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Abstract

The IMF Fund is now centred on crisis prevention and supervision}, particularly in developing as well as transition countries. While confirming that the IMF as a focal point of the international financial system, the Asian crisis tends to illustrate the limits, or excesses, associated with its action. A redefinition of its role along with its mandate seems necessary.

From its establishment at the end of December 1945, the role of the IMF has changed considerably because of the abandonment of the fixed exchange rate system, but also because of the surge of financial globalisation, which has profoundly affected the way that the institution was supposed to administer (Kirrane 1995). In addition, these countries nowadays have little need of any financial support from the IMF as they can easily depend upon international capital markets. The activity of the Fund has consequently shifted both sectorially in addition to geographically. It has increased its supervisory role; at the same time, the focus of its interventions has gradually shifted to developing countries and economies in transition. In fact, the IMF is in a sense condemned to concentrate on the countries it can impact through the conditions attached to the loans it grants (Padoa-Schioppa and Saccomanni 1994).

On the occasion of the IMF's 50th anniversary in 1994, the Director General, Michel Camdessus, stated that the institution was adapting to changing conditions without renouncing its original mandate. Thus, although it is true that surveillance, which was part of the original mandate of the Fund, is still its main subject of action after having taken precedence over the objective of exchange stabilisation from 1976, it remains to question the effectiveness of these interventions during the Asian crisis.

During the summer months of 1997, South East Asia was plagued by financial troubles (banking crises, foreign exchange crises, etc.). The crisis erupted in early July with the decision of the Thai authorities under the pressure of recurring speculative attacks since the start of the year, to float the baht, then their appeal to the IMF. The appreciation of the dollar against the yen and the main European currencies was the detonator of the crisis. Indeed, this persistent appreciation since the summer of 95 rendered the policy of anchoring the Thai baht to the dollar more and more unsustainable, aggravating the difficulties already experienced by the country, in particular because of the growth of its exports. The slowdown in Thai growth and also exports was fueled particularly by the industry's loss of competitiveness due to rising wage costs. Finally, the confidence of foreign investors was additionally undermined by increasingly apparent weaknesses in the banking sector, fueled by real estate speculation, the accumulation of non-recoverable debts, and so on. The growing probability of a fall in the value of the Thai currency against the dollar heightened concerns because a depreciation could only destabilise the banking as well as financial system as a whole by growing the debt load largely contracted in dollars and without having coverage.

Speculative attacks subsequently spread to other countries in the region (Indonesia, Malaysia, Philippines), which likewise had to appeal to the IMF (Indonesia in October 97 and Korea in November). The sources of contagion are numerous and different in different countries: the similarity of macroeconomic imbalances (notably the widening of the current account deficit) to a certain extent explains the spreading into neighbouring countries, however , with regards to Malaysia and to a lesser degree Indonesia, it is probably the result of competitiveness that has been the main vector of contagion. As the various economies of the region compete on common external markets, since one of them, in this case Thailand, renounced the dollar peg, the temptation became powerful, even irresistible, for the others to do the same so as to not lose competitiveness and not to see their market shares decrease compared to those of competitors. Speculators, perceiving the weight of this temptation, attacked the currencies of neighbouring countries of Thailand. Weaknesses in the banking sector, which is another point common to each one of these economies, certainly also added to making currencies more vulnerable. This particular characteristic was also present in South Korea, the last economy to have been hit and yet did not practice a policy of pegging its currency to the dollar. In the latter case, the close relationship between the state, banks and large Chaebols explains the accumulation of risky loans, which dealt a lethal blow to the entire financial system and undermined the confidence of foreign lenders.

Concerning the IMF, the essential lesson which can be drawn from the Asian crisis is the partial failure of the ambitious programme that had been put in place in the aftermath of the Mexican crisis: in particular, the role of supervision was plainly insufficient to avoid the financial crisis in Thailand, then its spreading to the rest of the region.

