Asian Financial Crises: A critical Analysis of IMF Remedy

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Abstract

In decades, the International Monetary Fund had a great impact upon maintaining the order of international financial market. This article is devoted to evaluate the IMF's approach to the Asian financial crisis and conclude some inspirations for development country such as China.

Keywords: Asian financial crisis, IMF

Introduction to IMF

The IMF was established at the end of World War II, out of Bretton Woods Conference in 1945. It is a specialized agency of the United Nations and is run by its 186 member countries. Among the member countries, America provides the most fund (approximately 4 billion USD) to IMF and therefore has absolute dominant quota, and hence its voting rights. In other word, IMF somehow represents the will of United States and American international economic status. American Treasury Secretary Rubin has emphasized the significance of IMF during Asian crisis that "Without the IMF, without the international community, the probability that this would have turned out very badly would have been much higher."

The main purpose of the International Monetary Fund as expressed in the first Article of Agreement include: (1) promote international monetary cooperation; (2) facilitate the expansion and balanced growth of international contribute thereby to the promotion and maintenance of high levels of employment and real income; (3) promote exchange stability, maintain orderly exchange arrangements among member states, and avoid competitive currency depreciations; (4)assist in establishing a multilateral system of payments of current transactions among members and in eliminating foreign-exchange restrictions that hamper world trade; (5)alleviate serious disequilibrium in the international balance of payments of members by making the resources of the Fund available under adequate safeguards, so as to prevent the members from resorting to measures that endanger national or international prosperity.

Since 1965, the foundation have provided approximately $1750 billion loans to those countries which went through financial crisis. Looking through the history, the IMF's remedy has a profound and long-lasting impact upon the economic growth of target area or country. In conclusion, the IMF's action to help Asian countries has given us some great enlightenment and warning.

The Economic Background

The Asian financial crises, which occurred in 1997, have been one of the most severe and unprecedenting economic events of the 1990s. Even though the circumstance of individual country was significantly different, some similar factors were common and triggered the crises. First of all, according to the ratio of exports to GDP, all the Asian economies were attempting to pursue export-oriented growth. A combination of relatively cheap but skilled labor force and falling barriers to international trade has accelerated the transformation of those countries into "export powerhouses"

Table. Exports of goods and services/GDP in East Asia

	1980	1995
Hong Kong	90	147
Indonesia	33	25
Malaysia	58	96
Philippines	24	36
Singapore	204	169(1993)
South Korea	34	33
Thailand	24	42

Sources: World Bank and, for Taiwan, CEPD.

The consequence of the high growth exported has led to fuel an investment boom in commercial and residential property. For instance, the real estate in Hong Kong and Bangkok started to soar. Banks were more than willing to lend the money to those constructions as well as other types of investment in the situation that the value of property continue to rise. In a word, during mid 1990s, the Southeast Asia was experiencing an unexpected investment boom, much of its financed with borrow money. Secondly, as the number of investment growth rapidly, the quality of many investments declined significantly. The result was the emergence of significant excess capacity. Last but not the least, the overvalued currencies and the quasi-fixed exchange rates were also a problem when there was an account deficit existed. In general, all of the factors brought some hidden troubles to the Asian financial crises.

The beginning and development of the Financial Crisis

Since May, 1997, International speculators initiated to attack Asian countries currency from both cash market and future market, which shocked the markets drastically. The crisis can be categorized to three stages. In the first stage, On May 14, 1997, speculators started to attack on the Thai currency, the baht. To defend the peg, Thailand government spends billions of dollars of its foreign reserves to purchase Thai baht. However, two months later, Thailand government announced that the baht would be devalued for as much as 20%--a record low. Later, the Thai government requests "technical assistance" from IMF. Following the devaluation of the Thai baht, the speculation spread to hit other Asian currencies. The exchange rate of countries such as Malaysia, Indonesia all hit the record low, and the Asian stock market continued to fall. Next, in the second stage, Oct. 23, the stock market of Hong Kong and Taiwan received another turmoil wave of speculation. Hong Kong's stock index falls 10.4% after it raises bank lending rates to 300% to fend off speculative attacks on the Hong Kong dollar. The plunge on the Hong Kong Stock Exchange wipes $29.3 billion off the value of stock shares. In the final stage, the financial crisis spread to South Korean and Japan. On Nov.3, Sanyo Securities Co. Ltd., one of Japan's top 10 brokerage firms, goes bankrupt with liabilities of more than $3 billion. It is the first

