Asia, the IMF and Australia

The following is the text of a speech given by Mr Ted Evans, Secretary of the Treasury, to the Sydney Institute, 17 February 1998. It discusses how the Asia crisis developed, in what way it differs from previous crises and the role and performance of the International Monetary Fund (IMF).

INTRODUCTION

Less than a year ago there was general agreement around the globe that the outlook for the world economy was more promising, in almost every respect, than for many decades. In less than six months, that rosy prognosis has given way to an equally widespread consensus that world economic growth will slow significantly — and with the range of serious forecasts extending to predictions of world deflation (not a high probability but worth noting as indicative of the extent of concern).

Events in Asia were central both to the development of the earlier euphoria and, more so, to the extraordinary turn of events. I would like tonight to address four aspects of those developments:

- why the Asian crisis occurred in such an unheralded manner;
- in what way has this crisis differed from its predecessors;
- what has been the role of the IMF and, in particular, are criticisms of its performance justified; and
- what policy lessons emerge, both for the international community and for Australia.

Some of these issues, particularly aspects of the first two, are already well documented and I shall therefore cover them only briefly by way of background to the other two issues which will form the substance of this address.

THE ASIAN CRISIS

Among the many comprehensive reviews of recent Asian developments I would like to draw on a recent one from Stanley Fischer[1] which I believe summarises the developments neatly. He notes as the key domestic factors leading to the difficulties:

- 'firstly, the failure to dampen over-heating pressures…
- secondly, maintenance of pegged exchange rate regimes for too long…
- thirdly, lax prudential rules and financial oversight.'

Fischer continues:

> 'As the crisis unfolded, political uncertainties and doubts about the authorities' commitment and ability to implement the necessary adjustment and reforms exacerbated pressures on currencies and stock markets. Reluctance to tighten monetary conditions and to close insolvent financial institutions has clearly added to the turbulence in financial markets.'

He has a lot more to say on the topic, including on the contribution of developments in the rest of the world, but the essence is in the points above. A question immediately arises: namely, if the issues can be so readily specified after the event, how could such a momentous development have escaped prediction.

Herein lies one of the policy lessons to which I shall return later; but, briefly, the answer to the question just posed turns largely on the distinction between what is **foreseeable** and what is **forecast**.

It happens to be a fact that virtually all of the shortcomings in each of the individual Asian economies affected by recent developments had been **foreseen** and had been the subject of comment and debate for some considerable time — though often with a reluctance to accept as weaknesses policies that had been perceived as strengths. To mention but a few, it has been well known that:

- banking systems in some countries have long been potentially vulnerable because of links (to government and/or business) which limited the exercise of prudent commercial judgement;
- government support of favoured enterprises by way of guarantees or regulation involved unquantifiable contingent fiscal liabilities;
- capital inflows had expanded rapidly in recent years and had become increasingly short-term; and

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1 Fischer S. 1998, 'The Asian Crisis': A View from the IMF, address to The Midwinter Conference of the Bankers' Association for Foreign Trade; Washington D.C., 22 January 1998.

- fixed exchange rate regimes are increasingly vulnerable in a world where even the major exchange rates move by sizeable amounts in markets which are prone to overshooting.

Yet that knowledge has not led to forecasts of the type of developments that have occurred; and the performance of the Asian economies as a group, if not individually, continued to defy the critics. The difficulty is that forecasting requires more than foreseeing the probability of an event; in the first place, it requires that a timetable be attached to the probability. This distinction is well enough known to have led to the longstanding comment about economic forecasters that they 'have forecast ten of the last two recessions'. That type of track record leads to caution in forecasting; and that caution is understandably prominent in situations like that in Asia for the past several decades where the discussion of miracles has created an associated expectation of infallibility (not of forecasters but of policy-makers).

Moreover, economists tend to look for linear responses to shocks but the reactions of markets are decidedly non-linear. If the underlying economic foundations contain structural weaknesses, even small shocks can be magnified by markets into substantial crashes. Thus, even though the IMF had forecast the events in Thailand more than a year before their occurrence, this did not lead to a forecast of the ensuing contagion.

