The Panorama of the East Asian Crisis and the IMF's Role Therein[1]

Abstract

This short version of my paper originally called *The Panorama of the East Asian and Russian Crises and the IMF's Role Therein* analyzes the economic facts of the East Asian crisis. The hypothesis of this short paper is that the IMF's involvement in East Asian crisis did not produce positive results for the East Asian countries and the international community at large. Indeed, the IMF's actions actually contributed to the crisis' contagion. This paper incorporates the comments and criticisms of economists, such as Joseph Stiglitz, Steven Radelet, Jeffrey Sachs, and Padma Desai, regarding the IMF's diagnosis and treatment of the above-mentioned crisis. It also analyzes the IMF's own defense and explanation of the intention of its policies.

After the analysis of the East Asian crisis, this paper enumerates the solutions suggested by the above economists to prevent future crises. Finally, the author's thoughts about the IMF's role in economic crises, and his vision for the IMF's and international community's responses to future crises are included.

"Financial globalization is a complex process in which the animal spirits of risk-prone, return-savvy investors from the developed market economies with global, electronic reach collide with the weak financial institutions, traditional corporate practices, and vulnerable political arrangements of emerging market economies with disastrous consequences for the latter." – Padma Desai[2]

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[1] This is a shortened version of my original paper called *The Panorama of the East Asian and Russian Crises and the IMF's Role Therein*. E-mail me for the original paper topakserdar@yahoo.com

[2] Padma Desai, *Financial Crisis, Contagion, and Containment: From Asia to Argentina* (Princeton: Princeton University Press, forthcoming), Chapter 1, 18.

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I. Introduction

In the 1990's, the media implicated the IMF in the coverage of recent crises in East Asia (Thailand, Indonesia, and South Korea (henceforth Korea)). Before I proceed with details about these crises, I feel obligated to offer a definition for the word 'crisis.' Economics Professor Michael B. McElroy, Visiting Associate Professor of Economics at Duke University, defines it this way: "an economic crisis may be said to occur when there are disruptions in usual patterns of supply and demand, such as embargoes, inflationary monetary actions, wars, technological changes, or asset market bubbles."[3] In East Asia, the economic crisis was associated with factors such as an unexpected depreciation of the exchange rate, an intense capital outflow, a dangerous decrease in foreign currency reserves, and a possible default on loans.

My hypothesis is that while the IMF cannot be held responsible for the birth of the crisis in Thailand, its subsequent actions were not able to prevent the contagion of the crisis to other countries. Specifically, the IMF's insistence on the implementation of its economic policies through conditionality agreements contributed enormously to the contagion of the crisis from Thailand to Indonesia and Korea.

II. What Happened in East Asia?

A) Thailand

Blustein introduces the chapter called "Winnie the Pooh and the Big Secret" in his book by giving an overall picture of the pre-crisis events: The world electronics market took an unexpected sudden downturn in mid-1995. Thailand, a major supplier of electronic components, witnessed a decrease in its exports: in 1996 Thailand's trade deficit became 8 percent of its GDP, an unprecedented statistic for that nation.[4] Essentially, the magnitude of the deficit did not worry

[3] Michael McElroy. interview by the author, 22 February 2003, E-mail, Duke University, Durham, North Carolina.
[4] Ibid., 55.

the Thai officials or the foreign investors because the economy remained stable, with a low inflation rate. Moreover, it was believed that the increasing deficit signaled the trust of foreign exporters in the Thai economy because the general perception was that Thailand could make efficient and profitable use of the foreign credit. Surprisingly, the baht depreciated. As Blustein puts it, the "go-go mentality" in the Thai banking system caused devaluations in the exchange rates which led to a crisis under the company of currency speculators who took advantage of the fixed exchange rate regimes. This "go-go mentality" was the product of the fast growing Thailand economy. Few questions were asked by the creditors to the borrowers during the lending process, because the creditors believed that the fast economic growth of Thailand would continue unendingly. Also, the Thai bank owners with close ties to government officials had extended credit mostly to these officials' real estate investments, assuming that they would be repaid in-full, even if the investments did not produce sufficient returns. The bank owners were followed by foreign investors who saw potential in Thailand's young fast growing economy. The newly liberalized capital market system amplified the capital inflow into Thailand. While all these events were unfolding, Thai banks did not hedge against their foreign currency debts because they thought that the government could keep the fixed exchange rate regime alive. Because the Thai government insisted on having an fixed exchange rate regime, currency speculators did not hesitate to take advantage of it which put pressure on the Central Bank's foreign reserves.

Local businesses, which had made very risky long-term investments using short-term loans, started to default on their loans, so foreign creditors began to ask for early payments. As a result, the Central Bank's supply of dollars began to be depleted.

Corden's analysis regarding exchange rates in Thailand is more detailed than Blustein's. He stresses that the speculators contributed to the depreciation of the baht, thus "the crisis was triggered by speculation against the currency, but in a fundamental sense did not depend on it."[5] The borrowing continued until the exchange rate depreciated, and then capital started to flow out because the creditors asked for early repayments.

Finally, Corden summarizes the elements that worsened the crisis in Thailand:[6] The depreciation of yen against dollar affected the then-to-the-yen-tied baht badly; Thai banks borrowed short-term from abroad and lent long-term to every Thai firm that asked for credit which brought up unsuccessful investments; and the foreign borrowing was unhedged. This is the so called "Unhedged Foreign-Currency-Denominated Borrowing" (UFB) problem.[7] Because the Thai borrowers believed that the exchange rate would stay fixed, they did not hedge against the depreciation of the exchange rate. Fixed exchange rates gave them a false sense of security.

