

## **Refocusing the IMF.**

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#### OVERDOING IT IN EAST ASIA

In the Asian currency crisis, the International Monetary Fund is risking its effectiveness by the way it now defines its role as well as by its handling of the problems of the affected countries. The IMF'S recent emphasis on imposing major structural and institutional reforms as opposed to focusing on balance-of-payments adjustments will have adverse consequences in both the short term and the more distant future. The IMF should stick to its traditional task of helping countries cope with temporary shortages of foreign exchange and with more sustained trade deficits.

Today's emphasis on structural and institutional reforms has not always been part of IMF programs. The IMF was founded in 1945 to help operate a system of fixed exchange rates, in which all currencies were pegged to the dollar, in turn fixed with respect to gold, that experts then considered necessary to encourage international trade. Although that system succeeded temporarily, differences in inflation between countries forced many to alter their currency values. When the fixed-rate system collapsed completely in 1971, the IMF was forced to find a new *raison d'etre*.

The fund found a new and important role, which is still appropriate for the current crisis, in the 1980s. Changes in economic conditions led Mexico and other Latin American countries to announce they could not meet the interest and principal payments on their large borrowings from overseas commercial banks. A default on those obligations would have wiped out the capital of many leading banks in the United States, Europe, and Japan, so the U.S. government provided a temporary bridge loan that allowed Mexico to meet its imminent payments. Negotiations then began between the Mexican government and representatives of the lending banks, who agreed to restructure the debts, lengthening maturities and lending additional money with which the borrowers could meet part of their interest obligations. Similar negotiations were later conducted with the other Latin American debtors.

To meet their interest obligations and reduce their outstanding debt, Latin American countries had to earn more foreign exchange by increasing their exports or decreasing their imports. So Latin American governments raised taxes, cut government outlays, and tightened credit to reduce domestic uses of national output. The IMF monitored these adjustments and provided moderate amounts of credit to indicate that it was satisfied with the policy progress that the debtors were making. But the primary provision of credit was left to negotiations between the foreign banks and each of the debtor countries.

Over time the process was successful. The region's economic growth eventually resumed, and the countries were generally able to service their rescheduled debts. The commercial banks wrote off some loans of small, heavily indebted countries. In the end the banks swapped their remaining loan balances for so-called Brady Bonds that had government guarantees but paid less interest or had a reduced principal. This approach succeeded because of a general recognition that the problem of the major Latin American countries was one of liquidity rather than insolvency-

-that is, they were temporarily unable to pay current foreign obligations but were not permanently unable to earn enough foreign currency by exporting to service and repay their debts.

The next major chapter in the IMF's history began with the collapse of the Soviet Union and the liberation of its former European satellites. These countries needed to shift from communism to a market economy and to integrate themselves into international financial markets. Their officials, bankers, and economists had little or no experience with market economics. The IMF could therefore provide useful advice on a much wider range of economic issues than it had previously done in Latin America or elsewhere in the world. Much of this advice--about the strategy of privatization, banking systems, and tax structures--was useful. Much of it was also controversial. But while economists outside the fund had a variety of views about the right way for Russia and the other countries of Eastern Europe and the former Soviet Union to proceed, the IMF was generally able to get its way because it brought substantial financial rewards to countries that accepted its advice.

The IMF is now acting in Southeast Asia and Korea in much the same way that it did in Eastern Europe and the former Soviet Union: insisting on fundamental changes in economic and institutional structures as a condition for receiving IMF funds. It is doing so even though the situations of the Asian countries are very different from that of the former Soviet Union and Eastern Europe. In addition, the IMF is applying its traditional mix of fiscal policies (higher taxes, less government spending) and credit tightening (implying higher interest rates) that were successful in Latin America. To assess the appropriateness of these policies, it is necessary to understand what is happening in Asia.

#### THE ASIAN MELTDOWN

The Southeast Asian currency collapse that began in Thailand was an inevitable consequence of persistent large current account deficits and of the misguided attempt of Thailand, Indonesia, Malaysia, and the Philippines to maintain fixed exchange rates relative to the dollar. Thailand's current account deficit--the sum of its trade deficit and the interest on its foreign obligations--had exceeded four percent of Thailand's GDP since 1990, implying that Thailand had to attract that much foreign capital each year. Such large current account deficits have inevitably ended in a sharp decline in the local currency's value when foreign creditors and domestic investors became concerned that the borrower would be unable to service its debts. Thailand's large current account deficit persisted for a surprisingly long time because creditors believed that Thailand might be "different" since much of the capital inflow came as direct investment by Japanese manufacturing firms and lending by their affiliated banks. Creditors also derived confidence from Thailand's high savings rate and its government budget surplus, noting that the current account deficit reflected enormously high business investment rather than government or consumer profligacy. But the primary thing that kept foreign funds coming to Thailand and local funds staying there was the combination of relatively high interest rates on Thai baht deposits and a promise that the baht's value would remain fixed at 25 baht per dollar. It looked like too good a deal to pass up.