In short, it is probable that given a similar circumstance in the future we could not rely on economic forecasts to predict something like the Asian crisis — but let's revisit that when we talk about policy lessons.

A NEW TYPE OF CRISIS?

In the extensive literature that has developed since the events in Thailand began to unfold in early 1997, considerable emphasis has been put on these developments being significantly different from what has been referred to as the classical balance of payments crisis of earlier decades; and related to that emphasis has been the development of renewed criticism of the IMF's role.

While there are several facets to this, a common argument put is that this is more of a financial than a fiscal crisis; and, in particular, that Asian fiscal positions have been in good shape and public debt low. Rather, the argument goes, the present problems lie with private sector debt and with inadequate financial systems.

Most of this commentary is well based in fact (though I shall return to the question of fiscal positions in a moment) and there is not the slightest doubt that the weaknesses of domestic financial institutions, supervisory regimes and inadequate commercial legal infrastructure have played a substantial role in the extent to which the crisis has both developed and spread. Recognition of that is important in developing solutions; but emphasis on differences might also mask the importance of fundamental similarities with the past which are equally important in seeking solutions.

In particular, a starting point in analysis should be that a common feature of both the classical and the new style financial crisis is **overexposure to debt**. Whenever an individual, an enterprise, or a country decides to increase its current control over resources (potentially, to increase its growth) it immediately takes on an obligation attached to which are certain expectations. The debt contract is done at a price, related to the risks for both the borrower and lender and both become vulnerable from that time onwards — vulnerable to both their own subsequent actions and those of the other party.

All of this is well established but equally easily forgotten, not least because the borrowing process works smoothly enough for most of the time — and is an essential part of the growth process. But it can come unstuck, and is prone to do so whenever artificial elements enter into the calculation of risk and its pricing. Those can take several forms, the most prominent being:

- the intervention of government, either as the borrower, in the classical case, or as the guarantor, in the Asian case;
- the intervention of government, not in the borrowing process as such, but in a way which influences the prospective return on investment and hence the pricing of the borrowing: either directly by subsidies or tax breaks or, less transparently, through the direction of financial intermediaries and / or the guaranteeing of related activities; and
- the intervention of government, by creating the expectation that exchange rates will remain fixed (or move only within narrow limits) but without the policies to deliver on that expectation.[2]

What has emerged in the Asian situation has been the prominence of such indirect intervention — in particular, through the close association of government and financial intermediaries and the implicit guarantees that go with it. This has been a longstanding feature of some of the countries now with problems and, of itself, has also been a contributory factor to the inadequacy of the supervisory mechanisms put in place.

More recently, as competition among the Asian economies to attract investments has intensified, the resort to intervention in the pricing of investments has also escalated. And the prevalence of eager and imprudent lenders in the rest of the world — again, in retrospect, inadequately supervised — added to create a volatile mixture.

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2 It is the caveat that is important here. Fixed exchange rates can be highly successful, as the case of Hong Kong shows, provided they are backed with adequate domestic policies.

I have elaborated this rather simple message a little to bring out two points:

- first, that the sound fiscal positions of the Asian economies — universally acknowledged as one element underlying the so-called Asian miracle — may not have been as sound as generally accepted if **properly specified**, ie while the fiscal positions look sound on conventional measurement, that measurement does not take account of contingent liabilities; including importantly, in these cases, those arising from the implicit and explicit guarantees associated with the types of banking regimes that have developed; and
- second, the fact that the debt is predominantly private — having been undertaken to finance private investments — is of no relevance if the pricing of that investment is severely distorted by government incentives, regulation or exchange market intervention. It does not take a socialist to conclude that borrowing for public sector purposes need not carry greater costs or risks than borrowing for private sector purposes when the latter is undertaken under artificial conditions.

These two points take us back to the unfinished and unsatisfactory Australian debate in the 1980s on the so-called 'twin deficits' hypothesis. Underlying the inability to find a satisfactory conclusion to that debate was inadequate attention given to the role of investment and the conditions in which resource allocation decisions are taken. In other words, dealing with the savings side of the savings/investment imbalance will not provide the complete solution to an external imbalance if serious distortions are left on the investment side.

