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Contents

CHAPTER 5

Financial-Sector Liberalization and the Asian Financial Crisis

The IFIs Got It Wrong Twice[1]

IWAN J. AZIS

Introduction

A large body of literature has been written about what caused the Asian Financial Crisis (AFC). Attention is usually given to structural weaknesses in the affected countries that led to self-fulfilling expectations and speculative attacks. One of the structural weaknesses is located in the region's banking sector; it became more severe and visible after the financial-sector liberalization. The equally frequent claim of "crony capitalism" is given as the main explanation for the crisis.

Under pressures from the international financial institutions (IFIs), all Asian-crisis countries liberalized their financial sector in the 1980s. Both deposit and lending rates were freed, so were credit allocations. Despite the higher growth following liberalization, the economy became much more vulnerable to external shocks, raising the likelihood of a crisis (Bekaert, Harvey, and Lundblad, 2001). In the aftermath of the shock, many analysts argued that the banking sector's vulnerability and the corresponding instability was closely associated with financial-sector liberalization policy (Kaminsky and Reinhart, 1999). Expressing it in a less forceful way, the International Monetary Fund (IMF) also admitted this through its attempts to stress the importance of the long-standing issue of sequencing (Johnston, Darbar, and Echeverria, 1997).

By most accounts, the AFC has been more severe than originally predicted, even after a set of proposed policies was adopted—in line with IMF conditionality. This raises questions about the effectiveness of those policies: What exactly are the IMFS's policies in the AFC, and how are they expected to help the region recover? Why have they failed, and what are the alternatives? This chapter explores these issues. First, a critical evaluation of the financial-sector liberalization policy is provided, a policy fervently advocated by the IFIs during the 1980s. Second, its inconsistency related to the preconditions required to insure net benefits is pointed out. It is argued that much of the ingredients of the AFC in 1997–'98 was the result of such a liberalization policy. Second, the subsequent discussion centers around the policies advocated by the IMF in response to the crisis. I compare those policies with the alternatives in order to understand why some of the intended outcomes could not be attained, indirectly suggesting that the alternative policies would have produced more favorable outcomes.

Financial-Sector Liberalization

An increasing body of literature has focused on why some countries in the region survived from the 1997 AFC. An often-quoted example is China. Most, if not all analyses, point to the relatively closed capital account as the key explanation.[2] In distinguishing countries that managed to survive the crisis and those that did not, John Williamson (1998), a proponent of the Washington Consensus, admitted that: "The one dimension in which there is systematic difference between the two groups is with respect to whether or not they had liberalized their capital accounts."

In all Asian-crisis countries, full current-account convertibility (trade liberalization) had been in place since the mid-1980s. They all accepted the IMF's Article VIII obligations. But liberalizing the trade and financial sectors are fundamentally different. The policy implications are not the same. Consensus on the postulate that trade liberalization brings significant economic gains has, by and large, been reached. It is not so with financial-sector and capital-account liberalization. Theoretically, one should distinguish between the welfare impacts of financial markets and those of other markets. The most critical difference is the role and presence of *asymmetric information*. In a financial market, providing information is central, yet it is precisely on this market that failures and asymmetric information abound, for example, moral hazards and adverse selection (Stiglitz, 1994).

One should contrast the potential short-term gains of the policy with the instability that the policy can create. Such instability could be a fertile ground for a financial crisis. Kamisky and Reinhart (1999) show that based on the episodes of seventy-six currency crises, of which twenty-six are also

characterized by banking crises, financial-sector liberalization appears to activate a boom-bust cycle—causing instability—by providing easy access to financing. Proponents of liberalization would argue that in order to reduce the risks of instability, several requirements and preconditions need to be met. In essence, they suggest some sort of microsequencing. The commonly suggested sequence is: improve the quality of regulation; make sure they are enforced; and improve the supervisory mechanisms. Once the markets are liberalized, the level of the bank's minimum capital requirements can be brought closer to what the Basle Accord suggests. There are variations to this, but basically that is the essence: Meet the "pre-conditions prior to liberalization."

However, when the Asian-crisis countries liberalized the financial sector in the 1980s, the aforementioned preconditions (assumptions) were not in place. Yet, they were rushed to liberalize by the IFIs. Ironically, when at the early stage the policy showed favorable impacts (higher economic growth and greater access to financial services), the IFIs applauded. But when the crisis hit, the very same countries previously praised were swiftly placed into the category of those with misplaced development strategies. All of a sudden, nothing was right with these countries. When confronted with such an embarrassing contradiction, the international institutions were quick to claim that they actually *saw* the faults, and had *already reminded* the governments about the existing flaws, such as the weak banking system, the unsustainable exchange rate system, and widespread corruption.