Japanese securities house to go bust since World War II. And in less than a month, The Bank of Korea abandons its effort to prop up the value of the won, allowing it to fall below 1000 against the dollar, a record low.

IMF Remedy to stabilize the Financial crises

In the preliminary stage of the crisis, Some of the Asian countries suggested the idea of creating an Asian Monetary Fund to help out those countries suffering in financial crises. This suggestion obtained the support from Japan, which had agreed to raise 50 billion dollars' fund. However, this scheme was declined during The 1997 annual meetings of the boards of the world bank group and the international monetary fund due to the reason that America representative insisted that the remedy to the crisis must be processed by IMF.

Finally, in order to resolve the monetary crisis, Asian countries made tough negotiations on the scheme of remedy with IMF. Although the causes and manifestations of each country were not consistent, the solution that IMF suggested had been "more of the same". Illustrating South Korean as an example, the IMF's stand-by credit of US $21 billion involved an austerity program and several structural reforms, with four main areas:

1. MACROECONOMIC POLICIES: in order to eliminate the current account deficit and to contain inflation to single digits in 1998, the government had to pursue stringent fiscal and monetary policies. Two main measures were attached to the IMF credit: (1) a package of tax increases and expenditure cuts, intended to render a small surplus in the budget balance in 1998 (from -0.5% of GDP in 1997), and to slow import demand; the IMF had initially demanded a fiscal surplus of as much as 1% of GDP but subsequently dropped this request; (2) a substantial increase in interest rates, in order the defend the currency, along with more governmental control on the expansion of the monetary supply, directed at controlling inflation.

2. FINANCIAL SECTOR RESTRUCTURING: strengthening prudential regulation by monetary authorities, revocation of licenses of several merchant banks, and rationalization of the commercial financial institutions;

3. CAPITAL ACCOUNT AND TRADE LIBERALIZATION: acceleration of financial opening, with full liberalization of the money market instruments, allowance of foreign investment in domestic financial institutions, authorization for foreign banks and brokerage houses to establish subsidiaries and elimination of ceilings on foreign investment in Korean equities; trade opening, which involved abolishing trade-related subsidies and liberalizing merchandise imports and foreign financial services.

4. LABOR MARKET REFORM: the labor market will have to be flexibilized, clarifying the circumstances and procedures for layoffs. Under the World Banks's US$ 10 billion Structural Adjustment Loan, the details of these measures have been discussed, in accordance with the Tripartite Accord reached between the government, the unions and the business community on February 6, 1998.

Response to the IMF remedy

The restrictive macroeconomic policies had a positive effect upon reducing the short-term debt crisis, increasing foreign exchange reserve, regaining the confidence of international investors, and ameliorating the further shock by speculators. But the policy itself do have some significant flaws.

In the circumstances, however, after the IMF announced the macroeconomics policy, the financial crisis had not been contained but continuing deteriorate. On August. 15, right after IMF open its remedy strategy, Thailand stock exchange index dropped 3.4% dramatically. All the trades within monetary market were suspended. In the early 1998, Asian financial market once again set off a wave of dumping. The currency exchange rate of multiple countries fell to record low. From this perspective, the reform measure by IMF had not received immediate effect but made the economic crisis worse. In fact, if the crisis worse to some extend, it will destruct the stability of region and even lead to global economics crisis.

