Article • August 2007

Ten Years After: The Lasting Impact of the Asian Financial Crisis

BY MARK WEISBROT*

The Asian financial crisis, which began ten years ago, was in many ways a formative event at the end of the 20th century. It brought to the forefront some pressing problems with the international financial system: the dangers of sudden reversals of capital flows (which precipitated the crisis); the problem of "contagion" – a new phenomenon as the crisis spread, for no clear reason other than the herd behavior of investors - to Russia and then Brazil; and the pro-cyclical nature of international financial markets – that is, international capital flows tended to come in when economies were growing and even overheating, and exit during downturns, thus exacerbating the swings of business cycles.

It changed some of the ways that economists and other observers think about the international financial system. For example, the idea that developing countries would necessarily gain from increased opening of their economies to international capital flows then prevailed in the most important policy and media circles at that time. Today there is more skepticism.

As a result of the crisis and the subsequent heightened understanding of these problems, there were a whole series of proposals for reform of what was often called "the international financial architecture." [1] These proposals included some very ambitious reforms: an international currency; a world central bank; an international regulatory body for the world financial system; an international bankruptcy court; and proposals for sweeping reforms of the International Monetary Fund (IMF). Some of these ideas were sound and sensible.

Ten years later, none of these proposed reforms have come to fruition. But something just as important actually did happen – in fact it is the biggest change in the international financial system since the breakdown of the Bretton Woods System of fixed exchange rates in 1973. The Asian crisis set in motion a process in which the IMF has lost most of its power over middle-income countries. This is a sea change in the developing world, and it is likely to be the most lasting impact of the crisis.

Center for Economic and Policy Research
1611 Connecticut Ave, NW
Suite 400
Washington, DC 20009
tel: 202-293-5380
fax:: 202-588-1356
www.cepr.net

*Mark Weisbrot is Co-Director at the Center for Economic and Policy Research.

This article will be published in an Asia Program, Woodrow Wilson International Center for Scholars publication, entitled *The Tenth Anniversary of the Asian Financial Crisis: Lessons Learned, Critical Assessments, and Charting the Path Forward.*

[1] See, e.g., Eichengreen, Barry J. *Towards a New International Financial Architecture: A Practical Post-Asian Agenda.* The Peterson Institute for International Economics: 1999, for an overview.

The reason that this is so important is because the IMF had vastly more power and influence over economic policy in developing countries than it would be able to exert on the basis of just its own lending. Of course, even this lending has been drastically reduced: its loan portfolio has shrunk from $96 billion as recently as four years ago to $20 billion today, with about half of the current loans owed by Turkey. But the real power of the IMF came from its position as "gatekeeper" for official credit, which gave it control over a very influential creditors' cartel. A borrowing country that did not meet IMF conditions would often not be eligible for loans from the much larger World Bank, regional banks such as the Inter-American Development Bank (IDB), high-income country governments including those belonging to the Paris Club, and sometimes even the private sector. This often gave the Fund enormous influence over economic policy in developing countries. Since the US Treasury Department holds not only a veto but an overwhelming dominance within the IMF – the other developed countries including Europe and Japan could outvote the United States but have not chosen to do so in the last 63 years – the IMF was also the most important avenue of influence for the United States in developing countries.

The IMF's failure in the Asian crisis was profound and publicized as never before, which permanently damaged the institution's credibility and authority in much of the world.

First, the IMF failed to act as a lender of last resort, when such a lender was most needed. In the Asian crisis, this would have been towards the beginning of the crisis, which began with the devaluation of the Thai baht in July of 1997. At that time the economies of the region were not beset by the kinds of serious structural imbalances or weaknesses that would by themselves have warned of disaster. [2] The regional current account deficit peaked at 5.9 percent of GDP in 1996, which is high but not overwhelming by historical standards, and it ranged from 3.5 percent for Indonesia to 8 percent for Thailand. But until the crisis, the countries were all taking in capital flows in excess of their current account deficits, and accumulating foreign exchange reserves. And all five countries were running domestic budget surpluses, or balanced budgets. So while some adjustment in the current account was due, there was no need for the depression that ensued.