Recall that in Blustein's analysis, the Central Bank's strategy did not help Thailand's economy recover completely. The amount of foreign debt was so high that the Central Bank's dollar reserves depleted with an increasing rate. Finally, in July 1997, Thai officials began their negotiations with the IMF officials.[8] The IMF recommended contractionary fiscal policies such as increasing taxes, decreasing government spending, decreasing imports to eliminate the existing trade deficit, and transitioning into a floating exchange rate regime. According to the IMF, the first two measures would turn the government's budget deficit into a surplus, and the third would allow stabilizing monetary policies to be implemented. Later on, contractionary policies were converted to expansionary ones whereas the floating exchange rate regime stayed,

[5] Max Corden, *Too Sensational: On the Choice of Exchange Rate Regimes* (Cambridge: The MIT Press, 2002), 198.
[6] Ibid.
[7] Ibid., 129.
[8] Blustein, 73.

as the existence of the "go-go mentality" came to the attention of the IMF. The foreign borrowers were saved by IMF bailouts whereas Thailand's economy as a whole suffered. The economic crisis in Thailand, however, was not to be so easily contained, as Indonesia quickly found itself falling prey to the very same crisis.

B) Indonesia

Blustein reports the Indonesian case in his chapter entitled "Malignancy."[9] Although Indonesia did not have as big an account deficit as Thailand did in January 1998, the Indonesian currency, the rupiah, depriciated 85 percent from 2400 to 15000 per dollar.[10] What went wrong in Indonesia?

The local banks and the Central Bank of Indonesia had created "a credit issuing company" that can be described by three commonly used words: *Korupsi, kolusi, dan nepotisme*, meaning corruption, collusion, and nepotism (favoritism based on kinship). The President Suharto and his family, and people with connections to the family such as the ethnic Chinese people who were the suppliers of the Indonesian military, vacuumed all the foreign investment benefits. Added to this institutional efficiency was the spillover from the Thai crisis.

Having witnessed the Thai crisis, the foreign creditors demanded early repayments from Indonesian banks and firms. The dollar reserves of the Central Bank of Indonesia depleted quickly, and as a result the devaluation of rupiah took place. Corden explains that Indonesia had a target zone exchange rate regime, meaning the exchange was tried to be kept in a certain range (-8 percent to 8 percent).[11] He claims that the target zone regime which had a relatively small fluctuation range did not cause the crisis, though it gave investors a façade of confidence. Corden

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[9] Ibid., 85-116.
[10] Ibid., 87.
[11] Corden, 205.

concludes that the "exceptional severity" of the crisis was caused by the UFB, the loss of confidence in the banking system, and the social and political weakness of Indonesia.[12]

Returning to Blustein's analysis, as Indonesia's dollar reserves reached almost zero, Indonesia sought the help of the IMF. The IMF program required the closing of 16 nonfunctioning private banks. Thus, the public's confidence in private banks shrank: people transferred their money to state-owned banks and foreign banks in Jakarta, thinking that the government would take the necessary actions not to allow the closing of its own banks and the foreign banks were safe. Blustein describes this attempt of the IMF as playing the role of a surgeon: "When done artfully, bank closures work like successful cancer surgery, in which the surgeon removes all the malignancy from the patient's body at once and leaves nothing but healthy tissue."[13] He stresses that the job is not done until one is sure that the remaining tissues (the banks in this case) are absolutely healthy.[14] It turned out that there was a flaw in the bank closing strategy: people close to the Suharto family whose banks were shut down gained control of non-closed banks and transferred their ex-banks' assets to their new banks. Thus, the "tumors" of the closed banks appeared in the not-yet-closed banks as contagion, showing the remaining weakness in the banking sector. Therefore the IMF's plan of getting rid of the rotten banks did not work; instead the sickness spread to the rest of the banks.

In January 1998 the IMF planned to stop the capital flight by increasing interest rates. Whether an expansionary monetary policy was good or bad remains a moot point. On one hand inflation soared, on the other hand the banking system was not allowed to fail.[15]

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[12] Ibid.
[13] Blustein, 108.
[14] Ibid.
[15] Ibid., 114.

Blustein reports on the IMF program for Indonesia in "Down the Tubes" chapter.[16] The rupiah kept falling basically because the markets had not seen an attempt for decreasing the foreign debt of Indonesian companies. The US government was against solutions which were aimed at decreasing the foreign debt of Indonesia through IMF money because some of the debt was owned by private firms. Therefore the firms had to accept the consequences of their failure to hedge against foreign borrowing. The US government thought that helping the borrowers would create a moral hazard problem: firms, knowing that they would be bailed-out in case of defaults on their debts, would keep applying for foreign loans. Capital controls were impossible to implement because of the high corruption level in the government. In the end, it was determined by the US Treasury and IMF that the Indonesian tax payers bear the burden of foreign debt of the Indonesian firms' mistakes. As an attempt to stop the cash outflow, the IMF tried to create agreements between the depositors and Indonesian banks on January 27, 1998.[17]

When it became clear to Suharto that there was no way that he could win the public's confidence back, he resigned on May 21, 1998.[18] The public confidence was still at a very low level. This was an example of the IMF's miscalculation. The IMF could have imposed programs, such as a debt restructuring program, that it eventually would impose successfully in Korea. The seemingly interminable Indonesian case was accompanied by another economic crisis in Korea.

C) Korea

Blustein reports on the Korean case in chapter "Sleepless in Seoul": in 1997, Korea asked the IMF for help.[19] In 1998, Korea's GDP decreased by 7 percent, wages dropped by 10 percent, and the unemployment rate increased to 10 percent.[20] What happened in between?