One of the common features to emerge after the financial-sector liberalization was the surge of interest rates. This occurred in all Asian-crisis countries. This trend significantly altered the incentive system and prompted nonprudent behaviors from within the banking sector (Hellman, Murdock, and Stiglitz, 2000). Under these circumstances the amount of investment credits going to risky sectors rose (adverse selection), the incidence of bailout in the absence of free-exit schemes increased (moral hazard), and the subsequent banks' franchise values (expected returns) declined. All these are precisely what the "preconditions prior to liberalization" are expected to avoid. Thus, the implicit logic is inherently self-conflicting: expect bank's prudent behavior while allowing franchise value to fall. The suggested preconditions, although seemingly logical, simply do not match with the prevailing institutional conditions.

The IMF persistently argued for simultaneously liberalizing the sector and meeting the preconditions. A study by the fund on the sequencing of capital-account liberalization using the case of Chile, Korea, Indonesia, and Thailand stresses the importance of proper sequencing if benefits from liberalization are to be achieved and risks minimized. This study also argues that financial-sector liberalization, especially in capital accounts, should be a part of a coordinated and comprehensive approach in which the sequencing of regulatory and institutional reforms are critical. The design of macroeconomic and exchange-rate policies should also play a vital role (Johnston, Darbar, and Echeverria, 1997). Although intuitively making sense, such conclusions are too broad and are far from practical. No one would argue against the importance of making liberalization policy (or any policy for that matter) consistent with the prevailing macroeconomic policy. But *how to do it* remains unanswered. The information contained in this study is of limited value to policy-makers. Even though many countries still had problems meeting the stated preconditions, they were pushed to accelerate liberalization by recommending one or two new measures to safeguard. More often than not, these measures are based on the practice of developed countries that have different institutional conditions.

The removal of credit controls under the liberalization policy in all Asian-crisis countries resulted in a surge of credits, including those allocated to the speculative real-estate sector. This occurred even at very high interest rates because some investors continued to borrow with such rates (adverse selection). Hence, a "bubble" was born—someone was able to sell something at a price well beyond the realm of making reasonable profits. The bubbles were also fully blown in the pay scales of executives and those who worked in finance, securities, and other firms, tremendously increasing their excessive purchasing power to create other bubbles in the prices of durable goods, including cars, houses, and luxury items. As a result income and consumption surged. Foreign investors were attracted to join the "party." They flocked into the Asian equity markets. Those who sought equity funds at high share prices found no difficulty in obtaining them. With the booming stock market, many industries expanded well beyond their means. Hence, the economy was growing like a bubble with a fragile foundation. A bursting of it was just waiting to happen.

Financial-sector liberalization was also responsible for the appreciation of the precrisis real-exchange rate in most Asian-crisis countries. Under perfect foresight (myopic assumption), the opening of capital markets to foreign investors increased the demand for, and prices of, domestic assets (Azis, 2002a; and Berg and Taylor, 2000). This pressured the real exchange rate to appreciate. Faced with such a challenge, governments in the region attempted to intervene in the foreign exchange market, followed subsequently by sterilization (sterilized intervention). The sterilization came in the form of either raising reserve requirements or through open-market-operations (OMO) by selling bonds or securities. This typically requires an increase in interest rate, which stimulates raised capital inflows, and results in increased pressure on the real exchange rate. As a result, an unfavorable combination of high interest rates and appreciating real exchange rate was produced. With uncompetitive rates, the trade sector suffered, causing the current account deficits (CAD) to increase.

Hence, the liberalization of the financial sector throughout the region consistently caused the standard "fundamentals" to be weak. In other words, it resulted in the appreciation of real exchange rates, credit booms, and high interest rates (Sachs, Tornell, and Velasco, 1996). Moreover, there is another factor that distinguishes the AFC from other crisis episodes: A considerable portion of CAD was financed by short-term foreign debts. Most of this debt was unhedged, made by either the private banking sector (e.g., Korea) or by the private nonbank corporate sector, as in Thailand and Indonesia. While domestic credits expanded significantly (credit boom) following the liberalization, the sheer size of short-term private foreign debts was much more serious than domestic credits. Measured in terms of its ratio to foreign exchange reserves, countries with the worst economic situation were precisely those that had short-term debt (STD) greater than their reserves [e.g., Indonesia (1.7), Thailand (1.5), and Korea (>2)]; see Table 5.1.