The problem was caused by a sudden reversal of private international capital flows to the region: from a net inflow of $92.8 billion in 1996 to a net outflow of $12.1 billion in 1997. This $105 billion turnaround represented, in one year, about 11 percent of the GDP of the five countries. To a large extent this speculative reversal was the result of policies that were strongly promoted by the IMF and the U.S. Treasury department. This build-up of short-term international borrowing was a result of the financial liberalization that took place in the years preceding the crisis. In South Korea, for example, this included the removal of a number of restrictions on foreign ownership of domestic stocks and bonds, residents' ownership of foreign assets, and overseas borrowing by domestic financial and non-financial institutions.[3] Korea's foreign debt nearly tripled from $44 billion in 1993 to $120 billion in September 1997. This was not a very large debt burden for an economy of Korea's

[2] The IMF's subsequently much-criticized 1997 annual report, published after the crisis had already begun, was optimistic for the region: "Directors welcomed Korea's continued impressive macroeconomic performance [and] praised the authorities for their enviable fiscal record." (IMF Annual Report 1997; page 57). The directors also "strongly praised Thailand's remarkable economic performance and the authorities' consistent record of sound macroeconomic policies." (Sachs, Jeffrey. "IMF is a Power Unto Itself," *The Financial Times*, December 11, 1997)

[3] Chang, Ha-Joon, Hong-Jae Park, Chul Gyue Yoo. 1998. "Interpreting the Korean Crisis - financial liberalisation, industrial policy, and corporate governance." *Cambridge Journal of Economics*, vol. 22, no. 6.

size, but the short-term percentage was high at 67.9 percent by mid-1997.[4] For comparison, the average ratio of short-term to total debt for non-OPEC less developed countries at the time of the 1980s debt crisis (1980-82) was twenty percent.[5]

Financial liberalizations in the other countries led to similar vulnerabilities. Thailand created the Bangkok International Banking Facility in 1992, which greatly expanded both the number and scope of financial institutions that could borrow and lend in international markets. Indonesian non-financial corporations borrowed directly from foreign capital markets, piling up $39.7 billion of debt by mid 1997, eighty-seven percent of which was short-term.[6] On the eve of the crisis the five countries had a combined debt to foreign banks of $274 billion, with about sixty-four percent in short-term obligations. The high percentage of short-term debt, especially relative to reserves, turned out to be deadly when investor panic set in.

Both the U.S. Treasury Department and the IMF pushed strongly for the legal changes that created the pre-crisis situation. The IMF went so far as to seriously consider changing its charter to make "capital account liberalization" - encouraging countries to remove restrictions on international borrowing and investing - a permanent part of its responsibility.[7]

The Asian crisis was a direct result of this financial liberalization, and the logic was fairly straightforward. With a high level of short-term international debt, a depreciation of the domestic currency increases the cost of debt service. Everyone needs more domestic currency to get the same amount of dollars for debt service, and the selling of domestic currency to get those dollars or other "hard" currencies drives the domestic currency down further. It does not take much to set off a rush for the exits, especially if the central bank does not have a high level of foreign currency reserves relative to the short-term debt. These reserves shrink further as more and more investors convert their domestic currency and domestic assets into dollars. Foreign lenders refuse to renew the short-term loans, and the downward spiral continues.

If ever there was a situation in which a lender of last resort could have made all the difference in the world - simply by providing reserves so that investors did not believe they had to get out today or get few or zero dollars tomorrow - this seemed to be it. But the IMF and its supervisor, the U.S. Treasury Department, were not interested in this kind of a solution. In September 1997, when it was still early enough to prevent most of the disaster, Japan proposed at a meeting of regional finance ministers that an "Asian Monetary Fund" be created in order to provide liquidity to the faltering economies faster, and with fewer of the conditions imposed by the IMF. This fund was to have been endowed with as much as $100 billion in emergency resources, which would come not only from Japan, but from China, Taiwan, Hong Kong, Singapore, and other countries, all of whom supported the proposal. After strenuous opposition from the U.S. Treasury Department, which insisted that the IMF must determine the conditions of any bailout before any other funds were committed, the plan was dropped by November. It is impossible to tell how things might have turned out

[4] Radelet, Steven and Jeffrey Sachs. 1998b. "The East Asian Financial Crisis: Diagnosis, Remedies, Prospects." Harvard Institute for International Development, April 20, 1998.