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[16] Ibid., 207-234.
[17] Ibid.
[18] Blustein, 233.
[19] Ibid., 117-150.

Korea appeared to be a prospering country. However, its banking system was different than that of any other nation: "The nation's banks, instead of competing as market-based institutions, were used by the state for channeling peoples' savings to the *chaebol* (nation's largest business conglomerates, clustered around one holding company. The parent company is usually controlled by one family. The companies hold shares in each other.)[21], with 'policy loans' – credits granted at low interest rates to government blessed projects – accounting for 60 percent of all loans in the late 1970s."[22] The existence of chaebol was an obstacle against the free market system as it created the incentive of lending excessively to clients, who had connections in the government. This was a moral hazard problem within Korean financial markets.

The chaebols' big industry firms continued to open one factory after another, for the sake of competition and ego satisfaction: "From 1994 to 1996, spending on new plants and equipment rose by nearly 40 percent a year. In some cases, these expansion programs reeked not only of excessive ambition but even megalomania."[23]

The funds for chaebol were coming from the interbank market abroad (the market in which banks borrow from each other), in which the interest rates on loans were lower. The private institutions that belonged to chaebol created a large debt. In addition to being fueled with an excessive amount of foreign-debt, Korea could not avoid the depreciation of its currency, the won, because of the lost confidence by foreign investors in Asian markets who had witnessed the depreciation of Thai baht and Indonesian rupiah. The IMF's inability to stop the depreciations in Thailand and Indonesia had increased the likelihood of the depreciation of the won. Korea had

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[20] Ibid., 117.
[21] "Yes but what exactly is a chaebol?" http://www.megastories.com/seasia/skorea/chaebol/chaewhat.htm; Internet, accessed 10 February 2003.
[22] Blustein, 120.
[23] Ibid., 121.

no other choice but to seek the IMF's help in order to stop their local banks' defaults on their loans, which could later lead to a bank run.

In November 1997, the IMF, having learned some lessons from the Thailand case, asked Korea about their foreign currency reserves.[24] The Korean government claimed that the reserves would last until the end of 1997, but this information was incomplete. What the Korean officials had failed to mention was that these reserves were held in overseas branches of Korean banks. Immediate access to them was, therefore, impossible. In addition to this, the debt of Korean firms was $50 billion more than registered as the foreign branches of Korean banks had been borrowing from "abroad."[25]

The IMF demanded the closing of banks that had lent heavily to the chaebol. Korean officials did not agree with the IMF on this, because they believed that an action of this type would definitely shake the public confidence in the Korean banking system. Finally, the IMF and Korea came to an agreement after the IMF's Managing Director Camdessus' visit to Korea. Korea agreed to open its economy to foreign competition and foreign involvement by opening of American brokerage houses, decreasing chaebol's credit receiving power, closing the nonworking banks if they didn't start functioning as expected in 30 days, and forcing large financial institutions to submit to audits by internationally recognized firms.

Blustein explains how Michael Mussa, the head of IMF's Research Department, thought that the current IMF plan would not help Korea to defeat the crisis. It would only help the foreign creditors bail-out. Instead, they should have been bailed-in.[26]

According to Corden, the Korean case is very similar to Thailand's case.[27] The excessive debt of chaebol and the Korean banks caused the crisis. Korea had a managed floating exchange

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[24] Ibid., 129.
[25] Ibid., 130.
[26] Ibid., 177.

regime in which the Central Bank of Korea intervened in the exchange rate market to adjust the exchange rate (not to fix it) as speculators do. "The [Korean] banks also had "foreign-currency-dominated" assets close to the value of their liabilities which eliminated the UFB problem."[28] Finally, one can say again that the exchange rate regime did not cause the crisis.

A daily newspaper, *Chosun Ilbo*, obtained the IMF staff report about the Korean rescue: it revealed that the bail-out money was not sufficient to cover the short-term debt of Korean banks.[29] This caused a panic among creditors who started to ask for immediate repayments instead of taking part in the negotiations for rolling over the short term debt.

After the elections in Korea, once the political climate became clearer, New York Fed President McDonough convinced US creditors to convert their short-term loans to long-term loans. So did German, French and Japanese bank officials. That way, Korea was able to get out of the crisis.

Other economists' analysis of the IMF offer some additional insight into the IMF's role in the East Asian crisis.

III. Steven Radelet and Jeffrey Sachs' East Asian Crisis Analysis

Radelet and Sachs outline four possible reasons for the crisis:[30] Extreme vulnerabilities and weaknesses of the Asian countries, the moral hazard problem, exchange rate devaluations, and the creditors' panic.

A) Extreme Vulnerabilities and Weaknesses of the Asian Countries

Radelet and Sachs prefer to call vulnerabilities and weaknesses of the Asian countries not a reason for, but rather a precondition of the crisis. According to them, this precondition is not

[27] Corden, 210.
[28] Ibid., 211.
[29] Blustein, 182.
[30] Steven Radelet and Jeffrey Sachs, "What Have We Learned, So Far, From the Asian Financial Crisis?" CAER II Discussion Paper, No .37, March 1999, 1.

great enough to cause crises in three so-far-well-performing countries. Support for this is that the average non-performing loans in Indonesia dropped from 12 percent to 9 percent between 1994 and 1996 because Indonesian banks had not gotten loans from abroad as the banks in Thailand and Korea had done, and they lent firms only a little more than usual.[31] This demonstrates that Indonesian banks were careful about capital inflows. What, then, caused a crisis in Indonesia? Radelet and Sachs proceed to commenting about the investments made with short-term borrowings. The boom in the investment market through the governments' pegged exchange rate policies decreased the quality of investment in East Asia. People were investing not because they were sure that they would gain in the long run, but because everybody else was doing it, and since their government had assured them that the interest and as a consequence exchange rates were "secured." Still this was not enough to create a crisis of this magnitude.

