REFORMING WORLD FINANCE

Lessons from a crisis

The IMF has been attacked for its handling of the world's economic and financial troubles. Here its deputy managing director, Stanley Fischer, responds

WHEN finance ministers and central-bank governors gather in Washington this weekend for the annual meetings of the IMF and the World Bank, the global economic crisis will dominate the agenda. The role of the IMF will come in for close examination. Three issues will feature prominently: the design of IMF-supported programmes in Asia and Russia, the international financial architecture, and how to respond to the immediate crisis without doing further damage to the international system. I consider these in turn.

The IMF programmes in Thailand, Indonesia and South Korea were designed to restore macroeconomic stability and growth, and to remedy structural weaknesses in each country. Early in each programme interest rates had to be raised temporarily to stabilise currencies. That was achieved in South Korea and Thailand, whose currencies are now stable in ranges about 35-40% below pre-crisis levels, with short-term interest rates of around 8-9%, also below pre-crisis levels.

Those who criticised temporary high interest rates fail to see that further depreciation caused by lower rates would have raised the burden of dollar-denominated debts. And while the burdens imposed by higher interest rates were temporary, those created by deeper devaluations would have been permanent.

Thailand embarked on its IMF programme with a current-account deficit of 8% of GDP. To shrink that, the programme included an increase in the budget surplus of 3% of GDP. Fiscal contractions suggested for Indonesia and South Korea were smaller, designed to cover only the expected interest costs of financial restructuring. Had we known, when the Thai programme was signed in August 1997, that Asia, including Japan, was heading for major economic slowdown, less fiscal contraction would have been recommended. As growth in South Korea, Thailand and Indonesia has slowed, the agreed fiscal deficit has increased; each country is running a sizeable deficit. More fiscal expansion, including additional social spending for the poor, would now make sense.

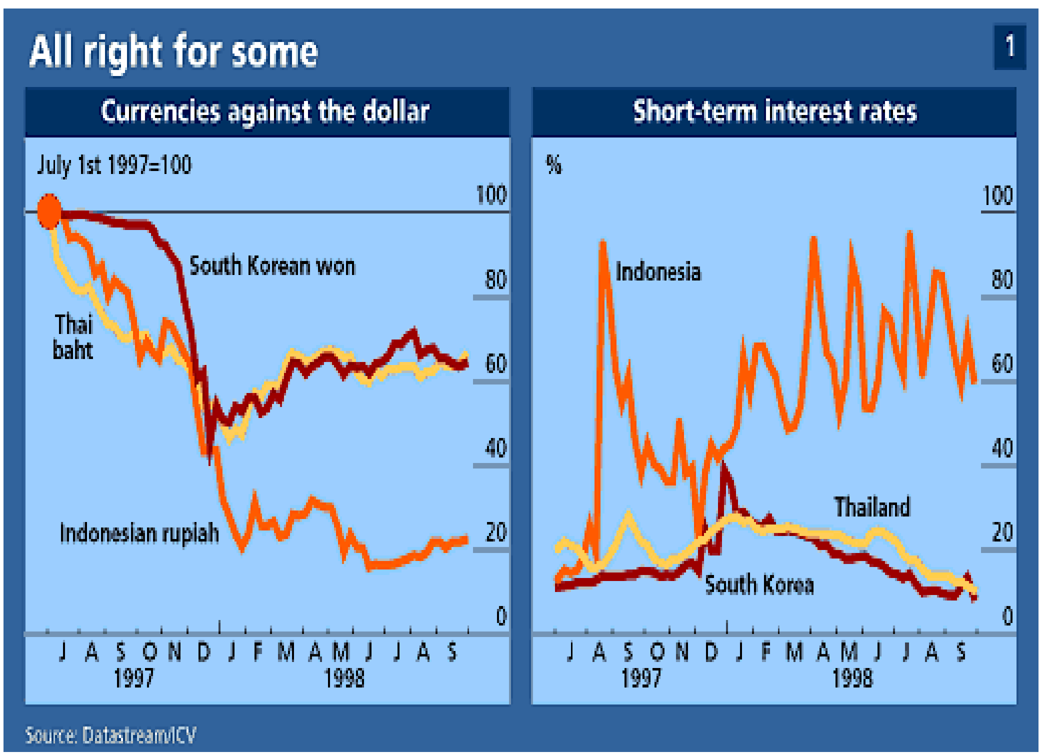
The inclusion of structural measures in these programmes has been criticised. But financial and corporate inefficiencies were at the epicentre of the economic crisis, and have to be dealt with to restore durable growth. Indeed, the priority now should be to accelerate restructuring. Some argue that because this will take a long time to have its effects, it was a mistake to try to move so rapidly. But delay does not make banking problems go away: as seen in Japan, it makes them worse.