With large short-term debts denominated in foreign currency, the exchange rate risk increased. In such circumstances currency and maturity mismatch abound, and a relatively small shock is sufficient to cause the system to fall into debt and exchange-rate crises (Chang and Velasco, 1998). Looking at the debtors' balance sheet, when the exchange rate depreciated, greater pressures on the liability side significantly constrained their capacity to expand. When the debtors are mostly banks, as in Korea, the depreciation adversely affected credit expansion. Where most debtors are members of the corporate sector, such as in Indonesia and Thailand, the capacity to invest became severely constrained. Hence, the positive relation between depreciating exchange rate and increased output in a standard macroeconomic model breaks down. The AFC that was originally characterized by only an exchange-rate crisis turned into a widespread economic crisis (recession).

Thus, the composition of capital flows matters. The sudden reversals of capital flows during 1997 and 1998 led many to believe that most capital flows in the region were of portfolio investment type. Reversals of such capital can strain the region's financial system sufficiently to cause or exacerbate its collapse (Reisen, 1999; Rodrik and Velasco, 1999). However, though it is true that portfolio investment was on the rise, data indicate that foreign direct investment (FDI) remained the largest in all Asian-crisis countries.

What is more critical to observe is the capital flows category of "others," in which loans and debts are the major components. As revealed in Table 5.1, in all Asian-crisis countries, foreign debts increased persistently until

Table 5.1. Foreign Debts (billion dollars, except the last row)

	Indonesia			Korea			Malaysia			Philippines			Thailand	
	End 1995	End 1996	June '97	End 1995	End 1996	June '97	End 1995	End 1996	June '97	End 1995	End 1996	June '97	End 1995	End 1996
Borrowers														
Banks	8.9	11.7	12.4	50	65.9	97.3	4.4	6.5	10.5	2.2	5.2	5.5	25.8	25.9
Public sector	6.7	6.9	6.5	6.2	5.7	4.4	2.1	2	1.9	2.7	2.7	1.9	2.3	2.3
Nonbank	28.8	36.8	39.7	21.4	28.3	31.7	10.1	13.7	16.5	3.4	5.3	6.8	34.7	41.9
Total	44.4	55.4	58.6	77.6	99.9	103.4	16.6	22.2	28.9	8.3	13.2	14.2	62.8	70.1
Lending Banks														
Japan	21	22	23.2	21.5	24.3	23.7	7.3	8.2	10.5	1	1.6	2.1	36.9	37.5
USA	2.8	5.3	4.6	7.6	9.4	10	1.5	2.3	2.4	2.9	3.9	2.8	4.1	5
Germany	3.9	5.5	5.6	7.3	10	10.8	2.2	3.9	5.7	0.7	1.8	2	5	6.9
Others	16.8	22.7	25.3	41.1	56.3	58.9	5.8	7.8	10.2	3.7	6	7.2	16.8	20.8
Maturity														
Short-term debt (STD)	27.6	34.2	34.7	54.3	67.5	70.2	7.9	11.2	16.3	4.1	7.7	8.3	43.6	45.7
Long-term debt (LTD)	16.8	21.2	23.9	23.3	32.4	33.2	8.7	11	12.6	4.2	5.5	5.9	19.2	24.4
STD and Forex														
Foreign reserves (forex)	14.7	19.3	20.3	32.7	34.1	34.1	23.9	27.1	26.6	7.8	11.7	9.8	37	38.7
STD/Forex	1.88	1.77	1.71	1.66	1.98	2.06	0.33	0.41	0.61	0.53	0.66	0.85	1.18	1.18

Source: Azis 2002a, Fig. 2.

the onset of the crisis. These are debts made by the private sector. At the time no one saw the trend as worrisome, let alone alarming. Not even the IFIs, probably because it was considered consistent with and to some extent expected as a result of the privatization strategy also advocated by them. Yet, financial and balance-of-payments crises become interlinked precisely because of the existence of foreign-currency-denominated liabilities (foreign debt) in the domestic financial system (Krueger, 2000).

The trend of rising foreign debts, especially short-term and unhedged, clearly aggravated the region's vulnerability to a shock, suggesting that it should be added to the list of "fundamentals" (Azis, 1999). Interestingly, there seems to be a close correlation between increased debts and crony capitalism. A relatively large proportion of loans or debts is generally found in a system where the degree of corruption and crony capitalism is high. This type of flow is also much more volatile and fragile when compared to FDI or portfolio investments. Based on a sample of a large number of countries, a study has found that corrupt countries tend to receive substantially less FDI and more foreign bank loans. The study also shows that such a result is robust across different measures of corruption and econometric specifications (Wei and Wu, 2001). Even though some of the assumptions used are subject to verification, this kind of study integrates two rival explanations for the AFC: vulnerability due to large foreign debts that led to speculative attacks, and crony capitalism that was indeed present in the region.

