity value. Given these figures, it is clear that improving the health of the financial and corporate sectors must be a top priority across the region.

The need to restore the appropriate conditions for viable financial institutions and firms to operate normally as quickly as possible dominates the short-run agenda. That means drawing a distinction between viable and nonviable firms; restructuring domestic and foreign debt; allocating losses between creditors, debtors, and taxpayers; and reorganizing corporate control, in particular, through mergers and acquisitions.

Exactly how these various steps occur will depend crucially on each country's legal and regulatory framework. Both financial and corporate restructuring involve many complex issues. The World Bank (1998a) lists four principles for bank restructuring. First, only viable institutions should stay in business, and losses should be allocated transparently while minimizing the cost to taxpayers. Second, financial discipline should be strengthened and moral hazard minimized by ensuring that shareholders take losses first, followed by creditors, and only lastly by deposit holders. Third, the restructuring process should maintain credit discipline on existing borrowers and provide incentives for new investors to provide fresh capital to the bank. Fourth, the restructuring process should be speedy, to restore normal credit flows and confidence in the banking system quickly.

So far, the crisis countries have had varying success in financial restructuring. Most have introduced legislation to strengthen prudential regulation and improve banking supervision. Throughout the region, disclosure requirements, auditing standards, loan classification, and provisioning rules are being improved. All the crisis countries have created financial restructuring institutions, such as the Indonesian Bank Restructuring Agency and the Thai Financial Sector Restructuring Authority. All have provided substantial public money for bank recapitalization, and all have closed down some insolvent institutions. Nonetheless, they still have a long way to go before their financial sectors are fully restructured.

Unfortunately, progress in corporate restructuring has been much slower than in the financial sector. The region's firms are heavily indebted both to local banks, and in some cases to foreign banks. In Indonesia, in particular, corporate foreign debt is huge, though virtually all firms have stopped servicing their debt. Corporate indebtedness is slowing down production and investment dramatically (because insolvent firms cannot borrow), and it is also preventing a speedy solution to the region's financial restructuring (because most banks' loans are to local firms).

However, corporate restructuring in the region is plagued with problems. Most important is the weakness of bankruptcy law and its enforcement. Even though the crisis-affected countries have revamped their bankruptcy laws in the past year, they do not have enough trained people to implement them. Second, the sheer logistics of restructuring hundreds of companies are formidable. Although some of the region's governments have promoted voluntary debt restructuring between firms and banks—by, for instance, removing tax disincentives and legal barriers—few formal institutions to organize corporate restructuring exist.

The sentiment that existing shareholders should lose control of the firms is widespread. However, some argue that such a view skirts two important considerations. First, insiders possess knowledge specific to the firm, and removing them would remove an important asset of the firm. Second, the crisis-affected countries face a shortage of domestic equity capital. As banks are largely in public hands, surrendering corporate control to creditor banks would be equivalent to nationalization. These concerns may be exaggerated, but experience suggests that reforming corporate governance is a long and difficult process, strongly opposed by those currently in control. Because existing owners have better information, and often strong political ties, dramatic and rapid corporate restructuring is unlikely.

Slow corporate restructuring has negative implications for the cost and sustainability of financial sector restructuring. As most financial sector assets are corporate liabilities, the existence of insolvent firms undermines the rationale for injecting new capital into banks. There is little justification for propping up banks if their debtors are all bankrupt. The result may simply be more fiscal transfers to cover new losses later on. In this respect, unfortunately, the experience of Mexico and Eastern Europe is not particularly encouraging. There bank restructuring took longer and cost the taxpayer more than anyone had envisaged.

REFERENCES

Asian Development Bank, 1999. *Asian Development Outlook 1999.* Hong Kong: Oxford University Press for the Asian Development Bank.

Deutsche Bank Research, various years. *Global Emerging Markets*. London.

International Monetary Fund, 1998a. *International Capital Markets, Interim Assessment.* Washington, D.C.

________, 1998b. *World Economic Outlook 1998.* Washington, D.C.

________, 1999. *The IMF's Response to the Asian Crisis.* Washington, D.C.

World Bank, 1998a. *East Asia: The Road to Recovery.* Washington, D.C.

________, 1998b. *Global Economic Prospects 1998/99.* Washington, D.C.

EDRC Briefing Notes Series

No. 9 Economic Openness:
Growth and Recovery in Asia
May 1999

No. 10 Interpreting the Asian Financial Crisis
May 1999

No. 11 Policy Response to the Asian Financial Crisis:
An Overview of the Debate and the Next Steps
May 1999