B) Moral Hazard Problem

Radelet and Sachs caution that there are two different scenarios behind the moral hazard issue. The first one is that the Asian investors were encouraged by the IMF policies in Mexico leading to bailouts of the investors so they invested their short term loans in every long-term investment possible without questioning its quality. The second one is that the closeness of some Asian firms to their government's members helped them to receive credits at anytime. They claim that the first story is not feasible, because in mid-1996 and 1997, the credit reports of Asian countries were very good, pointing to the result that almost nobody expected a crisis there. Their final word about the moral hazard problem covered by second scenario is that "cronyism [for example chaebol in Korea] … set the stage for the crisis, [although] it alone cannot account for the timing, severity, or even location of the crisis."[32] Finally, one can say that the IMF's

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[31] Radelet, 5.
[32] Ibid., 9.

existence did not encourage the foreign creditors to invest in Asia; what encouraged them was the then-booming economies of the East Asian countries.

C) Exchange Rate Devaluation

Radelet and Sachs' analysis of exchange rate regimes is similar to Corden's. They too support floating exchange rate regimes since they eliminate the UFB problem. Interestingly, they point out that the Asian crisis was preceded by the Asian currency devaluations. They claim that the fixed exchange rate regimes are a more important cause of the crisis rather than the devaluations themselves. The pegs are responsible for devaluations. The devaluations have two common effects: First, the depletion of foreign exchange reserves. And second, the creditors witnessed that the debtors could not pay them back as they promised before because they had not hedged against devaluation. These effects resulted in a panic situation in East Asia but not necessarily in a crisis.

D) The Creditors' Panic

Radelet and Sachs find the creditors' panic to be the reason for the severity and abruptness of the crisis.[33] A creditor who observes the ratio of short-term foreign liabilities to short-term foreign assets will be aware of a potential default in debt repayments when this ratio increases. It is therefore in the interest of a rational creditor to demand repayments. Assuming that the majority of creditors is rational, a capital outflow will take place. Radelet and Sachs offer proofs for their claim. They conjecture that the crisis was unanticipated, suggesting that its occurrence cannot be the cause of fundamentals. Also, an economic contraction of banking and corporate sectors took place first instead of a growth slowdown or recession which can only be explained by fundamentals. Additionally, no emerging markets in the world with low levels of short-term foreign liabilities to short-term foreign assets was hit, even those with high levels of

[33] Ibid., 9.

corruption and weak banking systems; the crisis hit several countries with widely varying economic structures and fundamentals within a relatively short period of time (for example, Korea and Indonesia had little in common although they shared a high short-term foreign liabilities to short-term foreign assets ratio); and the crisis eased up after about one year, even though several fundamental conditions were not significantly improved. The IMF should have tried to calm the creditors by helping the country to convert its short-term foreign liabilities to long-term liabilities. That way the ratio of short-term foreign liabilities to short-term foreign assets would decrease, and the creditors would not panic.

In the second part of their paper, they analyze the IMF's role in the crisis. Because of the fast trade and capital account liberalization, East Asian countries had not cared about spending time on regulating a market-based economy. They adapted capital flow liberalization as fast as they could and the IMF supported them in this path. Moreover, these countries did not work on creating organizations similar to the US Fed and other US regulating organizations in order to have a healthy free market-based economy. There is no international (worldwide valid) version of "bankruptcy law, deposit insurance, and a lender of last resort."[34] Therefore capital flows are not regulated as efficiently as in the US for example.

Another mistake of the IMF was to "worship" the belief of the necessity of high interest rates during a crisis. According to Radelet and Sachs, the benefits of higher interest rates do not necessarily exceed the benefits of lower interest rates during a crisis. The capital outflow may slow down but it is still present because of the lack of trust in the markets, and the debtors are pushed into a difficult position. In the East Asian case, higher interest rates were not helpful, the debtors' burden exceeded the gains from the retained foreign capital. They conclude that although high interest rates had a positive effect on exchange rates their costs to firms and banks

[34] Ibid., 12.

were high and irreversible, "and the interest rate policy may have helped to trigger the panic in the first place."[35]

The last mistake of the IMF they state is the closure of highly indebted banks. It was done without underlying policies such as deposit insurance, and therefore was doomed to fail. Thus Blustein's claim about malignancy (sick tumor removal) in Indonesia is shared by them as well. Another economist whose thoughts about the IMF's role in the East Asian crisis are parallel to Radelet and Sachs' is Padma Desai.

IV. Padma Desai's Analysis

Desai compares in the first chapter of her book *Financial Crisis, Contagion, and Containment: From Asia and Argentina* the developing countries and developed countries in terms of their economic history: developed countries have already developed the institutions such as the Fed which supervise the economy, their governments are more efficient in policy formulation and political decision making, and they invest in technology tremendously. The developing countries, however, have not yet developed the institutions that are necessary for a well-functioning economy. Therefore they find themselves left to the IMF which "in effect operated as a G-7 led institution aggressively extending a mandate of irreversible capital mobility in inadequately prepared and therefore financially vulnerable emerging markets."[36] This strategy of the IMF is not suitable for the countries whose institutional efficiency is low.