It is clear that financial-sector liberalization in the Asian-crisis countries have significantly contributed to the vulnerability of the region's financial sector. At the very least, liberalization increased the likelihood of a crisis. Yet, the IFIs vehemently and persistently advocated that these countries proceed with such a policy in the 1980s. The rival explanation for the AFC, crony capitalism and corruption, also holds some truth. These two explanations are interlinked through the composition of capital flows that tilts toward foreign debt. This type of flow has been found to be most volatile, and it clearly increased the region's vulnerability to crisis.

IMF Policy Response and Alternatives

A traditional policy mix of monetary tightening and fiscal restraints was imposed as part of the IMF funding conditions. Their "success" with the handling of the Mexican crisis in 1995 convinced the fund that such a policy mix would also be appropriate for Asia, despite the fact that the precrisis conditions in Asia were different.[3] Further, the IMF insisted on a rather drastic and fundamental change in the countries' institutional structures. The experience with policy adjustments of this kind in Eastern Europe and the former Soviet Union (from communism to market economy) had inspired the fund to do the same thing in Asia.

The first two columns of Table 5.2 summarize what the IMF believes to be the causes of the crisis and their corresponding policies. A weak banking system (labeled WEAKBANK in the first column) was among the most serious sources of economic vulnerability. This was reflected, among others, through the high growth of bank credits. Yet, before both the Mexican and Asian crises, the growth of bank credits in Asia has never been higher than that in Mexico and some countries in Latin America.

The IMF was also of the opinion that the fixed exchange-rate system prior to the crisis (labeled FIXEDER) had put the region in a susceptible position.[4] Again, the appreciation of the real exchange rate (RER) in the region was never higher than in Mexico, Brazil, and Argentina. Chinn (1998) revealed a similar finding. Depending on how one measures the RER, in one scenario using the consumer price index as deflator, the precrisis RER even depreciated, not appreciated (Azis, 2001). Ironically, in many instances during the 1990s the IMF praised the fixed rate system for its ability to propel a robust economic growth with stability. It is indeed too common to fault a financial crisis on the fixed-exchange rate system. When things go wrong, the rate tends to be overvalued. While the nominal rates may be fixed, the RER is likely to appreciate, hurting exports and the overall balance of payment.

Poor governance in the corporate, banking, and government sectors (labeled GOVANCE) is another source of vulnerability (Summers, 2000). The IMF believes that this has featured heavily in Asia, exacerbating the region's vulnerability. The prescribed policies are consequently based on the foregoing perspectives. The weak banking system needs to be resolved by systematic banking reform. When necessary it should also include the closure of nonviable banks. At the same time, the problems of poor governance had to be resolved by major reforms that allowed drastic and fundamental changes in microeconomic and institutional structures.

To the extent that a real appreciation of the exchange rate and the overall market confidence are determined by the inflation rate and government signals to the market (its seriousness to respond to the shock), at the early stage the IMF also requested the recipient countries to tighten their budgets.[5] This policy is fairly standard in the fund's conditionality.[6] According to the argument, a tighter budget would help reduce the inflation rate and simultaneously assure the market that government is dealing seriously with the problem.[7] Further, a more important and controversial policy prescribed by the IMF was to tighten the monetary sector by increasing the interest rates (labeled TMP).

In addition to curbing the inflation caused by currency depreciation, such a policy was also expected to prevent further capital outflows and/or

Table 5.2. Sources of Vulnerability and Policy Response: IMF Perspectives and Alternative Views

IMF Views				Alternative Views	
Sources	Policy	Expected Outcome	Unintended Outcomes	Sources	Policy
Weak banking system (WEAKBANK)	Budget, bank rest, fundamental reforms (CLM)	Resume bank lending (BLENDING)	High cost and ineffective restructuring (BCCOST)	Massive inflows and corporate debts (CORPDEBT)	Debt rescheduling and capital control (LBDH)
Fixed EXR system & RER appreciation (FIXEDER)	Tight money policy (TMP)	Positive net capital flows (CPFLOWS)	No real improvement in the balance sheet (NOBS)	Contagion (CGION)	Moderately tight net financial policy and gradual bank and corporate rest (MPBC)
Poor governance (GOVANCE)	Liquidity support and open cap. acc (LIQ)	Low inflation to avoid RER appreciation (RERAP)	No capital inflows and big windfall to savers (SAVERS)	Weak prudential enforcement (PRUDBANK)	
		Improved governance and improved BOP (GOVT)	High social cost (SOCCOST)		

attract new capital inflows, both of which would help strengthen the local currency. Only with CLM and TMP in place could the IMF's role as a lender of last resort to provide liquidity supports (labeled LIQ) could be carried out. However, according to the IMF's original mandate, such financial help should be directed only to support the country's balance of payment. Despite the IMF's frequent requests for budget consolidation and bank restructuring, no IMF resources could be used for those purposes.