[5] Chang et al, 1998.

[6] Bank for International Settlements data cited in Radelet and Sachs 1998b.

[7] "It is time to add a new chapter to the Bretton Woods agreement," wrote the IMF's Interim Committee in 1997, as the Asian crisis was getting under way. "Private capital flows have become much more important to the international monetary system, and an increasingly open and liberal system has proved to be highly beneficial to the world economy." (Interim Committee Statement on the Liberalization of Capital Movements Under an Amendment of the IMF's Articles, issued on September 21, 1997. See http://www.imf.org/external/pubs/ft/survey/pdf/100697.pdf)

differently, but it is certainly conceivable that not only the depression, but also even the worst of the currency collapses, might have been avoided if the fund had been assembled and deployed quickly at that time.[8]

After establishing itself as the broker for any international settlement, the IMF recommended a series of policies that appear to have worsened the crisis. Most of these followed a pattern of misdiagnosis that was seen in Argentina and elsewhere: high interest rates and a tightening of domestic credit to slow economic growth; fiscal tightening, including cuts in food and energy subsidies in Indonesia (later rescinded there after rioting broke out); and amazingly, further liberalization of international capital flows. South Korea, for example, was required to abolish nearly all of its remaining restrictions on capital flows, including those relating to the domestic financial services market and foreign exchange controls.[9] The IMF's inflation target for South Korea was 5.2 percent for 1998, as compared to 4.2 percent for the previous year. But the Korean currency (the won) had depreciated by 80 percent, making this target nearly impossible to achieve without a severe recession or depression.

The IMF made other serious mistakes that worsened the crisis. One of these was later acknowledged as an error in an internal Fund memo that was leaked to the press. This was the closing of sixteen Indonesian banks, a move that the IMF thought would help restore confidence in the banking system. Instead it led to panic withdrawals by depositors at remaining banks, further destabilizing the financial system.[10]

In the first few months of its intervention, the IMF also failed to arrange a roll-over of the short-term foreign debt owed by Indonesian non-financial firms. Indonesia was thus unable to stabilize its currency and economy, and firms could not obtain the necessary credits for essential imports and even exports. The Indonesian currency actually took its worst plunge just days after the second IMF agreement was signed in January of 1998. And the amounts of funds dispersed (much smaller than those committed) were too little and too late to slow the damage: in Indonesia, for example, only $3 billion had been disbursed by March 1998, as compared to a $40 billion commitment.[11] Even the IMF's own Independent Evaluation Office conceded that "[I]n Indonesia . . .the depth of the collapse makes it difficult to argue that things would have been worse without the IMF. . ."[12]

In retrospect, it is not surprising that the IMF failed to restore market confidence in the region. The Fund was negotiating, first of all, for recessionary conditions with the affected countries. This is generally the wrong thing to do in a recession; but the error was even less defensible in the Asian crisis then it had been in other, similar IMF interventions. The Asian countries had high national savings rates, low inflation, and balanced budgets. The only "structural adjustment" that was arguably needed was, in some cases, a reduction of the current account deficit. This could be, and

[8] Felix, 1998 has argued this point; for details on the politics of the proposal, see Altbach, 1997. (Felix, David. "IMF: Still Bungling in Asia," *Journal of Commerce*, July 9, 1998; Altbach, Eric. 1997. "The Asian Monetary Fund Proposal: A Case Study of Japanese Regional Leadership." Japan Economic Institute Report no. 47A, December 19.)

[9] Yung Chul Park, "Gradual Approach Capital Account Liberalization: the Korean Experience"; March 9, 1998.

[10] See Sanger, David E. "IMF Reports Plan Backfired, Worsening Indonesia Woes," *New York Times*; January 14, 1998.

[11] See Radelet and Sachs (1998b), for some of these and other arguments regarding the failure of the IMF to restore market confidence.