Desai states in the beginning of her analysis about the East Asian crisis that the IMF took four important points into consideration. First, there was a vast capital inflow due to more or less stable exchange rates and relatively high interest rates. Second, the short-term borrowings of East Asian countries were unhedged. Third, the short-term borrowings were invested long-term

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[35] Ibid.
[36] Desai, Chapter 1, 10.

in booming sectors, such as the real estate and property sector. And finally, the structural weaknesses of East Asian countries resulted in the miscalculation of the exchange rates and the duration of loans.

Desai's stance on the East Asian crisis treatment is that the IMF's intense focus on the structural weaknesses of the East Asian economies restricted its vision about the main reason for the crises, namely "the premature opening up of these economies to short-term speculative capital inflows."[37] As the IMF was busy in making structural arrangements, it did not take the "political constraints, traditional corporate practices, and well-established cultural norms" into account.[38] The IMF's effort to fix structural weaknesses exceeded its role as a macroeconomic adviser and created a potential threat for the sovereignty of the help receiving countries. In addition to negative effects created by the IMF, the hedge funds and investment banks worsened the crisis because of the depreciationary pressures the former put on the East Asian currencies and the massive unregulated capital inflow that the latter caused. Finally, "the IMF's structural reform agenda … placed the reform burden of crisis prevention on emerging market economies," because the hedge funds and investment banks had refused to become more transparent.[39] The IMF changed its fiscal policy stance by making it expansionary after observing that the government revenues and output level had decreased. The change was too little too late.

In a more general sense, Desai believes that it is ironic that once a developing country experiences economic instability because of not correctly paced capital market liberalization, it goes to the IMF, which actually had advised it to open its markets to international markets as quickly as possible in the first place. And unfortunately "once the horses of capital account

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[37] Ibid.
[38] Ibid.
[39] Ibid.

controls have been let loose from the stables, they cannot be brought back even if needed."[40] Desai believes that the IMF should allow temporary restrictions for the sake of winning time to establish supervisory market institutions.

Another criticism of the IMF that she brings up is that the size of its funding is significantly insufficient and that it materializes slowly, thus it cannot ease the "pain" of the "patient." Joseph Stiglitz, too, like Desai finds many flows in the IMF's policies during the East Asian and Russian crises.

V. Stiglitz vs. the IMF

A critical study of the IMF has been completed by Joseph E. Stiglitz 2001 Economics Nobel Laureate in his book *Globalization and Its Discontents*. Stiglitz explains how the IMF is not able to fulfill its significant objectives, such as ensuring macro stability, promoting global stability, and guiding the transition of countries from communism to a market economy.

Stiglitz analyzes the IMF's behavior during the East Asian and Russian crises. In the chapter "The East Asia Crisis: How IMF Policies Brought the World to the Verge of Global Meltdown", he states that the single most important factor which led to this crisis was the wrong timing and sequencing of the IMF policies.[41] First, rapid capital account liberalization increased the capital flow. The capital flew away from developing Asian countries during recessions to the investors in the developed countries who asked for early payments. As a result, not enough capital could be devoted to production in the developed countries, which in turn worsened the crisis. Second, rapid trade liberalization left no time to set up safety nets. The lack of safety nets, which included hedging against currency devaluations, and implementation of market restrictions against unfair competition, amplified the negative effects of the crisis. Third, the

[40] Ibid., Chapter 12, 10.
[41] Joseph E. Stiglitz, *Globalization and Its Discontents* (New York: W. W. Norton & Company, 2002), 89-132.

contractionary fiscal policy recommendations of the IMF enforced through the conditionality concept, which aimed at the elimination of the government budget deficit and creation of a balanced budget, were doomed to fail, because they limited the government expenditures to its revenues. This limitation destroyed the government's ability intervene in non-functioning/inefficient markets in the sense that the government did not have enough money to spend for solving the problems. These factors made it difficult for the government to collect taxes it needed; increasing the non-collectable taxes was impossible. Finally, contractionary monetary policy which aimed at the stabilization of the exchange rate caused the interest rates to increase to a high level which exacerbated the plight of the already in-debt East Asian firms. These firms defaulted on their loans, bringing the loan issuing-banks into difficulty, and forcing them to decrease their loans.

There was an additional negative effect of the contractionary policies. East Asian countries started to cut down their imports, through trade barriers, in order to obtain a trade surplus that could help eliminate the country's budget deficit and pay its creditors back. The neighboring countries, therefore, saw a decrease in their exports which caused budget deficits for themselves. He names this contagion effect 'beggar-thy-neighbor.'

He then blames the IMF for creating a moral hazard: The investors from the developed countries did not hesitate to make highly risky investments in the developing countries, because they knew that in the case of a default in payments the IMF would lend to the country money which they would get into their pockets.

Stiglitz finally remarks that the IMF has been resistant to change its 'one-size-fits-all' approach. Giving the same medicine to different patients did not cause the expected healing but jailed them to the bed for a longer time. China did not want any medicine from the IMF, instead

it produced its own medicine: capital controls.[42] That way it protected itself from excessive foreign capital inflow and outflow, which should have been recommended by the IMF to the other East Asian countries who themselves could have adjusted their own doses.

Until this point, the focus of this paper dealt with criticisms of the IMF by different economists with a limited chance for the IMF to defend itself. Now, I will analyze the defense offered by Kenneth Rogoff, the Economic Counselor and Director of the Research Department of the IMF.