Again, in turning to lessons below, I will pick up both the fiscal and investment issues.

THE ROLE OF THE IMF

The IMF has long borne the brunt of criticism in its relationships with countries in difficulty and those criticisms have heightened in the Asian episode. The latter should not be entirely unexpected as it is not all that difficult to find some shortcomings in any attempt to deal with a crisis situation — particularly after the event. However, for the most part, the criticisms have no more substance than they have had in the past.

The range of complaints about the Fund's performance is wide but two large issues continually reappear, albeit at different ends of the spectrum. Both of these are worth revisiting in the current situation and I shall do so briefly.

The first is the claim that 'Fund programs' lead to a severe slowing of growth and that the burden is borne heavily by the most disadvantaged in the community. Those who make these criticisms seem to be unaware that the Fund is prohibited, by its Articles of Agreement, from deliberately pursuing such a course. The Articles require the Fund:

> '(v) [to provide members]…with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.'
>
> and
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> '(vi) … to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members.'

The seeming conflict between these objectives and what emerges in practice arises because it is invariably the case that when the Fund works with a member country in such a circumstance growth invariably fails and hardship does fall upon the most disadvantaged within society. But to draw a link between that and the 'Fund program' is to make the most simplistic error of assuming that correlation implies causation. The **fact** is that the slowing in growth and its associated effects have by this stage become inevitable; they are the consequence, not of the 'Fund program', but of the policies that have been pursued in preceding years and which have led to the crisis; and the role of the Fund as required by its Articles is to so advise the country as to ameliorate those effects — not to worsen them.

That is not to suggest that the Fund, in its policy advice, is infallible. No one argues that and there is clearly scope for different judgements on specific issues. For example, the recommended fiscal stringency may initially have been overdone; and the proposed reforms of the banking sector might have paid more attention to the constraints imposed by its rudimentary nature — but these are second-order issues compared with the shortcomings in policy implementation.

The second criticism, often coming from the other end of the ideological spectrum, has somewhat more substance. It asserts that the existence of the Fund and its obligation to assist members in external difficulties creates a moral hazard in that it encourages both borrowers and lenders to be less rigorous in their due diligence processes than they would be in the absence of such a 'last resort' facility. While there is undoubtedly some theoretical substance in this, it is an empirical fact that countries will go to extraordinary lengths to avoid resorting to the Fund's facilities. It is thus a little fanciful to imagine countries deliberately getting themselves into such circumstances because of the existence of the Fund (though perhaps the same could not be said about lenders).

What is more believable — though it is not a criticism that I have seen given much attention — is that the Fund's existence leads to a moral hazard in another sense. Namely that, while it is the Fund's responsibility to assist member countries in external difficulties it has a more important responsibility in helping countries avoid such difficulties. This is widely known and it might be argued that the knowledge that the Fund is doing this (ie, undertaking surveillance of its members) will of itself contribute to an expectation that economies will be well governed; or, if not, that the international community will become aware of bad performance, through the Fund's activities.

If such an expectation exists then it must be conceded that there has been on many occasions, including in respect of the Asian economies, a failure of the Fund's surveillance processes. This does not necessarily imply a criticism of the Fund, *per se*, but a comment on the total process, including the response of governments in light of Fund advice — it is therefore related to the **effectiveness** of Fund surveillance. Herein lies the final, and most difficult, lesson.

SOME POLICY LESSONS

To the extent that there are differences between the Asian crisis and those of the past, they arise from the importance of structural issues: particularly the importance of sound legal and financial systems — which means systems that are both free to operate on a commercial basis and subject to effective prudential supervision. But there are wider lessons than that and they derive, not from the differences in those crises, but from longstanding issues related to good governance in the presence of debt. Picking up the points made earlier, there are important issues related both to the climate in which investment decisions are made and, not unrelated to that, the appropriate interpretation of fiscal positions.