Each of the foregoing policies has its specific rationale and objective. Bank restructuring and fundamental microeconomic reforms were meant to clean up the financial and real sectors, and enhance the quality of governance (labeled GOVT in the third column of Table 5.2). The corresponding improvements in the banks' balance sheets would allow banks to resume their intermediation function by extending loans (labeled BLENDING). A strict government budget together with tight monetary policy would help remove any inflationary pressures that might be fueled by exchange-rate depreciation. If successful, the real exchange rate could be prevented from appreciating (labeled RERAP). In turn, this would help increase the country's exports and improve the balance of payment position. The tightening of monetary policy by increasing the interest rates was also expected to generate positive net capital flows (labeled CPFLOWS).[8]

In reality, some of these intended outcomes did not materialize. Worse, several unintended outcomes emerged. In some instances the latter neutralized the positive results. The following is a list of such unintended outcomes. In restructuring the banking sector a huge amount of resources, mostly public money, had to be spent for the main component of the program: bank recapitalization. Indeed, a most notable sign of vulnerability prior to the crisis was the sheer size of private-sector debt, largely short-term and unhedged. The proportion of short-term debt in total foreign reserves reached more than 100 percent in those countries that were severely hit by the crisis, namely Korea, Indonesia, and Thailand.

As the exchange rate began to depreciate, the local currency value of the debts surged, hurting the balance sheet position of most corporate and banking sectors throughout the region. Hence, a recapitalization program was inevitable. In practice, however, the amount of resources used for the program went beyond what the countries could actually afford. The costs of bank recapitalization range from 30 to 60 percent of GDP. Yet, by 2000, well over two years after the program was implemented, the intended objective of resuming banks' intermediation function has not been met, implying that the program is cost ineffective (labeled ECCOST in Table 5.2).

In all Asian-crisis countries bank recapitalization had been financed largely by public money. Although each country has different formats and mechanisms, they all used some sort of government bonds. The value of bonds appear in the asset side of the banks' balance sheets, removing the prevailing banks' negative net worth. However, the actual financial position of the banks did not really improve. With a considerable amount of bonds in their assets, most banks still have liquidity problems (flooded with nonliquid assets). As a result, many recapitalized banks are not in a position to lend.[9] Hence, no real improvement in banks' balance sheets (labeled NOBS) is one of the unintended outcomes listed in Table 5.2. Worse, the regulatory policy imposed during the bank recapitalization program resulted in a substantial decline in the banks' small business lending, in part because their lending behaviors became excessively cautious, as clearly found in the case of Korea (Kim, 1999; Domac and Ferri, 1998).

Further, expected capital inflows did not occur, suggesting that the costs of setting high interest rates—credit crunch, exacerbating firms' balance sheets—are likely to exceed benefits. There is yet another kind of "cost" to the economy. The high interest rates provide huge windfalls to savers, mostly of the medium and high-income groups.[10] This has worsened the income disparity (Azis, 2000).[11] Another unintended outcome is related to the tightening of government budgets. It is often the case that this would mean massive expenditure cuts, including those items related to social overhead capital. In Thailand and Indonesia many subsidies (e.g., for fuel and food) had to be either drastically slashed or completely removed from the budget, causing prices of some basic necessities to increase. This led to further deterioration of the social conditions (labeled SOCCOST).[12]

From many discussions with policy-makers, analysts, and observers throughout the region, I found that most hold an opinion not necessarily in line with the IMF's.[13] In fact, at the early stage of the crisis Thailand, the country where the AFC began, clearly tried to avoid the involvement of the IMF. Blustein (2001) described the episode in great details, showing that the IMF was eager to jump into policy design in Thailand. At one point the Fund's first deputy managing director ordered a mission to depart for Bangkok, although not invited. His subordinate protested the order since it would clearly breach the protocol.[14] The director replied: "Just go, and in the time it takes for you to get there, I'll persuade them." At the end of course we know that, with the exception of Malaysia, all Asian-crisis countries came under the IMF program. The Fund has immense power to force governments to accept its policy advice since it can both withhold financial supports (IMF loans) and declare whether a country has been "Seal Approved" to be eligible for funds from other multilateral institutions and foreign countries.