VI. Kenneth Rogoff: the IMF Answers Back

Rogoff enumerates the four criticisms directed to the IMF: The IMF programs put difficult-to-achieve fiscal goals on cash-lacking countries. The IMF loans cause a moral hazard problem. The IMF policies make the economic situation worse in crisis countries. The IMF encourage developing countries to adopt capital flow liberalization which in turn destabilized their economies.[43] Rogoff responds to these criticisms as follows:

The IMF programs "lighten austerity rather than create it. Yes, really."[44] He says that the countries which are experiencing high financial problems come to the IMF. The IMF is lending to them at interest rates that they "could only dream of even in the best of times."[45] The IMF's conditionality is there to discipline their economy, and its conditionality serves as a substitute for the market forces that are lacking in that economy.

In addition, the help receiving countries' governments were given the chance to decide on how to construct the budget cuts recommended by the IMF. He concludes that "blaming the IMF for the reality that [in-crisis countries] must confront [their] budget constraints is like blaming

[42] Ibid., 182.
[43] Ibid.
[44] Ibid.
[45] Ibid.

the fund for gravity."[46] In his opinion, budget constraints are a crucial part in the recovery process.

Perhaps this can best be understood with a metaphor: Let's say that the IMF is your father and you are in your twenties. One day, you come to your father and tell him that you lost most of your money when gambling. What is your father's best bet? He will most likely tell you find a job and raise revenue instead of giving you the money you lost so that you can gamble again, even though you have the chance to make up your loss by gambling again. At the same time, he will financially support you to make sure that you survive but you will have to reduce some of your expenditures, at least you can decide which expenditures to give up. The question here is which developing countries have institutions that enable the Keynesian economics (expansionary fiscal policies lead to more output) to function.

Rogoff provides the statistics that foreign investors lost $225 billion in Asia, and because of these losses, the speed of the money inflow into developing countries decreased.[47]

Besides all these facts, Rogoff admits that the moral hazard theory "is clever ([himself] having introduced the theory in the 1980s)." According to him, one point that may help prove that moral hazard is not present is that most countries repay the IMF, thus leaving no subsidy to private lenders, that is, no bailout. Though he concludes that in the future this may not hold true for whatever reason (he does not give any further details after his conclusion), so moral hazard remains an important issue: moral hazard is a concern for the IMF, too.

There is a reason why the IMF does not ask countries to implement expansionary fiscal policy. Rogoff gives Arthur Laffer, Ronald Reagan's economic adviser, as an example. Laffer had advocated tax cuts thinking that they would boost the output of the US and therefore

[46] Ibid.
[47] Ibid.

compensate for their own costs. However, these tax cuts resulted in a government deficit. By the same token, IMF critics favor debt-financed fiscal policies, which make countries grow and increase their debts. Rogoff claims that the creditors will not believe in this story and supply the necessary funds for the countries.

Also, lowering the interest rates during a crisis will not satisfy the expectations of lenders, who require higher returns when the default risk rises. Governments are responsible for balancing the trade-off between high interest rates and low interest rates, but nobody can just assume "low interest rates are better."[48] The interest rates issue is a moot one. Thus far, Rogoff is the only analyst who defends the idea behind the high interest rates. I propose that, looking at what happened in Asia, high interest rates are unavoidable once a crisis begins, because they avoid further devaluation of the currency. However, their long-term existence is very harmful for the country's economy, since they amplify the burden of the debt of borrowers. Therefore once the exchange rate is taken care of by perhaps adopting floating exchange rate regimes, interest rates must be decreased immediately.

Rogoff claims that what Thailand did wrong was to insist on having a fixed exchange rate regime. According to him, Thailand did a favor to itself when it liberalized its capital market. On the contrary, he admits that the IMF "didn't warn [Korea] forcefully enough about the dangers of opening up to international capital markets before domestic financial markets and regulators were prepared to handle the resulting volatility."[49] Then he asks this question: Why were not Australia and New Zealand affected by the East Asian crisis? They had not imposed capital controls, like China and India which through capital controls avoided the so called "Asian flu." Rogoff's answer is as follows: Australia and New Zealand both had well-regulated capital

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[48] Ibid.
[49] Ibid.

markets and thus did not need capital controls to protect themselves from the “Asian flu.” Finally, he believes that in the long run countries will improve their financial markets and institutions in order to achieve full capital market liberalization. Even China is in the process of achieving capital market liberalization. He concludes that if one “invite[s] capital controls for lunch … they will try to stay for dinner”[50] as opposed to Desai who had said “once the horses of capital account controls have been let loose from the stables, they cannot be brought back even if needed.”[51]

The next section suggest answers a general question: How can one prevent crises before they happen?

VII. Solutions to Prevent Future Crises

I will now present the solutions suggested by various economists and by Anne O. Krueger, First Deputy Managing Director of the IMF. I will offer some additional insights and solutions myself.

Desai proposes that the hedge funds must be regulated and made more transparent so that their destabilizing effect can be minimized. There is also the Tobin Tax proposed in 1971 by Nobel Laureate James Tobin is about taxing the transitions in the currency markets so that their destabilizing effects can be minimized. Unfortunately, it is not enforceable due to mobility of currency markets thanks to the E-herd.[52] Desai mentions Temporary Debt Repayment Suspension which is similar to Anne O. Krueger’s sovereign debt restructuring mechanism idea which is explained later in this paper.[53]

[50] Ibid.
[51] Desai, Chapter 12, 10.
[52] Ibid.
[53] Ibid., 17.