After the Mexican peso crisis, the IMF the necessity 'to provide the market with timely and complete information on crucial economic variables' (Overlay, 1995: 42) as the only way to improve surveillance to member economies and ultimately prevent new crises. The task on the definition of leading indicators of macroeconomic slippages was to lead to the introduction at the begining of 1996 of the special standard of dissemination of data (special data dissemination standard). Key indicators include the level of foreign reserves, the balance of payments, monetary aggregates, the budget balance, inflation and growth rates.

The failure of the prevention mechanism was, in fact, foreseeable: it was indeed an illusion to believe that better information gathering and circulation might be enough to avoid crises. Firstly, since the information transmitted to the IMF comes from certain departments or agencies of the member countries, they can be manipulated and are therefore necessarily unreliable, for example the inaccuracy of the numbers provided by South Korea, Indonesia, Thailand and Malaysia on their respective levels of indebtedness as well as foreign exchange reserves was a perfect example of the intrinsic weakness of the system. On the other hand, classic macroeconomic indicators were not adequate to give a clear picture of a country's situation. Thus, regarding Asian economies, the role of the private sector in the outbreak of the crisis was such that information on the situation and modalities of private sector indebtedness would have been necessary, however they were not readily available.

In addition to the fact that it was not necessarily easy to determine the most relevant information, it would also be naïve to believe that their mere publication might prevent all slippage in time. In addition, errors of interpretation were always possible: evidence of the systematic complacency of observers towards Asian economies. The short-sightedness of the main international rating agencies, that

generally downgraded the ratings of Asian economies once the crisis was clearly declared and not before, provides outstanding example of this kind of attitude.

Lastly, the role of information and warning signs in the prevention of crises is also by definition delicate as these signals may themselves be the cause of panic phenomena on the markets. Given the gregarious nature of investors, the mere fact of drawing public attention to specific points of vulnerability in an economy may trigger panic actions, and thus incite information holders to interpret them in an alarmist way.

At the hypothetical level, the partly self-fulfilling character of the currency crises that hit the vibrant} economies of Asia undermined the prevention strategy. Indeed, if one accepts the concept a crisis may be triggered by a reversal of expectations not based on the deterioration of 'macroeconomic fundamentals' but on any event deemed relevant, such crisis (or at least the precise moment when it will be triggered) is by definition unpredictable, compromising the chances of being able to prevent it.

In the case of the Asian crisis, many people accused the IMF of 'not having seen it coming'. This accusation is excessively severe. IMF experts were apparently shocked by the speed with which Thailand's difficulties spread and the degree of contagion; however, the possibility of a crisis in Thailand had been clearly identified, as evidenced by the numerous warnings released by the Fund throughout 1996. A continuous dialogue was maintained between the IMF and the Thai authorities, and there had been pressure for emergency steps to be taken. In Indonesia, the excessive growth of credit to the private sector was already a source of concern in 1996 as the Central Bank imposed certain limits on different banks and other credit institutions. Lesser foresight seems to have prevailed in the case of Korea.

Even if the IMF did not ignore the risks, the fact remains that its warnings were in vain. The Fund's ability to influence was clearly limited and its primary weakness may be in fact its incapacity to cite any *ex ante* coercive power. Since the IMF is dealing with sovereign states, it cannot, outside periods of severe crisis, force them to reorient their economic strategy. Its powerlessness is further aggravated by the fact that so-called emerging economies now have easier access to private capital markets.

One of the primary causes of the difficulties seems to have been the inconsistency between the level of financial liberalisation and the level of maturity of local financial institutions. Therefore, a conclusion appears to be needed, which would strengthen the defenses of emerging economies against the turbulence imposed through financial globalisation. In the short term (that is, as long as these economies do not have the necessary maturity), there might be a question of reducing the consequences of globalisation by limiting the mobility of capital and, in the longer term, put in place a stronger local institutional structure.