The role of the IMF in Asia financial crisis has been widely criticized. Professor Jeffrey Sachs has stated that "the international community's initial response to the crisis, led by the IMF and the US Treasury, exacerbated rather than eased the crisis in its early stages. "

Policy lessons

Overall, there are several reasons why the remedy of IMF did not work out immediately for Asian countries:

First, the Fund omitted the special characteristic of Asian countries, as it has dealt before mostly with Latin American countries. Even its World Economic Outlook of October 1997 predicted a 1998 GDP growth for Korea of 6% in 1998, while it is now clear that the country will register a negative figure . The IMF's Annual Report 1997 even praised the "soundness" of Korea's and Thailand's economic fundamentals.

Second, the IMF is treating on equal foot different situations, such as Mexico in 1994 (or even Thailand and Indonesia in 1997), on the one hand, and Korea in 1997-1998, on the other. The macroeconomic policies and the structural reforms suggested by the IMF are similar despite obvious different backgrounds such as: (1) high current account deficits, exchange rate pegs and very large external debts, like in Mexico in 1994 and in Thailand and Indonesia more recently; (2) low and declining current account deficits, cautious exchange rate management and relatively low debt-service ratios, like in Korea in 1997-98. Moreover, the IMF's prescription seems to be totally independent from the state of economic fundamentals. Economies with budget surpluses (or small public deficits), high savings rates, low inflation and outward orientation, such as those in East Asia in the late-1990s, are equated with others afflicted with fiscal profligacy, low savings, high inflationary pressures and inward-oriented growth, such as Latin America in the 1980s. The IMF's requirements have been fairly similar in both cases, despite the obvious difference in the nature of their respective crises (private-related debt in Asia versus public-related debt in Latin America).

Third, the recessive impact of the excessively austere policies is especially important in economies with a long tradition of high and sustained growth.

Fourth, financial and trade opening, along the lines suggested by the IMF, will surely make East Asia more and not less vulnerable (Akyüz, 1998). For instance, although the IMF short-term requirements were meant to stabilize the currencies and to restore market confidence, the reaction of international capital markets, after the stand-by agreements with Thailand, Indonesia, and South Korea, has been a clear sign of their mistrust. In Korea, for instance, between December 4, 1997 and January 8, 21 1998 the exchange rate increased from 1,170 won per dollar to 1,788 won per dollar. Moreover, on a longer term, demanding further trade and financial liberalizations, despite the fact that the crisis had been due, to a large extent, to excessively rapid openings in both areas, might render the economy more vulnerable to future crises.

Fifth, the IMF programs have a clear bias in favor of private international financial institutions, as foreign creditors are not urged to share their part of responsibility in the crises, escaping instead unscathed. They are not even encouraged or suggested to roll over short-term debt into longer term instruments, a process which was simply left to eventual bilateral negotiations. This problem of moral hazard, inherent to the IMF's approach, has been widely acknowledged among specialists. As a main agent for bailing out, not national economies, but in fact foreign private creditors, the IMF could perfectly be accused of sowing the seeds of future crises. Private financial institutions, if assured that they will recover their loans, will continue to throw money recklessly in fragile economies.

Inspiration from IMF Remedy

In general, the failure of IMF remedy can be sum up to three reasons. First, the austerity measurement push government too hard. Secondly, it fails to combine the feature of Asian financial market. Third, the policy complied with the interest of power countries. In spite of that, we are still able to obtain some enlightenments from the IMF remedy.

First of all, historical experience has proved that a country's economic growth cannot rely entirely on external debt, also the demand cannot be pulled completely by exports. Therefore, government should focus more on enhancing the confidence of international investor, and keep a steady economics growth rate.

Secondly, to avoid the speculation to attack, government must further readjust financial structures and squeeze out the bubble. What's more, they have to enhance the regulation to avoid some bad behaviors or investments in present financial market.

Finally, as for developing country, the liberalization of financial market and opening up to the world is an inevitable trend. However, the degree of the openness of market should be adapted to the level of regulation. In other word, the premise of opening up to global market is to control the local market effectively.

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