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Managing Financial Crises: Discussion

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This is an extremely valuable paper, both for its explicit analysis of a number of the key issues of debate surrounding the Asian crisis and for what it reveals to us more generally about the IMF. The latter is especially important because of the harsh criticism to which the IMF has recently been subjected from both the far right and from the far left. In this regard, I find little correspondence between the pictures of the IMF drawn by its most vocal critics and the IMF revealed in the analysis presented in this paper. Of course, we must be on our guard that this paper is likely designed to try to make the IMF look good and recognize that not all of the staff at the Fund are as open minded or as of as high quality as the authors of this paper. Even making substantial allowances for these favorable biases, however, it is hard to see much connection between the IMF represented and depicted by Messers Boorman et al. and the simple minded hubris of the Fund envisioned by its harshest critics from both the left and the right.

Let me quickly acknowledge that there certainly have been cases of IMF officials displaying hubris and beliefs in their intellectual superiority and undoubtedly some IMF officials are simple minded, but neither of these labels can be applied to the authors of this paper and in my experiences with the Fund staff, which is admittedly biased toward members of the Research Department, the authors are more representative than the arrogant, close-minded bureaucrats typically depicted by the Fund's harshest critics.[1]

The Need for a Public Choice Rather Than a Preferred Policy Perspective

The Fund clearly made mistakes in its policy advise during the Asian crisis, but in doing so, it likely differed little from the mistakes that would have been made by any

[1] It is interesting to note that the recent external review of the IMF's surveillance activities also found the ugly IMF staffer to be the exception. See IMF (1999).

sampling of good international monetary economists. Where the Fund is faulted on its economic policy advise, this is usually because it has taken a position, most often one near the middle of the road, on some issue about which there is considerable disagreement among able economists. Thus to strong monetarists and supply side economists, the Fund appears to be far too Keynesian, while to strong Keynesians and Marxists, the Fund is far too monetarist.

Looking at the Fund from the standpoint of public choice analysis rather than my specific views on international macro and financial economics, the Fund is right where it should be, firmly in the middle. For example, for the past decade or so, the IMF has been too enamored with exchange rate based stabilization policies for my tastes, but so have many of my academic colleagues. I can present analysis to try to influence thinking at the Fund, and there is indeed some evidence that the Fund has been softening its views in this area, but it would be inappropriate for me to use my disagreement with the Fund on this issue as the basis for a general attack on the Fund as an institution. From a public choice perspective, what I should hope for is that the predominant views at the Fund avoid unreasonable positions that are outside of the range of legitimate professional discourse and that the Fund's management and staff keep an open mind to new evidence as it becomes available. I found nothing in the paper by Boorman et al. that fails to exude substantial professional competence and awareness of the uncertainties generated by complex situations and different theoretical views. Certainly the popular stereotype that the Fund worsened the Asian crisis because its management and staff did not understand that there can be more than one type of crisis receives little support from a reading of Boorman et al.

Admittedly, Boorman et al. represent the Fund at its best, but its hard not to be struck by the much greater degree of intellectual openness in Boorman et al.'s discussion of whether monetary policy was tightened excessively during the Asian crisis than in the charges by Joseph Stiglitz that it was. Critics of the Fund tend to be much too quick to charge it with ideological bias when the Fund's views conflict with their own. This makes it very hard for non-economists to reach informed opinions. The prevalence of criticism from both sides can easily generate the impression that the Fund is clearly doing a bad job, rather than doing its job of staying well toward the middle. When one of the harshest critics is occupying the position of the chief economist of its sister institution, the World Bank, this makes the position of the Fund especially difficult.

Monetary Policy and the Stiglitz Critique

Stiglitz's critique of tightening monetary policy in a crisis quite rightly shows that there are conditions under which it can be counter-productive – a point already made by prominent economists such as Charles Kindleberger, but one that deserved to be re-emphasized. For the most part, the presentation of the argument in the original paper by Furman and Stiglitz [1998] meets high professional standards. It points to the likelihood that higher interest rates will increase bankruptcies and argues that effects are likely to differ from one country to another.

Indeed, this point can be made more generally. Apart from avoiding cases where a tightening of monetary policy is counter productive, the amount of weight that should be given to limiting depreciations in the formulation monetary policy should vary systematically across countries. It is not always recognized that the theory of optimum currency areas is relevant not just to the issue of fixed versus flexible exchange rates, but also to the weight which should be given to internal versus external factors in determining macro economic policies under flexible rates (see Willett [forthcoming a]). To the ever-expanding list of criteria relevant for OCA theory needs to be added the currency denominations of international lending and borrowing and the effects of interest rate versus exchange rate changes on bankruptcies. But these factors must be integrated with previous OCA analysis, not considered in isolation.