The list of what I perceive as alternative views is shown in the last two columns of Table 5.2. For example, unlike the IMF, many hold an alternative view that massive amounts of inflows of private debts is the major source of vulnerability (labeled CORPDEBT). In some countries, policy-makers had detected the surge in such debts as early as 1992. But at the time the trend was considered normal, even expected as a consequence of increased private-sector role in the economy.[15] Many also believed that contagion (labeled CGION) played an important role in precipitating the crisis and intensifying its depth.[16] On the banking sector the alternative view agreed with the IMF assessments that this sector was weak. But most policy-makers and analysts are also of the opinion that financial sector's weaknesses actually began to appear right after the financial-sector liberalization in the 1980s. The key problem rests on the lack of enforcement of prudential regulations (labeled PRUDBANK), not the lack of regulation itself.

The alternative views tend to opine that any restructuring policy, be it for the banking or corporate sectors, had to be conducted in a gradual manner allowing agents to adjust to the new environment. A drastic measure can destabilize a system that needs to be rescued in the first place.[17] Since deteriorating market confidence precipitated capital outflows, some control measures in the financial policies (monetary and budgetary) were needed. However, unlike what was proposed by the IMF, the tightening of the financial policy should have been moderate so that it would not aggravate the already damaged balance sheets of many banks and corporate firms.[18]

Similarly, budget retrenchments ought to be done moderately. Some even argued that under the distress situation the budget should have been made more expansionary—in order to avoid the so-called "bad" equilibrium (Sachs and Woo, 2000; and Krugman, 1999). Notwithstanding the question of whether a gradual or moderate measure is more effective than a drastic one, the above policies alone were not likely to help strengthen the exchange rate. As long as indebted banks and the corporate sector could not resolve the debt mismatch, it would be difficult to avoid pressures on the exchange rate. Hence, the opinion expressed tends to opt for some sort of a debt rescheduling.[19]

Elsewhere I have explored, in greater detail, the conflicting nature of the two sets of policies, as well as how the "compromised" policies could be arrived at (Azis, 2002b). The scenario that is closer to what really happened is a combination of a tight monetary policy, with government budgets slightly slashed but with the restructuring of the banking and corporate sectors conducted in a gradual manner (in terms of Table 5.2 it is a joint-policy TMP-MPBC). Such a joint-policy scenario failed to produce a robust and sustainable recovery. Consequently, the IMF pushed for more drastic restructuring. The alternative views point to the damaging effects of high interest rates on the economy. On this issue, unless counterfactual policy simulations are conducted, any conclusions would be premature.

As I have shown elsewhere (Azis 2001; and 2002a) such counterfactual simulations by using a dynamic financial model applied to one of the Asian-crisis countries. It is revealed that by not adopting a high interest-rate policy the country's socioeconomic conditions would have been more favorable. Interestingly, the results of the counterfactual simulations are highly dependent on the effectiveness of debt rescheduling (LBDH in Table 5.2).[20] Further, I argued that the IMF's tight monetary policy not only failed to restore the exchange rate, it also exacerbated the loss of market confidence by pushing the country into a recession.[21] The ineffectiveness of interest-rate policy to strengthen the exchange rate is consistent with the conclusions of other studies (Turongpun, 2001; Gould and Kamin, 1999; Ohno et.al, 1999; Goldfajn and Baig, 1998). Moreover, the model simulations indicate that income distribution and poverty conditions would have been more favorable had the country not been stuck too rigidly with the IMF-style policy. In addition, the combination of nonhigh interest rates and partial debt resolution at the early stage of the crisis is found to be most favorable from the social indicators perspective.

By now it is widely accepted that the AFC is very different from a standard crisis caused by unsustainable current account deficits. The AFC is a capital account crisis featured by sudden withdrawals of foreign money due to panic and other reasons. The weak spot seen by investors is in neither the standard macroeconomic fundamentals nor the size of current account deficits. Rather, it is in the composition of capital flows to finance the deficits—that is—the currency and maturity mismatch of the country's debts. The phenomenon occurred because most of the financial sector in the region had already been liberalized (pushed by the IFIs), and capital was globally mobile more than ever. The IMF was ill-equipped to combat this new type of crisis, as confessed by the IMF's highest official:

> A lot is related to financial-sector issues, where the IMF staff did not have necessary expertise at all [. . .] we find ourselves making standard policy prescriptions [. . .] very seldom would you go wrong if you said "raise interest rates and tighten fiscal policy" [. . .] I thought the teams in Asia were sort of conditioned by the framework they had in mind.[22]