But the baht's fixed value relative to the dollar could not be sustained. The pressure for a devaluation of the baht increased in 1996 and 1997 when the Japanese yen declined by 35 percent relative to the dollar. Since Japan is Thailand's major trading partner, the sharp rise in the value of the dollar (and therefore of the baht) relative to the yen made Thai products more expensive and therefore less competitive and pointed to even larger trade deficits in the future. Foreign speculators as well as local investors began to sell bahts. The Thai government secretly bought the baht to support its value but eventually had to give up. At that point the IMF stepped in with a multibillion dollar rescue plan.

The Thai currency collapse spread to Indonesia, Malaysia, and the Philippines as financial investors became worried about their large current account deficits, high ratios of foreign debt to

local GDP, and deteriorating trade competitiveness. Each country was forced to abandon its fixed exchange-rate policy and let the market determine the currency's value. Indonesia lacked the reserves to meet its short-term obligations and called in the IMF. Malaysia has not yet done so, while the Philippines was already in an IMF program when the crisis began.

All of these countries clearly need to shrink their current account deficits by increasing exports and reducing imports. That in turn requires reductions in public and private consumption and investment. The proper remedy is a variant of the traditional IMF medicine tailored specifically to each country--some combination of reduced government spending, higher taxes, and tighter credit. Even in those countries where government budgets are already in surplus, an increase in taxes or a reduction in government spending will shrink the current account deficit. The experience in Latin America provides a useful model of what can be done.

But the IMF's role in Thailand and Indonesia went far beyond the role that it played in Latin America. Instead of relying on private banks and serving primarily as a monitor of performance, the IMF took the lead in providing credit. In exchange, it has imposed programs requiring governments to reform their financial institutions and to make substantial changes in their economic structures and political behavior. The conditions imposed on Thailand and Indonesia were more like the comprehensive reforms imposed on Russia, including the recent emphasis on reducing Russian corruption, than like the macroeconomic changes that were required in Latin America. In Indonesia, for example, in exchange for a \$40 billion package (more than 25 percent of Indonesia's GDP), the IMF has insisted on a long list of reforms, specifying in minute detail such things as the price of gasoline and the manner of selling plywood. The government has also been told to end the country's widespread corruption and curtail the special business privileges used to enrich President Suharto's family and the political allies that maintain his regime. Although such changes may be desirable in many ways, past experience suggests that they are not needed to maintain a flow of foreign funds.

The Korean situation is different from that of the four countries of the Association of Southeast Asian Nations and is more important because its economy is the 11th-largest in the world. Korea's problem did not stem from an overvalued exchange rate and an excessive current account deficit. The value of the Korean won had not been fixed in recent years but had gradually adjusted to maintain Korea's competitiveness. A collapse of the market for semiconductors, a major Korean export, had caused Korea's current account deficit to jump from 1.7 percent of GDP in 1995 to 4.7 percent of GDP in 1996. But by mid-1997 it was already back to a 2.5 percent annual rate and heading lower.

The Korean economy was performing well: real GDP grew at eight percent per year in the 1990s, as it had in the 1980s, inflation was below five percent, and the unemployment rate was less than three percent. Although there were recent bankruptcies among the smaller business conglomerates and merchant banks, this was clearly an economy to envy. Korea got in trouble in mid-1997 because its business and financial institutions had incurred short-term foreign debts that far exceeded Korea's foreign exchange assets. By October, U.S. commercial banks estimated that Korea's short-term debts were \$110 billion--more than three times Korea's foreign exchange reserves. With investors nervous about emerging markets in general and Asia in particular, it is not surprising that the Korean won came under attack.

Since Korea's total foreign debt was only about 30 percent of GDP (among the lowest of all developing nations), this was clearly a case of temporary illiquidity rather than fundamental insolvency. Moreover, since the current account deficit was very small and rapidly shrinking, there was no need for the traditional IMF policy of reduced government spending, higher taxes, and tight credit. Yet something needed to be done to stop the loss of foreign exchange and to maintain bank lending to the country and its healthy businesses. Because of the overhang of excess short-term foreign liabilities, each foreign bank acting independently had a strong

incentive not to roll over its loans. Investors, fearing a drain on Korea's reserves and a depressed won, were induced to anticipate the process by selling the won immediately.