[12] IMF Independent Evaluation Office. "The IMF and Recent Capital Account Crises: Indonesia, Korea, Brazil," page 38.

was, in fact, accomplished through increased exports and reduced imports due to currency depreciation. There was no reason to further shrink demand through monetary and fiscal austerity.

In the crucial first few months of the crisis (August to December 1997), the IMF concentrated on structural "reforms," and put forth the argument that the crisis was due to "fundamental structural weaknesses"[13] in these economies, rather than the much more easily resolvable liquidity problem that actually caused the crisis. The proposed structural reforms were in some cases politically unpalatable and economically unnecessary or even harmful: for example, mass layoffs in the Korean auto industry, which led to strikes and riots. There were the usual demands for trade liberalization and privatization. The conditions placed on Indonesia were unusually far-reaching and numerous - about 140 in all. They included not only removal of some restrictions on foreign investment, reducing tariffs and closing some banks, but such details as "allowing cement producers to export with only a general exporters license."[14]

These demands for structural reforms seemed to people in the region to be irrelevant to the crisis, and excessive. Talk of "crony capitalism" and corruption made good sound bites in the Western media, but in East Asia the image that stuck in people's minds was the picture of IMF Managing Director Michel Camdessus standing over Indonesia's President Suharto as he signed the agreement. Nationalist sentiments were inflamed. Camdessus himself did not help matters when he proclaimed that the Asian crisis was a "blessing in disguise," at a time when tens of millions of people were being thrown into poverty, and press reports described Indonesians in the countryside subsisting on tree bark, leaves, and insects.

After several months of failed efforts to restore confidence to the region through structural reforms and contractionary monetary and fiscal policies, the IMF - together with the U.S. government - finally did help to arrange what was really needed: a roll-over of the short-term debt into longer-term loans. This was accomplished in Korea and Thailand in January; unfortunately for Indonesia it took until April, which greatly extended the economic damage in that country. Part of the deal was for the governments of Korea, Thailand, and Indonesia to guarantee the loans that foreign banks had made to the private sector. This is what would be expected from an arrangement brokered by an international creditors' cartel, although it turned out not to make that much difference in this case, as the guarantees were not drawn upon. In the end, the real damage was done by not arranging the roll-over when the crisis started, and by the recessionary and financially destabilizing policies promoted by the Fund. The economic and human cost of these mistakes was very large: Indonesia, the world's fourth most populous country, had still not reached its pre-crisis level of per capita GDP by the end of 2004.

The IMF's failures, and the conditions that it required for the loans that were eventually made, caused the governments of the region to want to avoid ever having to borrow from the Fund again. As a result they have chosen to "self-insure," or pile up an enormous amount of international reserves. This accumulation of reserves had other causes, especially the policy of these countries to prevent their currencies from rising. And it is a solution that has significant costs, since holding international reserves such as U.S. Treasury securities brings a very low rate of return as compared

[13] Korea-- Memorandum on the Economic Program, Annex I, Request for Stand-by Arrangement; December 3, 1997, page 38 (quoted in Radelet and Sachs, 1998b).

[14] See Goldstein, Morris. "IMF Structural Conditionality: How Much is Too Much?" Peterson Institute for International Economics, Revision of Paper Presented at NBER Conference on "Economic and Financial Crises in Emerging Market Economies," Woodstock, Vermont, Oct. 2000.

with what could be obtained through investment in the domestic economy.[15] But this large accumulation of reserves – currently at $461 billion for South Korea, Malaysia, Thailand, Indonesia, and the Philippines – does provide these countries with a form of insurance that, if they had possessed ten years ago, could have mitigated or prevented the crisis, and would have kept them away from the IMF consortium.