On investment decisions, it is clear that Asian countries have repeated the mistakes of many of their western counterparts (in many of which, in varying degrees, those errors persist). The desire to give government preference to particular investments — rather than to get the overall economic climate right — is a hard habit to shake. Though many governments now see the problems in attempting to 'pick winners' they nevertheless lean towards policies which seem more designed to pick losers. The most obvious example of this is incentives given to investments on the basis that they would not otherwise occur.

The upshot of such misallocation of resources through poor investment decisions is that savings are squandered on projects with inadequate returns and, as we have seen in Asia, even in countries with high domestic savings the result becomes an external account problem.

While there may be no apparent fiscal problem in such circumstances, when the policies become unsustainable (for whatever reason) there are invariably pressures for the cost to be picked up in the fiscal accounts. If the mechanisms used to create the investment incentives include the direction of lending via the banking system, while that system remains under implicit or explicit government guarantee, the danger is extremely great — the more so because its magnitude is hidden until the crisis occurs.

The lesson in this area is one of increasing transparency: including by substantially improving fiscal accounting. This must extend beyond traditional cash accounting to pick up balance sheet items including, most importantly, contingent liabilities even where they cannot be quantified. Recent developments in New Zealand and Australia (including by Australian State Governments) are now at the forefront of world best practice and must form part of an improved surveillance regime within the IMF (which has responsibility for government accounting standards).

It is now clear that that surveillance regime must be enhanced in many other respects. This has been recognised for some time though not advanced sufficiently to have precluded the problems that have arisen in Asia. We should not need further prompting.

As indicated above, the surveillance shortcomings lie not in recognising the problems — though much could still be done through greater transparency, particularly in respect of more information on the standing of individual financial institutions and developments in commercial property markets (which are so often the route via which financial intermediaries and others get into unsustainable positions). But the main weaknesses in the surveillance process lie not in information shortages but in having the available information, and the analysis based upon it, converted into adequate policy action.

Here the difficulties lie both in the ever-present problem of governments being unwilling to act outside of their preferred timetable; and the shortcomings of the economics profession (including its policy advising arms) in making a strong case in convincing governments otherwise. One element of that is the forecasting problem identified above, ie the problem of knowing when to convincingly convert a probability to a forecast.

It is difficult to know whether there will ever be an adequate solution to the forecasting problem. A long series of crises in different parts of the world (none of which was forecast) ought to convince us that until better forecasting techniques are available, policy cannot be operated on the basis of forecasts alone: the heavy concentration on forecasts, by both governments and markets, may have been one of the most unhealthy developments of recent decades. Policies must be framed against a presumption that shocks will occur; to minimise vulnerability, policy must ensure that structural weaknesses are continually addressed: this, moreover, is the information that market participants really need, not forecasts.

Such an approach is well within the capability of policy advisers and, increasingly, is being practised in the more advanced economies. The medium-term framework of Australian fiscal and monetary policies and the concentration of structural policies upon continual and ongoing reform provide the only real armoury so long as external shocks remain unforecastable.

For the Fund, the challenge will be to garner sufficient political support to make its surveillance activities more effective. Greater transparency will be a key element of that. Whatever its shortcomings, crises like the recent episode cannot be handled other than by the Fund. The Australian Government has stressed this at every opportunity; and, signalling its confidence in the Fund, Australia has been one of only two countries (the other being Japan) willing and able to provide associated financial support to all three Asian countries which have called on the Fund's assistance. The continuing criticisms of the Fund display a fair deal of academic rigour combined with a greater dose of political naivety.

For Australian governments, both Commonwealth and State, the lessons are clear:

- sustaining fiscal surpluses until debt levels are judged adequate; and
- heightened pursuit of structural reforms, to yield better returns on investment, improve competitiveness and minimise both internal and external financial vulnerability.

This has been the focus of current government policies.

The Asian crisis will slow the growth that otherwise would have been obtainable in Australia and, as forecast, put pressure on our current account. This will not be of concern providing the markets — those from whom we borrow to sustain our growth — understand that we have the important structural reform priorities right.