What Korea needed was coordinated action by creditor banks to restructure its short-term debts, lengthening their maturity and providing additional temporary credits to help meet the interest obligations. The creditors should have preferred this course to having the borrowers default on their loans, just as the creditors did 15 years earlier in their negotiations with the Latin American debtors. The rate of interest required to attract such long-term foreign lending on a voluntary basis--and thereby avoid a withdrawal of private lending to other emerging-market countries--was about four percentage points above the interest rate on U.S. Treasury bonds and therefore well within what Korea could finance by its exports. During November the interest rate on ten-year dollar bonds issued by the government-backed Korea Development Bank varied between two percent and four percent above the interest rate on U.S. Treasury bonds. Even a four percent premium on a completely restructured Korean foreign debt would have been equal to only about one percent of Korea's GDP and about four percent of its exports. The IMF could have helped by providing a temporary bridge loan and then organizing the banks into a negotiating group. (In fact, the IMF did just that in late December with the help of the national central banks after its original plan had failed.)

Instead, the IMF organized a pool of \$57 billion from official sources--the IMF, the World Bank, the U.S. and Japanese governments, and others--to lend to Korea so that its private corporate borrowers could meet their foreign currency obligations to U.S., Japanese, and European banks. In exchange for those funds, the IMF demanded a fundamental overhaul of the Korean economy and a contractionary macroeconomic policy of higher taxes, reduced spending, and high interest rates.

The IMF's program emphasized eight structural problems of the Korean economy that it said had to be changed. Foreign investors are not able to acquire Korean businesses by purchasing their shares or to own majority stakes in Korean businesses. Korea's domestic financial markets are not fully open to foreign banks and insurance companies. Imports of some industrial products are still restricted, especially Japanese cars. Korean banks do not apply good Western banking standards of credit evaluation but follow what might be called the Japanese development model, in which the government guides banks to lend to favored industries in exchange for an implicit guarantee of the loans. The Bank of Korea is not independent and does not have price stability as its only goal. The corporate structure involves large conglomerates (the chaebols) with an extremely wide range of activities and opaque financial accounts. Korean corporations generally have very high debt-to-capital ratios that make them risky debtors for domestic and foreign lenders. Finally, Korean labor laws make layoffs very difficult and provide strong impediments to the flow of workers between firms.

The IMF said that it would provide credit only as Korea altered these central features of its economy. It predicted that economic growth in 1998 would be only half the 1997 level and that the unemployment rate would double. These conditions would be exacerbated by the IMF's requirement for high interest rates and for tighter fiscal policy to reduce the budget deficit between 1997 and 1998. Many private observers estimated that the adverse effects on output and employment would be substantially worse.

## EVALUATING THE STRATEGY

The fundamental issue is the appropriate role for an international agency and its technical staff in dealing with sovereign countries that come to it for assistance. It is important to remember that the IMF cannot initiate programs but develops a program for a member country only when that country seeks help. The country is then the IMF'S client or patient, but not its ward. The legitimate political institutions of the country should determine the nation's economic structure and the nature of its institutions. A nation's desperate need for short-term financial help does not give the

IMF the moral right to substitute its technical judgments for the outcomes of the nation's political process.

The IMF should provide the technical advice and the limited financial assistance necessary to deal with a funding crisis and to place a country in a situation that makes a relapse unlikely. It should not use the opportunity to impose other economic changes that, however helpful they may be, are not necessary to deal with the balance-of-payments problem and are the proper responsibility of the country's own political system.

In deciding whether to insist on any particular reform, the IMF should ask three questions: Is this reform really needed to restore the country's access to international capital markets? Is this a technical matter that does not interfere unnecessarily with the proper jurisdiction of a sovereign government? If the policies to be changed are also practiced in the major industrial economies of Europe, would the IMF think it appropriate to force similar changes in those countries if they were subject to a fund program? The IMF is justified in requiring a change in a client country's national policy only if the answer to all three questions is yes.

The Korean case illustrates the need for this test very well. Although many of the structural reforms that the IMF included in its early-December program for Korea would probably improve the long-term performance of the Korean economy, they are not needed for Korea to gain access to capital markets. They are also among the most politically sensitive issues: labor market rules, regulations of corporate structure and governance, government-business relations, and international trade. The specific policies that the IMF insists must be changed are not so different from those in the major countries of Europe: labor market rules that cause 12 percent unemployment, corporate ownership structures that give banks and governments controlling interests in industrial companies, state subsidies to inefficient and loss-making industries, and trade barriers that restrict Japanese auto imports to a trickle and block foreign purchases of industrial companies.