Finally, Desai discusses the Meltzer Commission, which was an attempt by the US to fix the IMF. The Meltzer Commission introduced the idea that under free capital mobility the world markets could create a list with the countries names on which met the criteria that included floating exchange rate regime, a small ratio of short-term liabilities to short-term assets etcetera set by the IMF. The countries on the list would be IMF-tested and approved and therefore would incur relatively small losses. These countries would be able to get more loans at the market interest rates whereas the rest of the countries would get smaller number of loans with higher-than-market interest rates. As a result, the overall risk in the world markets would be lowered. The Meltzer Commission "failed to reformulate the question of how a leaner IMF agenda can be implemented fairly in emerging markets if the market-based, … free capital mobility and floating exchange rates cannot work to [developing countries'] advantage in view of their structural and institutional weaknesses."[54] Desai concludes that "in my view, the Fund cannot evolve in new, realistic directions if it regards even a market oriented, temporary departure from its policy orthodoxy of fully free capital market mobility as a reversal. In that basic sense, the Fund is nonreformable."[55]

Despite Desai's hopelessness about a reformed IMF, Blustein's solutions are more preemptive to answer the question "How do you prevent a crisis?" He describes two[56] angles from which to answer this question. One angle covers the solution suggestions directed to developing countries.[57] Developing countries can levy taxes on the short-term foreign capital and work on bail-in mechanisms like in Korea that will transfer some percentage of the debt burden to panicky investors. He argues that the IMF should have stopped worrying about structural

[54] Ibid., 26.
[55] Ibid., 31.
[56] Three in the normal version
[57] Blustein, 376.

problems, but instead should have tried to reschedule the interbank debt of the Indonesian banks like it did in Korea and to form a repayment guarantee to be given to Indonesian depositors.

Another angle is directed at the foreign investors. Blustein cautions that they should not keep lending to countries with weak institutions like they did in the case of Thailand, because the government officials in them tend to feel encouraged to keep doing whatever they are doing, i.e. wrong policies, corruption etcetera.[58]

Krueger, first deputy managing director of the IMF, defends her proposal of the Sovereign Debt Restructuring Mechanism (SDRM) on October 17, 2002 in an IMF meeting. The SDRM differs from CAC and is better than them in two ways: "first, the [SDRM] would deal with the existing stock of debt, including instruments that do not provide for collective action, and second, the votes of creditors holding participating debt instruments would be aggregated, allowing a single vote to restructure multiple debt instruments."[59]

The way the SDRM works is when a debtor reports to the Sovereign Debt Dispute Resolution Forum (SDDRF), which is an independent legal institution registering claims of the debtors and supervising the restructuring process, that it is incurring difficulties in repayments and may therefore default on its loans, the SDDRF will ask the *private* creditors of that debtor to offer to restructure his debt, for example by converting the soon maturing loans to long-term loans while maintaining the present value of the debt.[60] However, some debt reductions may be necessary. When the mechanism begins to work, the debtor must become more transparent and share the information about its debts and repayment ability with all of its private creditors. The

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[58] Ibid.
[59] Anne O. Krueger, "Crisis Prevention and Resolution: The Role of Sovereign Debt Restructuring," Remarks at American Enterprise Institute symposium, *International Monetary Fund*, 17 October 2002, available from http://www.imf.org/external/np/speeches/2002/100702a.htm; Internet; accessed 2 March 2003.
[60] Anne O. Krueger, "Sovereign Debt Restructuring: Messy or Messier?" *Annual Meeting of the American Economic Association*, 4 January 2003, available from http://www.imf.org/external/np/speeches/2003/010403.htm; Internet; accessed 5 March 2003.

contract between the creditors as one party and the debtor as the other must be binding on every single debtor and may give priority to creditors on a senior basis. If the debtor fails to accomplish the new payments, the SDRM mechanism can be stopped. The debtors and creditors can return to the point they started at. Radelet and Sachs, too, favor the SDRM. They point out the need a better defined international private debt mechanism whose source should be private funds instead of the IMF.

Stiglitz, thus far most sensational IMF critic, does not suggest any reforms for the IMF, nor does he say that the IMF should be abandoned; instead, he draws a general picture regarding the world markets. He argues that think tanks, a more advanced independent media, public discussions and educating the new generations about democracy are musts for a better world. In the last chapter "The Way Ahead" Stiglitz prepares a list of "key reforms" that will increase macro stability:[61] Firstly, one must understand the risks that come with capital market liberalization, and capital controls must be planned and structured carefully. Secondly, bankruptcy reforms must be created. They must be adjusted to each debtor countries' economic, political, and cultural specifications. While doing this the private creditors like the IMF itself should not play a central role, because their information about debtor countries' needs, and economic, political, and cultural specifications will be limited. Thirdly, improved regulations in banking adapted to the specifications of debtor countries are needed in order to regulate the lending of private banks. The new banking system must be able to provide capital to firms which can make use of it and create jobs. Fourthly, a better risk management system for exchange rate fluctuations is needed. The developed countries like US should "provide loans to the developing countries in forms that mitigate the risks, e.g. by having the creditors absorb the risks of large real interest fluctuations." Fifthly, safety nets must be improved. The institutions which assist

[61] Ibid., 214-252.

small businesses and labor markets must be improved to deal with the negative effects that come from fluctuations in the world markets. Sixthly, better responses to crises should be developed. Finally, there must be a return to basic economic principles such as designing expansionary fiscal and monetary policies, to adjust the aggregate demand during a recession, instead of focusing mainly on the recovery of investor confidence. In the end, that is what US does when its economy is in "crises."

Lastly, Corden summarizes his findings in "The Exchange Rate Regime: Too Sensational, Hollowed Out, Unimportant" chapter.[62] He has some advice for developing countries: "Be pragmatic: adopt flexible pegs that are supported by banking controls."[63] This will avoid unnecessary short-term capital inflow, and will not let another East Asian crisis happen. Capital outflow controls may not be as much helpful in avoiding crisis as believed.