Conclusions

There are formidable risks involved when a country embarks on financial-sector liberalization. The IFIs, the proponents of such a policy, often undermine the risks of instability it can create. The pressure by the IFIs on the Asian-crisis countries to pursue this policy during the 1980s, and their standard suggestion to provide necessary preconditions prior to liberalization (such as good quality regulation, legal frameworks, and supervisory mechanisms), are inherently self-conflicting. Given the region's existing institutional conditions, the liberalization policy encouraged imprudent behaviors (reducing the "franchise value") of the banking sector, something that the preconditions tried to avoid. By the mid-1990s, all Asian-crisis countries had liberalized the financial sector, making this sector much more vulnerable to external shocks. When the shock came in the summer of 1997, they all fell into crisis. The push by the IFIs for liberalization, which overlooked the prevailing institutional conditions, clearly raised the likelihood of a crisis.

After the crisis burst, the policy response advocated by the IMF also contained several faults. The Fund's insistence on severely tightening the monetary policy by raising the interest rates proved to be counterproductive. Its arguments for drastic and fundamental microeconomic adjustments seemingly make sense; who would not agree with ending corruption, curtailing special business privileges, and imposing the practice of good governance? But in addition to the fact that this is outside the IMF's mandate, such adjustments severely undermine the source of stability. The Fund's involvement in issues that go beyond its mandate during the AFC was eloquently expressed by former staff member Morris Goldstein: "Both the scope and the depth of the Fund's conditions were excessive. [. . .] They clearly strayed outside their area of expertise. [. . .] If a nation is so plagued with problems that it needs to make 140 changes before it can borrow, then maybe the fund should not lend" (*New York Times*, October 21, 2000). Some analysts went further by comparing the IMF with a heart surgeon who, in the middle of an operation, decided to do some works on the lungs and kidneys too.

Demanding sweeping changes in the region's institutional structures is not really needed for the return of capital, nor is it required to restore market confidence. On the other hand, to make such a drastic change in the midst of a currency crisis could be more disastrous than helpful. Changes would have been more effective when conducted gradually, such that only few shocks would be created in the system. While acknowledging the importance of institutional reforms, many policy-makers are fully aware that comprehensive and fundamental reforms, especially when conducted rather drastically, are difficult to implement. Not even OECD countries could execute the programs with such great detail and comprehensiveness as the IMF prescribed. Because of these differences, wrangles and disputes over program implementation often characterized the process, even after the official letter of intent (LOI) had been signed.

Both the advocated financial-sector liberalization and the policy response to the AFC proved to be unsuitable to the prevailing conditions in the region. The IFIs got it wrong twice. Liberalization increased the likelihood of a crisis, and the broad structural reforms failed to restore confidence. The tightening of the monetary sectors skewed the relative income distribution by disproportionately benefiting the high-income savers, worsened the financial positions of many sectors, particularly the medium and small industries, and dampened investment that resulted in a major recession. This further damaged market confidence, something that the IMF intended to restore in the first place. The social repercussions of economic contraction have been serious. No wonder international criticism of the Fund's role in the recent Argentine's fallout is currently being echoed throughout Asia.

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Notes

1. I have benefited from the comments and suggestions of participants in the following meetings: (1) Conference on "Social Implications of the Asian Financial Crisis," jointly organized by the UNDP and Korean Development Institute (KDI), Seoul, 1998; (2) Carnegie Endowment for International Peace conference on "The Politics of Economic Reform in Asia," Bangkok, June 4–5, 1999; (3) IMF meeting on the fund's approach in Indonesia, Washington, D.C., September 5, 2000; (4) NBER project meeting on "Exchange Rate Crises in Emerging Markets" Cambridge, MA, September 15, 2000; (5) Internal seminar at the Asian Development Bank Institute, Tokyo, December 19, 2000; and (6) the "Asia Panel," Center for International Studies (CID), Harvard University, Cambridge, MA, April 20–21, 2001. Exchanges of views with Walter Isard, Masahiro Yoshitomi, Takatoshi Ito, Sudradjad Djiwandono, Wing Thye Woo, Kanit Sangsubhanand, and Jae-ha Park on the subject are also highly appreciated. The usual disclaimer applies.
2. China's financial sector remained controlled throughout the 1990s. Further, a large size of foreign reserves ($140 billion in 1997), and the Yuan's devaluation in 1994 are important factors that enabled China to escape from the shock.
3. Nobel laureate James Tobin and Gustav Ranis (1998) are among those who believe that the IMF programs in Asia were based on the Fund's experiences with Mexico in 1994: "The IMF's Asian packages are based on its experiences with Latin America, in particular with Mexico in 1994."