The IMF's reputation, authority, and legitimacy was also permanently damaged by its mishandling of the crisis. Prior to the crisis, the Fund was not very well known in the United States and developing countries; the crisis did not make it a household word, but it raised the IMF's profile considerably and in a very negative way. In 1998 there was a proposed 50 percent or $90 billion increase in the Fund's capital, with $18 billion coming from the United States. Legislation for the $18 billion contribution from the United States failed on three votes in the Republican-controlled House of Representatives, passing only after the Senate approved it and attached it to a conference spending bill. As a condition of the funding, the U.S. Congress appointed a commission of economists to evaluate the IMF, World Bank, and other international financial institutions; its report was highly critical of the IMF.[16]

Perhaps even more damaging were the unprecedented public criticisms that the Fund received from prominent economists. Joseph Stiglitz, who was then Chief Economist at the World Bank and was later to receive the Nobel Prize in economics, told the *Wall Street Journal*: "These are crises in confidence . . .You don't want to push these countries into severe recession. One ought to focus. . . on things that caused the crisis, not on things that make it more difficult to deal with."[17] Jeffrey Sachs, then at the Harvard Institute of International Development, was even more blunt, calling the IMF "the Typhoid Mary of emerging markets, spreading recessions in country after country."[18]

The IMF's credibility was further undermined as a result of the Argentine crisis, where it was widely seen as an author of the policies that brought about and then worsened the steep 1998-2002 recession. Once again the Fund failed to act as a lender of last resort, and again when it was badly needed. After the currency and then the banking system collapsed at the end of 2001 and beginning of 2002, the IMF provided no help. Instead – together with the World Bank – it drained a net $4 billion, or a sizeable 4 percent of GDP, out of the economy. As in the Asian crisis, the IMF tried to pressure the government to adopt a host of unpalatable measures, and – since Argentina had defaulted on its foreign public debt – to offer a more favorable settlement to these creditors. In this case, however, the government of Argentina stood down the IMF – and won. In September of 2003, Argentina even temporarily defaulted to the IMF. This default to the IMF was unprecedented for a country that was not a "failed state" such as Iraq or Congo. At the time, no one knew what the consequences would be, since it was possible that the Fund could force a cut-off of credit to the country. But politically this was not possible – instead, Argentina's default effectively forced the IMF to roll over its debt.

[15] See Dean Baker and Karl Wallentin. "Money for Nothing: The Increasing Cost of Foreign Reserve Holdings to Developing Nations." Center for Economic and Policy Research, November 2001. http://www.cepr.net/documents/publications/reserves.pdf

[16] See "Report of the International Financial Institutions Advisory Commission," U.S. House of Representatives, March 2000. Found at http://www.house.gov/jec/imf/ifiac.htm

[17] Davis, Bob and David Wessel, "World Bank, IMF at Odds Over Asian Austerity," *Wall Street Journal*; January 8, 1998, page A5.

[18] Sachs, Jeffrey. "With Friends Like IMF…," *Cleveland Plain Dealer*; June 6, 1998, page 10B.

After three months of contraction following its default, Argentina began to grow rapidly and has now been the fastest growing economy in the Western hemisphere over the last five years, averaging about 8.6 percent annual GDP growth. Moreover, it achieved this growth by following policies that the IMF was against: including a central bank policy that targeted a stable and competitive real exchange rate, an export tax, a freeze on utility price increases, and a hard line on negotiations over the defaulted debt. Argentina's success showed that it was possible for a developing country government to stand up to the IMF – and not only live to tell about it, but achieve a rapid and robust economic recovery. This experience further undermined the Fund's authority and legitimacy.

Russia has also experienced rapid growth since it lost the last remnant of its IMF program, the fixed exchange rate that collapsed in August of 1998. Rising oil prices have also allowed Russia, like the Asian countries, to accumulate enormous reserves and thus not to worry about ever having to borrow from the IMF again. The IMF-sponsored program in Russia, which began in 1992, was possibly the worst of all the Fund's failures in its history, with the country losing more than a third of its GDP in the ensuing 6 years, and tens of millions falling into poverty. But unlike the IMF's failure in the Asian crisis, this disaster had limited impact on the Fund's reputation because it was not well known or reported in the Western media as an IMF policy failure.