It is sad but interesting to note that in his attacks on the Fund, Stiglitz tends to replace his valuable analysis that counterproductive monetary policy is a possibility and that the orientation of monetary policy should vary across countries, with the assumption that monetary policy was clearly counterproductively tight across all of the Asian crisis countries. As the analysis in Boorman et al. clearly demonstrates, this assumption does not hold up to the evidence. In the first place, monetary policies were not nearly as tight in the Asian countries as critics have usually assumed. Many commentators, including some professional economists, have taken high nominal interests as signs of tight money, when in fact they were due much more to risk and inflation premia. The country with the highest nominal interest rates, Indonesia, was in fact the country with the easiest monetary policy, but it seems unlikely that Stiglitz would want to hold up Indonesia as an example of appropriate policy responses.

The Stiglitz critique, as it evolved, overlooked evidence that depreciations could themselves have powerful effects on bankruptcies and that in open economies, some degree of monetary tightness is necessary to keep depreciation from sparking a vicious circle of inflation. Again, the comparison of Indonesia with the other Asian countries is instructive. I especially liked Boorman et al.'s focus on the behavior of monetary aggregates as an indicator of monetary tightness, since during crises it is extremely difficult to determine what proportion of an increase in nominal interest rates is due to monetary tightening, which should have a positive impact on the currency, and what is due to increases in expectations of inflation and default risk, which should be avoided with currency depreciation.

Another particularly useful point made by Boorman et al. is that Malaysia should not really be used as a poster child for capital controls and other heterodox policy responses to crisis. As they note, capital controls were not imposed until the worst of the crisis had pasted and Malaysia's fiscal stance was one of the most conservative in the region. Despite the frequency with which it has been cited in policy discussions, the speed of Malaysia's economic recovery is hardly solid evidence against the IMF and financial orthodoxy.

Defense of the Fund's Basic Strategy

I find absolutely convincing Boorman et al.'s defense of the basic IMF strategy during the Asian crisis against the polar alternative of massive financing with little or no policy conditionality on the one hand, and virtually no financial assistance on the other. Arguments in support of the first alternative are typically based on beliefs that the problems were predominately due to panic-induced liquidity crises, not to fundamental problems. It is generally conceded that Thailand and the Philippines had overvalued currencies prior to the crisis and hence the speculative attacks on them were justified. The Indonesian rupiah and the Korean won were not obviously overvalued, however. It is often argued that therefore the attacks on them were due to unjustified contagion based on panic and/or herding behavior by investors. If these countries were just innocent victims, than unconditional liquidity loans would be justified.

This analysis is not convincing, however. A quibble is that the estimates of the real appreciation of the won and the rupiah vary substantially. A review of several recent studies of the crisis reveals estimates for real appreciation of the won ranging from +11.5 to –10.3 percent and for the rupiah from +9.6 to –5.5 percent. Those arguing that the speculative attacks were unjustified have unsurprisingly tended to use numbers toward the bottom end of the range.

Much more important for understanding both the spread of the crises and the depth of the subsequent recessions was that, as Boorman et al. stress, at heart these were financial as well as currency crises. I agree that assuming no major disturbances to their financial sectors, the won and the rupiah were not obviously overvalued prior to their crises. However, this non-overvaluation was based on substantial current account deficits financed by large capital inflows. As the size of financial sector problems in these countries became clear, it did not require panic or herd behavior for international investors to cut back substantially on the size of ongoing capital inflows. This in turn would cause the prior equilibrium exchange rate to become substantially overvalued. Hence, with sticky exchange rate regimes in these countries, financial crisis generated currency crisis. Likewise, in Thailand, the interaction between currency and financial crisis led to a required depreciation that was much larger than the initial overvaluation. I have argued that during the crises, currency markets likely did overreact, (Willett 2000a) but that this was not a major cause of the crises. There were elements of a classic bank run that in my judgment did justify some lender of last resort type lending by the IMF, but there were real problems. Thus, I agree that the IMF's basic strategy was correct.