4. For example, on an IMF mission to Thailand in early 1997 Stanley Fischer wrote a letter to Thai Finance Minister Amnuay Viravan stating: "We continue to believe that the introduction of a more flexible exchange rate arrangement is a policy priority."
5. In the second column of Table 5.2, bank restructuring, fundamental changes, microeconomic reforms, and tightening of government budget are combined in a policy item labeled CLM.
6. Lawrence Summers, the then U.S. Treasury Secretary, once joked that IMF stands for "It's Mainly Fiscal."
7. In the case of Thailand, the IMF demanded a substantial budget surplus, including raising the value-added tax from 7 to 10 percent and cutting expenditures by 3 percent of GDP. Putting the figures into perspective, Blustein (2001) compared it with what would have happened if the cut applied to Americans, i.e., as if the U.S. raised taxes or cut government benefits by $300 billion each year, or over $1,000 for each person.
8. For more detailed explanations of the IMF policies, see Timothy Lane et. al (1999).
9. The constraint on banks' supply of loanable funds (the "credit channel effect") was more significant than the decline in the demand for credits during the crisis. For a conceptual analysis see Kashyap and Stein (2000), for empirical proof in one of the Asian crisis countries, see Azis and Thorbecke (2002).
10. This unintended outcome is labeled SAVERS in Table 5.2.
11. Using a price endogenous model applied to one of the Asian crisis countries, it has been shown that a high interest rate policy deteriorates inequality (see Azis, 2001).
12. One could argue, however, that the IMF did not have sufficient time to analyze the costs and benefits of each policy. They were expected to produce a policy package when the economy was already in crisis. Though this is reasonable, it remains the fact that some of the fund's policies were ineffective. In some cases, they even aggravated the undesirable outcomes.
13. Obviously the views are not identical in all countries. I found differing opinions among analysts and policymakers within the same country. But what is more interesting is that in almost all cases the differences are more on the priority (ranking of importance) rather than about the substance or types of policies.
14. Unless invited or requested the IMF should not interfere with domestic policies. Each year, IMF staff missions visit member countries to conduct an assessment of the country's economy and to consult with policymakers in relation to what is known as "Article IV." The director's order to go was clearly outside such a mission.
15. When reminded about it, a senior minister once told this author that "the private sector knows better than the government in deciding how much, and under what terms they have to borrow," Although they might know precisely what they did, they were also surely aware that without incorporating the standard risks (in interest and exchange rates), the short term and unhedged foreign borrowing could potentially create a financial disaster.
16. The IMF also believes that a process of contagion could play a role. In the words of the then Fund's managing director Stanley Fischer (2000): "contagion or weaknesses in the affected economy? The answer is both. Establishing the presence of excess volatility and contagion in the system is complicated by the fact that a crisis of confidence can push a country from a good to a bad equilibrium."
17. This gradual approach is not to the liking of the IMF. The following statements of Ann Krueger, the Fund's managing director, when commenting on the rescue program in Indonesia sets an example: "Market sentiment has been adversely affected by conflicting signals in some key areas, such as privatization, and continued concerns about progress of the broader reform agenda." She further remarked that "structural performance criteria" of the program had not been met. Accelerated restructuring of corporate, state-owned enterprises and banking sectors are among the disputed issues (IMF News Brief no. 02/7, January 29, 2002).
18. The combination of gradual restructuring and moderate financial policy is denoted by MPBC in Table 5.2.
19. This policy measure is labeled LBDH in Table 5.2.
20. Actually, the Brady Bonds scheme introduced in the 1980s to resolve the debt crisis in Latin America, in which some debts were swapped for government-guaranteed bonds with lower interest rates (some also with reduced principal), is an alternative form of debt rescheduling. There are no compelling reasons why such a scheme will not work in Asia. In early

1998, when I asked Stanley Fischer why in Asia the IMF did not do what it did in Latin America, he indicated that it is much more difficult to organize effective meetings between a large number of private debtors and lending banks, most of which are not syndicated banks. In Latin America, most debtors are governments, and most lenders are syndicated banks.

21. Not to mention that raising the interest rate would also further weaken the already weak banking system. Krueger (2000) clearly states that "raising the interest rate addresses the balance-of-payments crisis at the costs of weakening the financial system still further."
22. Remarks by the IMF Institute's director Mohsin Khan, as quoted in Blustein (2001).