# The Asian Crisis and the Changing Role of the IMF

Since it began operations in 1946, the IMF has steadily evolved in response to changes in the world economy. What steps is it taking to meet the new challenges posed by the Asian crisis?

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THE ASIAN CRISIS has focused unprecedented attention on the IMF. While the ensuing debate is a healthy part of the process by which the institution is held accountable, the spotlight on the IMF has also revealed a number of misconceptions about its evolving role in the international monetary system. In particular, it is often stated that the IMF was established to manage the system of fixed exchange rates set up at the end of World War II, and that since the breakdown of that system in 1973, the institution has been searching for a rationale.

It is true, of course, that the IMF has evolved and adapted since it began operating in 1946. Nonetheless, its current activities are closely consistent with its initial purposes—testimony to the foresight of the founders of the international economic system set up after World War II, a system that has helped produce more growth and more prosperity for more people than in any previous fifty-year period (see box).

## International cooperation

The IMF, with its 182 member countries, is the premier forum for international economic cooperation and consultation. Issues relating to the organization and functioning of the international system are generally discussed and, when decisions are needed, decided on in the IMF—by the Executive Board, the Interim Committee of the IMF's Board of Governors, and by the Board of Governors.

Almost every major international economic issue or problem of recent years has been discussed in the IMF and usually acted upon (often together with other institutions, especially our Bretton Woods nonidentical twin, the World Bank): the Mexican and Asian crises; technical and financial assistance to the economies in transition, including Russia; the debt problems of the poorest countries (in close cooperation with the World Bank); the attempt to improve international banking standards; economic assistance to countries emerging from chaos in the aftermath of wars and natural disasters; the ongoing effort, initiated following the Mexican crisis, to improve the quality and public provision of data; the unfortunately long-running problems of the Japanese economy this decade; the activities of hedge funds and their role in the Asian crisis. The list goes on and will go on.

Much of what the IMF does consists of *surveillance*—reporting by the staff to the Executive Board and, through it, to member

governments on developments and problems in the international economy and in individual economies. The staff's surveillance of the international economy is published, after discussion by the Board, in the semiannual *World Economic Outlook* and in the annual *International Capital Markets* report. In addition, the staff reports regularly to the Board on world economic and market developments, and provides briefings on the international economy for meetings of the Group of Seven industrial countries (the G-7), and other "Gs" and organizations.

About once a year, the IMF staff prepares an *Article IV* report for each country, an in-depth analysis of the country's economic policies and performance. In its discussion of the report the Board conveys its views—encouraging or critical—to the policymakers of the country. Through this process, policymakers encourage their colleagues in other countries to improve policies.

Although Article IV reports are not published, so as to preserve the frankness of discussions, since 1997, with a country's consent, the summing-ups of the Board's discussions of the report have been released to the public. So far, press information notices (PINs) containing the summing-up and other economic information have been published for about half the Article IV discussions held since the decision was taken to release PINs, and these are available on the IMF's web site. In addition, countries may publish the concluding statement of the Article IV mission, in which the IMF team that visited the country summarizes its views, generally foreshadowing the conclusions of the staff report to the Executive Board. Gradually, an increasing proportion of the IMF's membership is moving to make public the conclusions of their Article IV consultations.

In recent years, especially in the wake of the Mexican crisis, the IMF has strengthened and broadened its surveillance, paying particular attention to, among other factors, the quality and timeliness of the data it receives from member countries, the strength of their domestic financial systems, and the sustainability of private capital inflows. By providing warnings of impending problems, IMF surveillance should help prevent crises. When a crisis is averted, surveillance has succeeded and is unlikely to be noticed—and there have been many cases in which IMF warnings were given and action was taken that averted a crisis. But surveillance may fail, either because warnings are given and not heeded or because a problem is not anticipated.

## Promoting international trade

The IMF promotes international trade *directly* by encouraging trade liberalization, through both surveillance and its lending programs with member countries. It has always done so, and the purposes of the IMF require it to continue to do so. It is therefore a surprise that the Asian programs we support are criticized for requiring borrowers to take specific trade liberalization measures. Although trade liberalization was at one time controversial, and import-substituting industrialization a popular prescription, the weight of experience, as well as more formal econometric evidence, have conclusively established the benefits of trade liberalization and integration into the world economy.

Even more important, the IMF promotes international trade *indirectly* by encouraging countries to liberalize foreign exchange controls on trade in goods and services ("the establishment of a system of multilateral payments in respect of current transactions"). These controls were pervasive at the end of World War II, but by now 144 member countries have accepted Article VIII status with the IMF, which certifies that they allow full convertibility of their currency for current account transactions.