In the case of East Asian countries, it was the dysfunctions of the banking systems that were at the heart of the difficulties, which obviously resulted in steps to improve the prudential regulation of this sector at both national and global level. This posed an issue, however, since some rules may be valid under specific conditions and may be inadequate in others, as the example of Indonesia, which conformed to principle to the Cooke ratio requirements for years. In this area, it might be appropriate to capitalise on the expertise already acquired by the BIS (Bank for International Settlements), but the IMF probably also has a role to play, specifically in the area of exchange rate surveillance.

Despite this rather negative observation on prevention, the crises also had some positive albeit partially ambiguous, aspects: the extent of IMF interventions and the spontaneity of the calls made to the Fund by states facing financial difficulties was a clear departure from the past, with the role of the IMF as the focal point of the international financial system. Regarding the peso crisis, the IMF was initially ignored because it was initially a 100% US intervention. It was only following the disagreement between the Presidency and Congress that the IMF sought to regain control (Minton-Beddoes 1995, Shields 1997). Regarding the Asian crisis, the IMF was front and centre, although the need for Washington's support was rapidly felt. Perhaps the United States' commitment to Thailand's rescue operation failed to restore confidence in the region. In any case, the spontaneity of recourse to the IMF instructions even if, in some cases, as in Korea, the authorities showed some hesitation - shows increased credibility of the institution. The seeming automaticity of its interventions could, however, itself be at the root of difficulties, as will be shown later on, especially as it lacks legal foundations.

Although prevention clearly did not work well, the crisis management system was apparently successfully. Thus, the emergency funding mechanism set up in the summer of 96 was used for the first time regarding the Philippines in July 97. The scale of the crisis, however, forced the establishment of another mechanism, ease of supplementary reserves which was employed for South Korea in the course of December 97. This scheme, targeted at Member States facing exceptional difficulties in their balance of payments due to market fluctuations, aimed to provide funds more rapidly, but the repayment would be quicker and above all more expensive. The goal was to discourage late recourse to the IMF and help remedy the moral hazard issues discussed in the next section.

Any kind of financial rescue operation by definition poses a so-called moral hazard problem. Using a guarantee entails the risk of not discouraging or even encouraging risky behavior. In addition, once the rescue operation is implemented, there is a great risk that it will encourage the beneficiary authorities to delay the necessary adjustments.

The reason for the principle of conditionality is precisely to solve the problem of moral hazard by compelling the beneficiaries of the rescue operation, generally the States, to a certain financial discipline. Conditionality discourages public authorities from persisting not in good ways because of the rigour associated with adjustment programmes imposed by the IMF to punish defaults. It has an undoubtedly dissuasive effect on the political leaders, who will have to face the popular discontent that will not fail to engender the use of the austerity programmes associated with the rescue operations. Consequently, moral hazard seems to be resolved through conditionality in the conduct of governments. It should not be forgotten, however , that conditionality, if it is too strict, may have the opposite effect to that sought by encouraging governments to delay the moment when they turn to the IMF, thus increasing the difficulties they are prey to (Fischer 1997).

In addition to this possible perverse effect, conditionality does not in any case eliminate moral hazard altogether, particularly because of the increasing role played by the private sector. In Asia, it was in fact the markets that the IMF's interventions made it possible to bail out, even indirectly, and not the States, because the bulk of the debt was made by private operators (banks or companies) and not by government authorities. It was indeed the local private investment banks that fueled debt by lending indiscriminately in the real estate sectors specifically thanks to funds easily acquired on the international capital markets.