After reading so many different opinions about how to prevent future economic crises, I further developed an understanding about the nature of economic crises, and what can be done in order to prevent them form happening.

I believe that the IMF as an institution is analogous to an emergency room (ER) of a hospital. The patients that pay a visit to ER are the ones who are under dire conditions, such as the blood circulating in their body is getting less and less (diminishing of the foreign currency reserves, capital outflow) due to a wounded area on their body (weaknesses in their economies and mismatches of the duration of loans and investments) or perhaps patients may have heart attacks (negative supply shocks) due to institutional inefficiencies, and so forth. In the ER, the patient is given some blood to replace that, which it lost, or is saved from the heart attack. The amount of reserved blood is limited and can be collected from healthy (financially healthy)

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[62] Corden, 245-260.
[63] Ibid., 257.

donators only (the G-7 countries). Therefore the wound must be healed as soon as possible in order to keep the blood reserves of the ER available for other potential patients. In order to heal the wound the patient must be transferred to a hospital where it can be taken care of for a long term. Future heart attacks can be avoided or made less painless after successful diagnosis of the causes of the attacks in a hospital.

It is my understanding that the IMF does not yet have the long term facilities that a hospital does. The SDRM suggested by Krueger can be a good place to start building such a hospital. The IMF with its current status can save the countries from "heart attacks and losing blood" but it needs to incorporate changes in order to dive into root causes of the problems. It must explain its patients that the only prescription that will save them in the long run is to learn how to have a healthy living. Healthy living is like having good institutions, e.g. right incentives and less corruption. Healthy living will prevent heart attacks and good institutions will prevent crises.

Another important reality is that hospitals, too, have limited blood reserves, meaning that the IMF cannot become this desired lender of last resort. It is possible that the patients have more prolonged sicknesses like cancer (like the institutional inefficiencies caused by chaebol in Korea) which can only be treated in a hospital and not in an ER.

I agree with Blustein on the fact that the foreign investors should be careful in lending to countries with weak institutions as they may encourage the officials of that country to keep having their unsound policies. Above all the citizens of developed countries some of whose taxes are given to the IMF's hands must be informed about how they are used.

I also agree with Desai that the hedge funds must be made more transparent and regulated. I propose that if a country is operating under a fixed exchange rate system, then the

hedge funds ability to obtain that country's currency must be limited trough legal terms. That way their destabilizing effects are eliminated. Whenever that country incorporates a floating exchange rate regime, then the hedge funds can participate in currency market. That way both parties win: the country experiences the stabilizing effect of the hedge funds and the hedge funds have one more currency market to function. Thus countries will have an additional incentive to switch to a floating exchange rate regime as soon as possible.

Next, I must admit that I agree with Rogoff about what to do when there are big and unsustainable budget deficits. For countries with unsustainable budget deficits, the applicability of Keynesian economics is debatable. It is true that the US recovered from Great Depression partially through expansionary policies (having initially implemented contractionary ones which turned out to be disastrous), but one must keep in mind that US at that time had the level of institutional efficiency to enable the correct application of those policies. Therefore, the IMF's hesitance regarding expansionary policies in developing countries is understandable. However, the IMF's insistence on contractionary policies until the budget is under control signals its distrust of a country's economy, which shakes the confidence in markets. The metaphor that I described with regard to Rogoff, the IMF's role as father of a developing country, can be taken further by the IMF. The father can start treating his child more like an adult once he starts to show signs of wanting to make up for his loss and assigns him responsibilities such as finding a job to compensate for his loss. He may let his child borrow money from his friends and/or mother, friends and mother being treasury bonds in this case, while looking for a job. With a better understanding of life, the child will hopefully find a job and make up for his loss and pay everybody back.

Referring to Rogoff's argument about temporary capital controls, an important question is if it is possible to implement capital controls until a country creates the required level of institutional efficiency and then to remove the capital controls. In my opinion, this depends on very much the skills of a country's government and institutions including NGOs that can work together to improve the institutional efficiency and markets of their country so that the capital controls can be minimized with time; and even introduced again when needed and lifted when not needed anymore.

Finally, I agree with Desai that the IMF needs to become more transparent. At the end, the IMF policies will be shaped by the whole world, which may be fairer to everybody.

VIII. Conclusion

The analyses presented throughout this paper demonstrate step-by-step the mistakes made by the IMF, and the harmful impact those mistakes had on the regional economy and international market. In response to the mistakes made by the IMF, I have proposed numerous suggestions and potential solutions for IMF policy and for the institution of the IMF itself. I believe that the implementation of these proposals would create an IMF that can better respond to international crises, and mitigate rather than augment them. It is important for the IMF and the recipients of IMF credit, to coordinate policy in a long-term manner. Specifically, there must be some institutional framework which can diagnose potential signs for crises, and perhaps provide pre-emptive aid.

This paper also raised questions about the credit-receiving countries ability to recover from crises and prevent the future ones. It is important to recognize the responsibility of the developing countries themselves in financial crises, and for this reason I support a gradualist approach to the liberalization of capital markets.

It is essential to identify the cause of the crisis in order to provide the best remedy for the source of the problem, and not just the symptoms thereof. With this long-term perspective, the IMF and the international community as a whole can take a *proactive*, rather than a *reactive*, role with regard to financial crises. With a proactive role, the IMF could potentially stop crises before they start, or at least prevent the contagion thereof. In this way, my proposal for a reform of the IMF would, potentially, ensure that crises such as those in East Asia would not be repeated.

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