## Purposes of the IMF

The goal of the representatives of the 44 countries who met at the United Nations Monetary and Financial Conference in Bretton Woods, New Hampshire in 1944 was to rebuild the international economic system, whose collapse had contributed to the Great Depression and the outbreak of war. To this end they proposed setting up the International Monetary Fund, the World Bank, and what much later became the World Trade Organization.

The primary purposes of the IMF, set out in Article I of its Articles of Agreement, have remained essentially unchanged over the past fifty years:

- *To promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems.*
- *To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income . . . .*
- *To promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation.*
- *To assist in the establishment of a multilateral system of payments in respect of current transactions . . . and in the elimination of foreign exchange restrictions which hamper the growth of world trade.*
- *To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with the opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.*
- *In accordance with the above, to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members.*

## Currency fluctuations

The fixed exchange rate system set up at the end of World War II lasted until 1973, and was a means of promoting exchange rate stability, not an end in itself. Once it lost its viability—a result of the incompatibility of fixed exchange rates, capital mobility, and policies focused on domestic objectives—there was no choice but to move to a more flexible system.

The concern over competitive devaluations reflected in the IMF's charter and the system-wide implications of changes in exchange rates continue to motivate IMF policy recommendations. A major IMF concern in the Asian crisis has been that Asian countries' currencies would become so undervalued and their current account surpluses so large as to damage the economies of other countries, developing countries included. This is one reason the IMF has stressed the need first to stabilize and then to strengthen exchange rates in the Asian countries during the crisis—and, for this purpose, has urged them not to cut interest rates until their currencies stabilize and begin to appreciate.

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## IMF lending

Despite its other activities—surveillance, information provision, and technical assistance—the IMF is best known for its lending. The IMF operates much like a credit union, with member countries placing deposits in the IMF, which are then available for lending to any member who needs to borrow and meets the necessary conditions.

Why are IMF-supported programs so often unpopular? The main reason is that the IMF is typically called in only in a crisis, which is often a result of the government's having been unwilling to take action earlier. If the medicine needed to cure its economic illness had been sweet, the country would have taken it long ago. Rather, the medicine will usually be unpleasant, in essence requiring the country either to live within its means or undertake changes with short-term political costs. The government probably knows what has to be done, but rather than take responsibility, finds it convenient to blame the IMF when it has to act. Similarly, when structural changes have to be made, the losses are often immediate and the gains some way off. Despite all this, there are countries where the IMF's support is welcomed, among them the transition economies that have seen hyperinflation defeated and growth begin during IMF-supported programs.

The secrecy that until recently has often attended IMF-supported programs may also have contributed to their unpopularity. A public that knows neither what is being done nor why is less likely to support measures that are difficult in the short run but that promise longer-run benefits. In the recent Indonesian, Korean, and Thai programs, the governments' Letters of Intent—their letters to the IMF's management describing their programs—have been published and also made available on the IMF web site.

## Response to the Asian crisis

Before the Asian crisis broke, the IMF had warned Thailand of potential problems, but the government took no action. The IMF's staff also warned governments about financial sector weaknesses in several of the countries that were subsequently badly hit in the crisis. But the IMF failed to foresee the virulence of the contagion effects produced by the widening crisis. Some of this contagion reflected rational market behavior. The depreciation of the Thai baht could have been expected to erode the competititiveness of Thailand's trading partners, and this, in turn, put some downward pressure on their currencies. Moreover, after problems surfaced in Thailand, markets began to take a closer look at the problems in Indonesia, Korea, and other neighboring countries. What they saw, to different degrees in different countries, were some of the same problems Thailand faced, particularly in the financial sector. Also, as currencies continued to slide, the debt-service costs of these countries' private sectors increased. Consequently, residents hastened to hedge their external liabilities, intensifying exchange rate pressures. But markets overreacted and the extent of the exchange rate adjustment exceeded any reasonable estimate of what might have been required to correct the initial overvaluations of the affected currencies.

Hence, in many respects, Indonesia, Korea, and Thailand faced similar problems. They all suffered a loss of foreign investors' confidence in their economies and a deep depreciation of their currencies. In each country, weak financial systems, excessive unhedged foreign borrowing by the domestic private sector, and a lack of transparency about the ties among government, business, and banks all contributed to the crisis and complicated efforts to defuse it.

But their situations also differed. Thailand was running an exceptionally large current account deficit amounting to 8 percent of GDP; Korea's was worsening; and Indonesia's was already at a more manageable level. Also, the three countries called in the IMF at different stages of their crises, with Korea coming the closest to catastrophe before it forcefully implemented its IMF-supported program.