Thailand, for example, this process was fueled by the BIBF (Bangkok International Banking Facilities) which assured the intermediation operation between international creditors and Thai traders involved

especially in real estate projects. In South Korea, bad debts were the consequence of loans granted to key industrial groups by banks acting more as agents of the government than as credit institutions. The intervention of the IMF consisted of bailing out the finances of the government to enable it to take on the debt of the private operators. Under these conditions, the IMF intervened, not to punish the mistakes of governments, but to correct the dysfunctions of the private sector, which was a significant departure from its original mandate. Moral hazard was also reinforced in this case, because financial intermediaries, even if they had not received explicit guarantees from the state, felt shielded from the risks because of the extremely close links between the leaders of these institutions and politicians. Conditionality in the traditional sense of the term, imposed by definition on governments, might only have a reduced influence under these conditions and moral hazard remained intact in this new configuration. It was additionally questionable whether IMF interventions for the benefit of private operators were not the gateway to repeated system malfunctions.

Lastly, while it is true that the problems of the emerging economies were due to internal private defaults, they have also been fed externally by agents on whom conditionality has no hold either. It is not always easy to dissuade markets from lending to governments that persist in bad policies or to private agents who take on excessive debt. Some agents of the private sector may be too eager to lend to a country if they know it will appeal to the IMF instead of being unable to pay its debts.

Thus, during the Mexican peso crisis, it was the holders of tesobonos and other securities of the same type that were the main beneficiaries of the rescue operation: after having benefited from considerable returns in exchange for theoretically very high risks, they were taking, they ultimately did not have to face the supreme risk, that of not being paid because of the currency crisis, thanks to IMF intervention IMF (Shields 1997). The absence of sanctions for these agents could give rise to fears of additional defaults of the same kind in the future. In the case of the Asian crisis, foreign lenders, who were partially responsible for the disorder because they were the ones who fed the spiral, get away with it. In South Korea, for example, important foreign creditors were, under leadership of the major US banks, to negotiate directly with the public authorities for the conversion of a large portion of short-term private debt into long-term debt with a guarantee by the State, which amounted in a way to nationalisation of private debts.

Since the private sector is at the root of the issues, the international community ought to ensure that it shares the financial costs of crisis solutions (Fischer 1997). This is likely to explain the IMF's inflexible stance on the necessary consolidation of the Indonesian banking sector, for example, or its insistence that some Indonesian and Thai banks having bad debts, or the over-indebted Korean chaebols, be put in bankruptcy proceedings (Camdessus, 1997). The lack of bankruptcy legislation in most of these countries, however, did not assist matters. In addition, as mentioned above, sanctions did not necessarily affect all those responsible. Generally, the market sanction for operators who were too adventurous remained a prerequisite for the smooth running of the system (Adda 1996). IMF interventions as a lender of last resort, however much they may be needed, ought not to be automatic in any way, otherwise they run even greater risks to the system. The lack of clarity on the conditions of intervention as a lender of last resort is probably the answer. On this point, however, the IMF's room for manoeuvre is narrow, because it is about ensuring the short-term stability of the international financial system without compromising it in the long run by increasing moral hazard. In fact, the challenge is to find a way to maintain capital flows to emerging economies by providing credit guarantees, but at the same time imposing certain risks to avoid substantial flows and misguided uses.

Apart from the very principle, the modalities of possible intervention by the IMF were also problematic. The provision of emergency aid to re-launch battling economies was always combined with economic policy recommendations designed to correct the causes of imbalances, however the focus of these recommendations was rarely agreed upon. The effectiveness of the interventions was first of all far from being indisputable. Thus in Asia, contrary to what was observed in the situation of Mexico, the massive IMF intervention did not stop the fall of currencies or stock markets.

The first question is whether the conditions enforced by the IMF to the States in difficulty were suitable. Since most of its work had shifted away from the industrialised countries to concentrate on developing countries, the IMF has mainly tackled the problems of three categories of countries: the poorest countries (mostly in Africa), the so-called countries in transition (from Central and Eastern Europe) and the indebted countries of Latin America. The remedies recommended in the case of Thailand and South Korea in particular were similar to those that were successfully administered in Mexico in 95. However, the difficulties faced by the dynamic countries of Asia were of different nature, because it was the banks and the large industrial groups that were in financial trouble and not the public authorities, one can only be sceptical about the usefulness of these remedies. In South Korea, for example , the setting of an inflation target of only 5%, while the local currency, the won, lost more than 60% of its value in 97, did not appear to be reasonable. The recessionary impact of the proposed policies (contraction of domestic demand, restrictive monetary policy, increase in tax revenues by widening the tax base and so on) was hardly in doubt, and one can then legitimately question the desirability of such policies for a nation that has faced an implosion of its banking system. In the case in point, the imposition of high interest rates and an austerity programme to help curb growth did nothing to help the restructuring of the financial sector, quite the opposite.