Imposing detailed economic prescriptions on legitimate governments would remain questionable even if economists were unanimous about the best way to reform the countries' economic policies. In practice, however, there are substantial disagreements about what should be done. Even when there has been near unanimity about the appropriate economic policies, the consensus has changed radically. After all, the IMF was created to defend and manage a fixed exchange-rate system that is now regarded as economically inappropriate and practically unworkable. Similarly, for a long time the advice to developing countries that came from the World Bank, the IMF's sister institution, and from leading academic specialists emphasized national plans for government-managed industrial development. The official and very influential U.N. Economic Commission for Latin America preached the virtues of protectionist policies to block industrial imports in order to encourage countries to develop their own manufacturing industries. Now the consensus of professional economists and international agencies calls for the opposite policies: flexible exchange rates, market-determined economic development, and free trade.

Today, there is nothing like unanimity about the appropriate policies for Korea or Southeast Asia. Korea's outstanding performance combining persistently high growth, low inflation, and low unemployment suggests that the current structure of the Korean economy may now be well suited to Korea's stage of economic and political development and to Korean cultural values stressing thrift, self-sacrifice, patriotism, and worker solidarity. Even if it were desirable for Korea to shift toward labor, goods, and capital markets more like those of the United States, it may be best to evolve in that direction more gradually and with fewer shocks to existing businesses. Unless the reforms could only be done under the duress of an IMF program or are specifically needed to end the liquidity problem, making the transition in the midst of a currency crisis would be very poor timing.

The short-term macroeconomic policies that the IMF prescribed for Korea are equally controversial. The program calls for the traditional IMF prescription of budget deficit reduction (by raising taxes and cutting government spending) and a tighter monetary policy (higher interest rates and less credit availability), which together depress growth and raise unemployment. But why should Korea be required to raise taxes and cut spending to lower its 1998 budget deficit when its national savings rate is already one of the highest in the world, when its 1998 budget deficit will rise temporarily because of the policy-induced recession, and when the combination of higher private savings and reduced business investment are already freeing up the resources needed to raise exports and shrink the current account deficit?

Under the IMF plan, the interest rate on won loans is now about 30 percent, while inflation is only 5 percent. Because of the high debt typical of most Korean companies, this enormously high real interest rate of 25 percent puts all of them at risk of bankruptcy. Why should Korea be forced to cause widespread bankruptcies by tightening credit when inflation is very low, when the rollover of bank loans and the demand for the won depend more on confidence than on Korean won interest rates, when the failures will reduce the prospect of loan repayment, and when a further fall in the won is an alternative to high interest rates as a way to attract won-denominated deposits? Although a falling won would increase the risk of bankruptcies among Korean companies with large dollar debts, the overall damage would be less extensive than the bankruptcies caused by very high won interest rates that would hurt every Korean company. Finally, why should Korea create a credit crunch that will cause even more corporate failures by enforcing the international capital standards for Korean banks when the Japanese government has just announced that it will not enforce those rules for Japanese banks in order to avoid a credit crunch in Japan?

#### ENCOURAGING EXCESSIVE RISK

The IMF faces a serious dilemma whenever it deals with a country that cannot meet its obligation to foreign creditors. The IMF can encourage those creditors to roll over existing loans and provide new credit by promising them that they will be repaid in full. That type of guarantee was implicit in the IMF's \$57 billion credit package for Korea. But promising creditors that they will not lose in the current crisis also encourages those lenders and others to take excessive future risks. Banks that expect loans to be guaranteed by governments do not look as carefully as they should at the underlying commercial credit risks. And when banks believe that the availability of dollars to meet foreign exchange obligations will be guaranteed by the IMF, they will not look carefully at the foreign exchange risk of the debtor countries.

There is no perfect solution to this "moral hazard" problem. In principle, the IMF and the Korean government should provide the guarantees needed to keep current creditors engaged while swearing that it is the last time that such guarantees will be provided. Although there may be no way to make such a promise persuasively, the IMF may have encouraged future lenders too much by the speed with which it took control--without waiting for lenders and borrowers to begin direct negotiations with each other. The call by IMF Managing Director Michel Camdessus for member governments to provide an additional \$60 billion in IMF resources, on top of the \$100 billion increase requested last September, just after announcing the Korean program in December also encourages banks and other lenders to believe they will be bailed out in the future.