The designs of the IMF-supported programs in these countries reflect these similarities and differences. All three programs called for a substantial rise in interest rates in an attempt to halt the downward spiral of currency depreciation. They also advocated forceful action to put the financial system on a sounder footing as soon as possible, strengthening financial sector regulation and supervision, increasing transparency, and opening Asian markets to foreign participants.

In drawing the lessons of this crisis, the IMF will have to seek both to make its warnings more effective and to improve

the quality of its economic forecasts, particularly of crises. Many have suggested that crises could be prevented, or at least mitigated, if the IMF went public with its fears. Two factors make this suggestion difficult to carry out. First, the IMF's access to information and its ability to act as a confidential advisor to governments would be lost if it made confidential information public. Second, the IMF could, by going public, create a crisis that otherwise would not have happened—a responsibility not lightly to be assumed. Moreover, there should be no illusion that forecasting of this type can ever be perfect and that all potential crises can be avoided. Some impending crises will be missed. For this reason, and because in any case not all warnings are heeded, we shall have to continue to improve our capacity to deal with crises even as we strive to improve surveillance to prevent them.

## Evolution of the IMF

While the purposes of the IMF have not changed, it has over the years been called upon to advise and assist an ever-wider array of countries facing an ever-greater diversity of problems and circumstances—not only industrial economies with temporary balance of payments difficulties, but also low-income developing countries with protracted balance of payments problems, transition countries struggling to establish the institutional infrastructures of full-fledged market economies, and emerging market countries seeking to secure the private capital inflows needed to maintain high rates of economic and human development.

Of course, the IMF has maintained its primary focus on sound money, prudent fiscal policies, and open markets as preconditions for macroeconomic stability and growth. But, increasingly, the scope of its policy concerns has broadened to include other elements that also contribute to economic stability and growth. Thus, to different degrees in different countries, the IMF is also pressing, generally together with the World Bank, for sound domestic financial systems; for improvements in the quality of public expenditure, so that spending on primary health care and education is not squeezed out by costly military buildups and large infrastructure projects that benefit the few at the expense of many; for increased transparency and accountability in government and corporate affairs to avoid costly policy mistakes and the waste of national resources; for adequate and affordable social safety nets to cushion the impact of economic adjustment and reform on the most vulnerable members of society; and, in some countries, for deregulation and demonopolization to create a more level playing field for private sector activity.

This broadening of the scope of IMF policy concerns has met with mixed reactions. Some applaud the IMF for tackling the structural problems and governance issues that, in many countries, stand in the way of macroeconomic stability and sustained growth. But others roundly criticize the IMF, either for intruding too far in what they see as the domestic affairs of sovereign nations or for failing to go far enough.

Finally, the diversity of its member countries and of the problems they face has led the IMF to establish a wider array of facilities and policies through which it can provide financial support to members. In addition to the traditional stand-by arrangement that usually lasts 12–18 months and is designed to help finance temporary or cyclical balance of payments deficits, the Extended Fund Facility (EFF) supports three- to four-year programs aimed at overcoming more deep-seated macroeconomic and structural problems. The Enhanced Structural Adjustment Facility (ESAF) also finances longer-term programs, but with extended repayment periods and at a concessional interest rate for low-income countries. At various times in the IMF's history, new facilities have been established to address particular problems. The most recent of these is the Supplemental Reserve Facility (SRF), which was created in December 1997 to assist emerging market economies facing crises of confidence while providing strong incentives for them to return to market financing as soon as possible: it allows the IMF to make large short-term loans at higher rates than it normally charges. The first borrower under the SRF was Korea.

What is the net effect of all these changes? Certainly, the IMF has not been completely transformed. One important feature that remains the same is the emphasis on sound policies at the national level and effective monetary cooperation at the international level. The corollary of this is that the IMF is not just a source of financing or a mechanism for crisis management, as is commonly believed, but mostly, in its daily business, a cooperative institution for multilateral surveillance. It must also be acknowledged, however, that from its relatively simple origins, the IMF has evolved into a complex institution with complex tasks to fulfill. So even if the IMF continues to look at all its member countries through the same prism—the requirements for economic stability and growth—it has to deal in a differentiated way with the full spectrum of problems and possibilities in 182 distinctive member countries. The increased complexity of the IMF reflects the diversity and complexity of the international economy.

There is surely much to be said for an organization that, while sticking to its basic objectives, has shown the flexibility to adapt—in terms of its approaches to problems, and the instruments and procedures it employs—to an ever-changing global environment and thus to continue to serve the needs of its members. In the years to come, the IMF will have to continue to adapt to new problems and to react to criticisms as new challenges confront the world economy. F&D

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