Problems That Were Slighted: The Political Dimension

To leave the analysis here would be misleading, however. Boorman et al. suggest a few lessons that can be used to improve implementation on the future, and in general, I agree with their analysis. My disputes with the authors concern almost entirely issues that they did not discuss or glossed over quickly. While a strong supporter of the IMF from many of the attacks on it from the far left and right, I am far less complacent about the IMF's performance than the authors appear to be. This is because, understandably, the paper focuses on the economics of the IMF. I agree that this deserves good marks, with one exception to be discussed below. In my judgment, the major problems with the performance of the Fund have to do with politics not economics.

This is not the place to go into detail about criticisms of the Fund, but let me briefly mention three types of problems. Boorman et al. note that the announcement of IMF programs during the Asian crisis did not have the favorable effect on market confidence and capital inflows that the Fund had expected. I tend to agree with Boorman et al.'s defense of the Fund against the charges of critics such as Radelet and Sachs (1998) that because of the Fund's misplaced strategies, the initial IMF programs actually worsened confidence.[2] These failures of IMF programs to lead to substantial

[2] It is interesting that Kaminsky and Schumukler (1999) found that the dollar value of Asian stock markets tended to rise initially rather than fall in response to he announcements of IMF programs. A considerable portion of the worsening in confidence that occurred around the early days of IMF programs with Indonesia, Korea, and Thailand was due to a series of revelations that short-term external debt was greater and usable international reserves were lower than had been reported. I am sympathetic, however, to the charges that in designing programs the IMF was not sufficiently attentive to the political problems of implementing financial sector reforms. See, for example, Calamiris (1998).

improvements in confidence are not isolated instances, however. The credibility of the IMF's seal of approval has been seriously eroded and the effectiveness of the catalytic effect of Fund programs to attract private capital flows has been correspondingly diminished.[3]

Critics can hardly argue that in the Asian cases Fund programs allowed the recipient countries to avoid necessary adjustments. Indeed, Boorman et al. document that the real adjustments by the crises countries have been remarkably large. Adjustment in the Mexican case was also quite substantial. However, with many Fund programs, this has not been the case. Contrary to the perception of the left that Fund programs typically impose excessive austerity on recipient countries, studies of IMF programs suggest that much more common are Fund programs that are ineffectively enforced.[4] There are both internal and external political reasons that help explain this. Internally, bureaucratic career incentives cut against advocacy of tough enforcement and many national governments have become adept at playing upon these incentive structures.[5] This is sometimes reinforced by the desires of the major shareholders of the IMF, the governments of the industrial countries, to use the Fund as a cheap way to provide aid for geopolitical purposes without having to directly tax domestic voters. Aid to Russia is a major case in point. Thus, the problem is not just a lack of sufficient political oversight.

[3] See Willett (forthcoming b). Both these credibility issues and Boorman et al.'s suggestion that the Korean experience suggests limits to how much policy adjustments can substitute for financing in the short run raise doubts about the realism of the view expressed in the recent Task Force Report of the Council on Foreign Relations, that future IMF financial packages should be smaller. See Council on Foreign Relations (1999).

[4] See, for example, the analysis and references in Bird (1996) and Killick (1995) and Killick et al. (1998).

[5] See, for example, Meltzer (1998), Vaubel (1996), and Willett (2000a).

Mission Creep

Such concerns are particularly apparent in the debate over mission creep in the scope of IMF policy conditionality. I am quite sympathetic to the IMF's argument that the scope of its policy oversight and conditionality needed to be expanded from the traditional macroeconomic and exchange rate policy to include the financial sector. But, broadening the scope of policies covered in IMF programs has gone much farther than this. Nor does all of this expansion come just from the IMF's management and staff. Reportedly, the United States government took advantage of the Asian crisis to bring heavy pressure, both directly and through the IMF and World Bank, on Asian governments to undertake a wide range of liberalization measures that could in no way meet Martin Feldstein's [1998] suggested criteria for the appropriateness of policy conditionality measures.[6] I would favor most of these measures on economic grounds, but I do not think that these are instances where the end justifies the means.

The recent groups of task force reports on reform of the IMF, including the External Surveillance Review commissioned by the IMF itself, have been unanimous in recommending that the Fund needs to scale back the range of its policy conditionality and work out a clearer division of labor with the World Bank. In many areas, such as transparency, the IMF in recent years has shown a remarkable degree of responsiveness to external criticism, but in this area, the IMF's responses have been quite negative. Not surprisingly, there are many individuals within the Fund who agree with some of these criticisms and Boorman et al. gingerly suggest, "The need for greater prioritization may be another lesson from the Asian programs." But then Managing Director, Michael Camdesus' response to the recommendation of the External Evaluation of IMF

Surveillance that IMF conditionality be limited to the areas of core Fund competency was that: “This recommendation runs counter to most of the pressure on us from the Board and the membership.” No substantive rebuttal was offered.