At the same time, the message to emerging-market countries sent by painful and comprehensive reform programs was that they should avoid calling in the IMF. Malaysia is now doing just that, even though its conditions are roughly similar to those of Thailand and Indonesia. More generally, the tough program conditions make it difficult to get a country to work with the IMF until it is absolutely necessary. The IMF appears like the painful dentist of the old days: just as patients postponed visits until their teeth had to be pulled, the countries with problems wait too long to seek technical advice and modest amounts of financial help.

The desire to keep out of the IMF'S hands will also cause emerging-market economies to accumulate large foreign currency reserves. A clear lesson of 1997 was that countries with large reserves could not be successfully attacked by financial markets. Hong Kong, Singapore, Taiwan, and China all have very large reserves, and all emerged relatively unscathed. A country can accumulate such reserves by running a trade surplus and saving the resulting foreign exchange. It would be unfortunate if developing countries that should be using their export earnings to finance imports of new plants and equipment use their scarce foreign exchange instead to accumulate financial assets.

When the foreign exchange crisis hit Korea, the primary need was to persuade foreign creditors to continue to lend by rolling over existing loans as they came due. The key to achieving such credit without an IMF guarantee of outstanding loans was to persuade lenders that Korea's lack of adequate foreign exchange reserves was a temporary shortage, not permanent insolvency. By emphasizing the structural and institutional problems of the Korean economy, the fund's program and rhetoric gave the opposite impression. Lenders who listened to the IMF could not be blamed for concluding that Korea would be unable to service its debts unless its economy had a total overhaul. Given the magnitude of the prescribed changes, lenders might well be skeptical about whether Korea would actually deliver the required changes, regardless of what legislation it enacted. Even the \$57 billion IMF pool did not promote confidence in Korea's ability to pay since the IMF emphasized that the money would be released only as Korea proved that it was conforming to the IMF program. Unsurprisingly, after the program was announced, the bond rating agencies downgraded Korean debt to junk bond status.

As a result, by late December Korea's reserves were almost gone, shrinking at a rate of \$1 billion a day. The U.S. government and the IMF recognized that the original strategy had failed and agreed to accelerate \$10 billion of the committed loans as a bridge to prevent a default. More important, the U.S. Federal Reserve and the other major central banks called in the leading commercial banks and urged them to create a coordinated program of short-term loan rollovers and longer-term debt restructuring. The banks agreed to roll over the loans coming due immediately, and the crisis was averted. The banks are now meeting with the Korean government to develop plans for longer-term restructuring. The situation in Korea might have been much better and the current deep crisis avoided had such negotiations begun much earlier.

Several features of the IMF plan are replays of the policies that Japan and the United States have long been trying to get Korea to adopt. These included accelerating the previously agreed upon reductions of trade barriers to specific Japanese products and opening capital markets so that foreign investors can have majority ownership of Korean firms, engage in hostile takeovers opposed by local management, and expand direct participation in banking and other financial services. Although greater competition from manufactured imports and more foreign ownership could in principle help the Korean economy, Koreans and others saw this aspect of the plan as an abuse of IMF power to force Korea at a time of weakness to accept trade and investment policies it had previously rejected.

The IMF would be more effective in its actions and more legitimate in the eyes of emerging-market countries if it pursued the less ambitious goal of maintaining countries' access to global capital markets and international bank lending. Its experts should focus on determining whether the troubled country's problem is one of short-term liquidity and, if so, should emphasize that in its advice and assistance. The IMF should eschew the temptation to use currency crises as an opportunity to force fundamental structural and institutional reforms on countries, however useful they may be in the long term, unless they are absolutely necessary to revive access to international funds. It should strongly resist the pressure from the United States, Japan, and other major countries to make their trade and investment agenda part of the IMF funding conditions.

The IMF should remember that the borrowers and the lending bankers or bondholders should bear primary responsibility for resolving the problems that arise when countries or their

corporations cannot meet their international debt obligations. The IMF should provide technical assistance on how the debtors can improve their current account balances and increase their foreign exchange. It should act as a monitor of the success that the country is making in moving toward self-sustainable liquidity, providing its own funds as an indication of its confidence in the country's progress rather than as a bailout of international lenders and domestic borrowers. If the IMF can focus its attention on this narrower agenda, it can devote more of its scarce staff talent to the problem of crisis prevention. The IMF should work with countries that have not yet reached a currency crisis in order to prevent the large current account deficits or the excess short-term debts that could later precipitate a crisis. If the fund is seen more as a client-focused and supportive organization than as the imposer of painful contractions and radical economic reforms, it is likely to find that countries will be more willing to invite its assistance when it can be most helpful.

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