The IMF's aid programmes have, it is true, changed somewhat with time and now include, alongside the traditional orthodox recommendations, a series of steps that include the restructuring of the banking sector. According to a confidential IMF report, the institution had contributed to shaking confidence and exacerbating the crisis by, for example, demanding the closure of 16 banks in Indonesia. Moreover, while the need to clean up the financial system as a whole was indisputable in most crisis-stricken Asian countries (and particularly in Thailand, Indonesia as well as South Korea), the modalities for achieving this goal were, to say the least, open to critique. Beyond that, by trying to correct private sector defaults, the IMF was prone to overstep its mandate and risk somehow becoming guilty of interfering with the internal economic affairs of some countries. When it comes to Indonesia, for example, by demanding in-depth reform of the modus operandi of the entire economy, the IMF went past a boundary. While there is no doubt that the country would benefit from operating in a more transparent environment and free of the distortions imposed by the persistence of monopolies and other barriers to competition, it is legitimate to ask whether it is up to the IMF to dictate its conduct to the Indonesian government, especially since the societal costs were considerable. Paradoxically, in this country, it appeared that the insistence of the IMF to put in place an insufficient adjustment policy ended up producing the difficulties that it was supposed to remedy by feeding in particular the resumption of inflation.

The IMF's difficulties with this economic crisis were probably due to the excessive extension of its mandate. Initially tasked with resolving balance-of-payments imbalances, the IMF gradually felt invested with an ever wider mandate without its analytical instruments being modified, or any collective reflection on the best ways to implement it.

The record of IMF action in the Asian crisis was mixed, to say the least. Still the institution must probably be less criticised for its incapability to prevent crises than for its clumsiness in their management. Beyond this, the Asian crisis highlighted some questions about the Fund's role, the desirability and the legitimacy of its interventions.

The relative failing of IMF interventions was due to the inadequacy of the institutional framework designed in the forties to manage relations between nation-states operating in an environment of segmented markets and reduced mobility of capital. The *ad hoc* adaptation of the institution's mandate posed a problem, in particular due to the rise of the private sector. Today, financial markets are functioning globally and the private sector is playing a growing part, while the institutional framework continues to be nation-state based. If the IMF wants to stick to its original mandate of ensuring the prosperity of the member states by guaranteeing a certain stability of the international monetary system, it must now acquire new instruments and consider much more cooperation with some other institutions.

With regard to crisis management, the inadequacy of the mechanisms presently in place in relation to the *modus operandi* of the international economic system} is also evident. The rigidity of the IMF's macroeconomic approach in fact reflects the gap between the instruments at its disposal} and the growing burdens it believes it has to assume. It must be acknowledged that the IMF at first intended to assume the functions of lender of last resort with countries facing balance of payments problems; in Asia this was not the case because private operators (banks and companies) were at the heart of the difficulties. The role the IMF is expected to perform in developing economies dealing with acute financial difficulties is far from clear. The inexactitude of its mandate has led to several types of abuses such as the rescue of private operators and interference in the definition of how the economies operate.

Consequently, the time has come to redefine the role of the IMF and its mandate, but also to make clear the conditions of its interventions and their articulation with those of other institutions such as the World Bank (Kirrane 2003). A new conference, similar to that held at Bretton Woods in 44, may clarify the particular responsibilities of the various multilateral economic institutions which will be required to cooperate more closely in the future to ensure the stability of the international financial system.

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