Programme problems

If their design was right, why have the IMF programmes worked less well than hoped? There are two answers. First, governments were initially reluctant to implement them. In each of the three countries the programme began to take hold and the currency to stabilise only after a new government took office. And second, the external economic environment has worsened, due especially to the Japanese recession.

The consequences have been most visible in the three countries' exports. Rapid export growth to the United States helped bring Mexico out of its 1994-95 crisis. This time, the value of exports from Thailand, Indonesia and South Korea to both Europe and America did indeed rise in the year to the second quarter, but the value of their exports to Japan has declined sharply, by about 25%. So exports have not, so far, served as a source of growth.

Where do these countries stand today, a year after the start of their IMF programmes? Remember that the average American recession lasts about a year, and that a year into the Mexican crisis, there was a period of severe jitters. There are important signs of progress in both South Korea and Thailand, in the stabilisation of their currencies, the fall in interest rates and the start of bank and corporate-debt restructuring (see chart 1). Growth could still resume this year, though much depends on the external environment. A year from now each country is likely to be growing again and to have made more progress in structural reform than most of its neighbours—a good basis for sustainable recovery.



The problems in Indonesia are deeper, for the civil unrest that accompanied the end of the Suharto regime led to massive capital flight and a loss of investor confidence that will take time and careful political and economic management to repair. Critics blame the closing of 16 banks at the start of Indonesia's IMF programme for the collapse of the rupiah and investor confidence. But a careful look at the timing suggests the main culprits were President Suharto's illness in December, perceptions that the government would not carry out the programme, and excessive creation of liquidity by the central bank.

Indonesia has made some progress in recent months. The rupiah has strengthened, as foreign assistance has started flowing in. But attempts to keep food prices below world levels have failed and rice prices have risen. So the government, with the assistance of the World Bank, is removing general subsidies on food and switching to the provision of subsidised rice and other essentials for the poor. A start has been made in dealing with the linked problems of internal and external corporate debt and the banking sector, though more needs to be done.

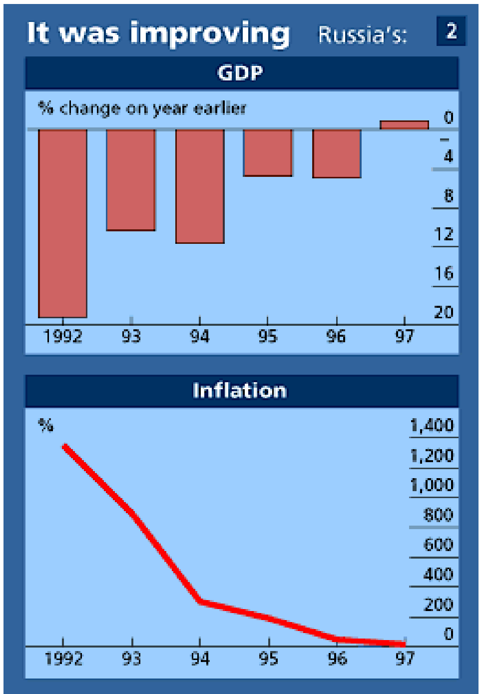
Russia's dance

Ever since 1992 the IMF has been the world's main vehicle for assisting Russia and promoting economic reform. This was difficult from the start, for reformers never had full control over economic policy. Nevertheless, the world's stake in Russian reform was too critical not to make the effort.

Some progress was made: the rouble was stabilised and inflation cut to single figures, and positive growth was recorded in 1997 (see chart 2). On the structural side, privatisation took off. But little was done to restructure the military-industrial complex. And the government, unable to collect enough revenues, was often in arrears on wage and pension payments. The banking system was ill-regulated and heavily exposed to the risks of devaluation. And corruption was a huge problem for the economy and for foreign investors.