In order to improve the effectiveness of the IMF and restore the credibility of its seal of approval, the IMF must substantially increase its track record for enforcing its programs. While there has been some slippage in the Asian programs, the overall effects have been quite positive. If the IMF could bring its average for other programs up to this level, its credibility would be substantially enhanced. Beyond improving its internal incentive structure and convincing its major shareholders of the importance of increasing its autonomy from short-term political pressures, the IMF also needs to develop a capacity for political economy analysis. It makes little sense for the IMF to champion policy conditions that a national government may be willing to agree to, but has little desire or capacity to implement. There needs to be more national government ownership of programs and the IMF needs to pay more attention to the enforceability of its programs. The Fund needs to give more attention to the first-best policy that is politically feasible, not just the first-best policy based strictly on economic criteria.[7] It then needs to judge on economic grounds whether this Nth best policy is likely to be sufficiently effective for the IMF to put its reputation at risk in support of the program.[8] This is of course not how economists like to approach policy issues, but it seems clear that most of the activities in which the Fund engages are ones of political economy, not pure economics. To pretend otherwise is to put one’s head quite deeply into the sand.

[6] See, for example, Pempel (1999).
[7] This was also a recommendation of the IMF’s External Surveillance review team, IMF (1999).

One Bad Mark: Underemphasizing the Financial Sector

Now a word on where the IMF should have done better on its economic analysis of the Asian crisis. Most of the relevant officials at the Fund, along with most economists in academia and the private sector, failed to pay sufficient attention to the financial sector aspects of the crisis. This mirrors the traditional failures of most graduate classes in international money or open economy macro to give much attention to such issues. The IMF certainly did no worse than the average economist, but this is a case where we might have hoped that the Fund would do better.

The reason for neglect of the financial side by most international monetary economists is easy to see. It is because this has not been important for most of the cases of balance of payments or currency crises on which we have focused attention. However, contrary to frequent allegations, the Asian crisis was not a new type of crisis. The experiences of countries in the Southern Cone of Latin America in the 1980's were quite similar. These were familiar, however, to few international monetary economists who were not experts on Latin America. One would have hoped that the IMF would have been in a better position to draw on these experiences than the typical international economist, but this seems to not have been the case. Indeed, one of the major recommendations for improvement in the generally favorable External Surveillance Review was for the IMF to do a better job of stressing to national governments the relevant experiences of other countries.[9]

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[8] See Willett (2000).

[9] Again, see IMF (1999). This is a suggestion to which the Fund has responded positively. The Fund is also in the process of substantially expanding its capabilities for financial sector analysis.

Doing Better in the Future

Boorman et al. correctly emphasize that improving crisis management will not be easy. Once a crisis hits, there are no good options, thus crisis prevention should be a major focus of policy. Boorman et al. offer a sensible set of suggestions. I would particularly emphasize two points.

One is the advantage of avoiding adjustably pegged exchange rate regimes. Most economists, if not policy makers, recognize the substantial difficulties of operating sticky exchange rate regimes in the face of substantial international capital mobility. More open to debate is the scope for wider band, crawling peg regimes.

The second is that financial liberalization must be undertaken very carefully. I do not think that the recent crises support the popular view that financial markets are inherently unstable, but they do vividly illustrate that in the face of bad incentive structures, financial liberalization can have disastrous results. Of course, the best response to this lesson is to improve incentive structures rather than to abandon liberalization, but it is clear that liberalization should be based on a comprehensive plan, not piecemeal actions. In developing such plans, political as well as economic realities must be taken into account.

I would also emphasize that several recent empirical studies of the Mexican and Asian crises have found that holding adequate levels of international reserves is an effective method of protecting countries from contagion.[10] Holding higher levels of reserves is costly, but being hit by crisis is even more so.

[10] See the analysis and references in Bussièrre and Mulder (1999) and Nitithanprapas and Willett [2000].

Concluding Remarks

In summary, I found this to be an impressive paper that demonstrates that good economics is alive and well at the Fund. It is time to start working on the politics.

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