The final blow to the IMF's creditors' cartel in middle-income countries came when Latin America found an alternative source of credit just a few years ago: the government of Venezuela. When Argentina decided to pay off its last remaining $9.8 billion to the IMF in 2006, Venezuela committed $2.5 billion – and more after that. Bolivia, which labored under IMF agreements for 20 consecutive years – with the exception of 9 months – and whose per capita income last year was less than it was 28 years ago, allowed its last agreement with the Fund to expire in March of 2006. The government declined to negotiate for any new agreement with the Fund. This was especially significant because Bolivia is still a low-income country – one which last year had almost all of its IMF and World Bank debt cancelled under the Heavily Indebted Poor Countries (HIPC) Initiative. Just a few years ago, an IMF agreement for Bolivia would have been a prerequisite for other loans and grants from developed countries, including Europe. But this is no longer true; the rules of the game for Latin America, and for middle income countries generally, have changed. Bolivia has re-nationalized its hydrocarbons industry and vastly increased royalties on foreign companies over the last two years, netting an additional $670 million in government revenue, or 6.7 percent of GDP, in the process. These and other reforms by the new democracies in South America would have been difficult, if not impossible, just a few years ago when the IMF/U.S. Treasury, together with the World Bank and IDB, had much more influence.

It is in Latin America that the collapse of the IMF’s power has had the most significant impact. Venezuela's offers of credit, without policy conditions, to Argentina, Bolivia, Ecuador, Nicaragua, and other countries has changed the equation. Since the IMF was Washington's main avenue of influence in the region, U.S. influence has dropped precipitously, and most of the region is now more politically independent of the United States than Europe is. This comes at a time when the majority of the region now has left-of-center governments, including Argentina, Brazil, Venezuela, Ecuador, Bolivia, and Uruguay. These six, plus Paraguay, are currently meeting to form a new lending institution called the "Bank of the South." Although many details remain to be worked out, the intention is clearly to form an alternative to the Washington-dominated IMF, World Bank, and IDB. The new Bank would focus on development lending and lending for regional economic integration, but the participating governments are also looking to set up a regional stabilization fund that would give countries an alternative to the IMF when they are in need of balance of payments support.

The Asian countries also took steps in the direction of a regional stabilization fund with the Chiang Mai Initiative that began in 2000. This includes a collection of bilateral currency swap arrangements among the ASEAN countries plus China, Japan, and South Korea. Under these arrangements, the contracting countries would be able to access at least some foreign exchange reserves in the event of a liquidity or balance of payments crisis of the type that was experienced in Asia in 1997. But this initiative is still tied to the IMF in that for almost all of the swap arrangements, a country wanting to tap into more than 20 percent of the agreed upon reserves would need an IMF agreement. The limit was originally 10 percent, and it is possible that the Chiang Mai Initiative will further weaken its "IMF link." More recently, in May, thirteen Asian countries, including Japan, agreed in principle to pool part of their $2.7 trillion of reserves for a stabilization fund, although it is not clear how long it might take for this to be realized.

These regional alternatives to the IMF offer the best chance at reform that can help prevent a repeat of the Asian financial crisis, and allow developing countries more policy space to pursue more effective macroeconomic and development policies. The ten years since the Asian financial crisis have produced a very important result – the collapse of the U.S. Treasury/IMF creditors' cartel in middle income countries. But they have also shown how far we are from any practical reforms at the international level that would involve the participation of the high-income countries – regardless of whether it is reform of existing institutions such as the IMF and World Bank, or the creation of new institutions. This can be seen from the handling of the recent scandal at the World Bank, where Paul Wolfowitz was replaced as Bank president with another neo-conservative from the Bush administration, and the current selection process for a new IMF chief, who by tradition will be a European approved by Washington. Both of these processes have taken place without significant input outside of Europe and the United States, despite demands from the majority of member countries for a change in governance that would give other countries a voice. These events indicate that the high-income countries are not significantly closer to reform of the international financial system than they were a decade ago. For the foreseeable future, reform will therefore have to take place at the national and regional level.

The independence that middle income countries have won from the Fund will also need to be extended to the low income countries, for whom the IMF-led creditors' cartel remains in full force. In April the IMF's Independent Evaluation Office reported that since 1999, nearly three-quarters of aid to the poor countries of Sub-Saharan Africa has not been spent. Rather, at the IMF's request, it has been used to pay off debt and accumulate reserves. These are some of the poorest countries in the world, who desperately need to spend this money on such pressing needs as the HIV/AIDS pandemic. Freeing the low-income countries from the restrictions of IMF-led creditors' cartel should be the next item on the agenda of international financial reform.