The extent of Russia's fiscal problem is hard to overstate. In 1997, federal tax receipts amounted to 9.7% of GDP, less than $4 billion a month. The budget deficit was 6.9% of GDP. Since 1996 the Russian government has been in a race between its need to collect more taxes and a rising interest bill on its growing debt. This year tax collection improved. In the second quarter, for the first time, federal revenues covered non-interest spending. But falling oil and commodity prices reduced export revenues, interest rates rose, and the government had to roll over $1 billion a week of GKOs, or short-term rouble-denominated debt.

In July the international community faced a hard choice: whether to help Russia try to prevent devaluation. The adverse effects of a devaluation were clear and the reformist Kiriyenko government was making progress on taxes and in other areas. So the decision was made to help, recognising that this was a calculated risk. An official package of $22 billion was assembled, on condition that the Russians undertake major tax reforms; and a voluntary debt restructuring scheme for GKO



Sources: Russian authorities; IMF staff estimates

holders to switch to longer-term dollar obligations was introduced.

The take-up of this offer was, however, small. The programme could still have been viable if GKO holders had been ready to roll over their maturing holdings. But after the Duma rejected two tax measures (though it passed most of the legislation submitted to it), and with doubts about the ability of the government to deliver on policy commitments growing, this did not happen. So the government was faced with an unenviable choice between devaluation, debt restructuring or both. It chose both: the rouble was devalued, the GKO restructuring was imposed unilaterally and a temporary moratorium was put on private debt payments.

The contagion following Russia's actions has been serious. The realisation that Russia was, after all, not too big to fail shook investor confidence—although it is hard to credit that sophisticated investors who had earned an average of 50% a year on GKOs since 1994 really believed these investments were safe. Investors were concerned that other countries might follow suit and unilaterally restructure their debts, although almost all have rejected this.

Much of the contagion was caused by technical factors. Highly leveraged investors have had to realise assets to meet margin calls; investors seeking to move out of emerging markets have sold in the most liquid markets to raise cash. The shocks are now reaching rich-country markets too.

The new Russian government is in an extremely difficult situation. In the short run it may employ a mixture of money printing and more controls. But these approaches will not work; sooner or later a Russian government will have to return to the tasks of stabilising and reforming the economy. At that point the world may be able to re-engage financially. In the meantime we should encourage the authorities to try to agree with creditors how to restructure the GKOs and how to lift the 90-day moratorium on private debt payments.

What went wrong in Russia? Fundamentally, although progress was made over the years, successive governments have been too weak to implement their desired policies. The international community, through the IMF, was right to try to support reform in Russia. And the IMF was right from early on to stress the need to sort out the fiscal mess. Eventually, as a weak internal situation combined with external shocks, the crisis came. Its effects will take time to overcome, but the story of Russian reform is not yet over.

There is no shortage of suggestions for reshaping the international financial system. Among the main ones are plans to strengthen national banking and financial systems; mechanisms to reduce contagion; capital controls; the need to minimise moral hazard; new exchange-rate regimes; and reform of the IMF itself.

Banking weaknesses have either caused or aggravated all the recent crises. Most of these weaknesses were identified in advance by the IMF, but efforts to get countries to take pre-emptive action were not successful. The development of international banking standards, the Basle core principles, is an advance. But although we are starting to strengthen surveillance of banking systems, enforcement mechanisms are lacking. One option among others might be to impose differential provisioning requirements against loans to different countries, depending on the standards met by their banking systems.

Containing contagion

The virulence of the recent contagion raises troubling questions about financial markets. Admittedly, contagion is rarely baseless: the markets treat countries in better shape more kindly than those in worse shape. Nonetheless, the technical factors contributing to contagion suggest it has been excessive—and that a way should be found to moderate it. That task will fall mainly to financial regulators, who should ensure greater transparency of positions being taken by investors, and consider when leverage can be excessive.

Fuller information should increase the efficiency of international capital flows. Through its special data dissemination standard, the IMF is prodding countries towards greater transparency. The standard needs strengthening, for instance by providing more timely data on foreign-exchange reserves and complete data on forward transactions by central banks. We also need better information on short-term debt, on which the Bank for International Settlements and others are working.

Malaysia's decision to impose controls on capital outflows—and support for the idea among some academics—raises the question of whether such controls will once again become widespread. The IMF's position has long been that capital-account liberalisation should proceed in an orderly way: countries should lift controls on outflows only gradually as the balance of payments strengthens; liberalisation of inflows should start at the long end and move to the short end only as banking and financial systems are strengthened. We have not opposed Chilean-style, market-based measures to regulate capital inflows at the short end, but they must be considered case-by-case (Chile has recently eased its controls).

Yet long experience shows that any short-term benefits that controls on outflows produce will be outweighed by their long-term disadvantages, as they encourage domestic evasion and capital flight, and discourage foreign investors. After Malaysia's imposition of controls, other Asian countries have firmly rejected them, as has Latin America. We should, even so, recognise that the lure of isolation from the international system will increase unless market turbulence settles.

Next is the issue of moral hazard. It is hard to see evidence of this on the part of policymakers. Most countries do their utmost to avoid going to the IMF. The thornier issues arise on the side of investors. Some point to investors who take excessively risky positions on the back of an IMF safety net. Others are concerned that investors who should have paid a penalty may be bailed out by IMF lending.

These worries should now be mitigated as most investors in Asian countries, and especially investors in Russia who bet on the "moral-hazard play", have taken very heavy losses. We need to balance concerns over moral hazard against the costs for the system of exacerbating instability by failing to assist countries in need. This issue is closely tied to the question of how to "bail in" the private sector (ie, get it to roll over its debts or provide new money rather than rushing for the exit). The IMF and other groups, including the G22, are working on this high-priority problem.

We also again need to appraise exchange-rate regimes for emerging market countries. The recent crises have all taken place in countries with fixed or semi-fixed exchange rates. Yet several countries, including Argentina, have benefited from a fixed rate; and currency crises also affect countries with flexible rates. The argument has been made that there are really only two stable exchange-rate systems: a freely floating rate, or the adoption (perhaps via a currency board) of another country's currency. With the expected success of EMU, more currency blocks may develop. But for now, we are in an uncomfortable in-between world in which floating rates are sometimes too volatile and fixed rates sometimes too vulnerable to attack.

Lastly there is the question of reforming the IMF. Many of the changes discussed above will affect its role. There is also general support—including from the management of the IMF—for greater transparency in IMF operations. There has been much progress in recent years, as a visit to our website (www.imf.org) can show. More can be done, but only with the full support of the membership.

It is sometimes argued that the IMF is not accountable. That is not true. It is fully accountable to its membership, through the 24-member executive board that represents the 182 member countries. No loan or other big decision is taken without the board's approval. Overall IMF policies are set by the 24-member interim committee, made up of finance ministers and central-bank governors, which meets twice a year. Most complaints about accountability are really about transparency. If more details of IMF operations were published, there would be more room for appraisal by outsiders—which would be to the good.

What to do now

While work on the international financial architecture moves ahead to prevent the next crisis, we need urgently to contain the present one. Four steps are needed.

First, as the balance of risks in the international economy has shifted, so should the stance of monetary policy in America and Europe. This week's cut in American interest rates is welcome news. It is also good that European central bankers have suggested that European rates should converge to the low levels in France and Germany rather than meet in the middle.

Second, Japan's continuing recession is a major problem, both for Japan and for the rest of the world. Rapid action to sort out its banks, and further fiscal stimulus, would go a long way to help Japan and the rest of Asia recover.

Third, the key to stopping the spread of the crisis is Latin America; and in Latin America it is Brazil. Latin American countries have made genuine progress in structural reforms this decade. They have reacted courageously to recent financial pressures by tightening monetary and fiscal policies. Brazil's President Cardoso has left no doubt that he will take more fiscal action after the election.

The international financial system, which has sustained the world economy through 50 years of growth and prosperity, needs reform to ensure that this continues—and that the mistakes of the 1930s are not repeated. For the IMF, which has had a central role in the system, to continue to play its part, it needs the support of its membership as it adapts to a changing world economy—and it urgently needs the quota increase.

* Stanley Fischer is first deputy managing director at the International Monetary Fund. The views expressed in this article are those of the author. They are not necessarily shared by the International Monetary Fund's executive board.

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