

## ASIAN PROBLEMS AND THE IMF

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Between 1990 and 1996, capital inflows to emerging market countries rose from \$60 billion to \$194 billion. Mexico's problems in 1995 changed the form of those capital transfers, and equity owners learned from their losses. After 1995, portfolio investment declined, but direct investment increased. Banks were bailed out, so they continued to lend, and bank loans rose with direct investment.

No one carefully monitored those capital flows. When problems developed in Asia in 1997, neither the International Monetary Fund (IMF) nor the private lenders knew the true magnitude of the debts of some of those countries. Firms borrowed directly and through their subsidiaries. Often the total was not shown on any balance sheet. The provision of the IMF Articles of Agreement requiring surveillance, and the decision to strengthen surveillance following the 1995 Mexican problem, proved to be of little use.

Though important, the IMF's failure to monitor seems small beside the elementary mistakes of private lenders. The lenders ignored three principles of prudent behavior that history has shown repeatedly to be a major reason for financial failure.

### Mistakes of Private Lenders

First, Asian banks and other Asian borrowers used short-term renewable credits from foreign banks to finance long-term loans. All banks do this to some extent, but the extent matters a great deal. When the foreign loans were not renewed, the Asian banks and corporations faced large defaults.

Second, Asian banks and corporations borrowed in foreign currencies—yen, marks, and dollars—and loaned in local currency. They

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accepted the exchange risk without hedging. Their reasoning was appalling—interest rates were lower abroad. They failed to realize that the difference in interest rates, after allowing for the difference in inflation, included the risk of currency depreciation. I suspect that this risk is now apparent.

Foreign lenders shared this myopia. They did not show concern about making short-term dollar or yen loans to borrowers that financed long-term domestic assets.

Third, many, perhaps most, U.S. and other bankers did not ask to see consolidated balance sheets. They did not monitor the total assets and liabilities of the borrowers.

These three elementary errors are evidence of the pervasive problem of moral hazard. The banks expected to be bailed out again, so they acted imprudently, without regard for basic banking principles. The result has been that equity investors, debt holders, and owners of claims denominated in foreign currency have taken large losses. By mid-January 1998, stock markets in Indonesia, Malaysia, and Thailand had lost about 75 percent of their value on December 31, 1996 (*The Economist* 1998: 98). In the Philippines and South Korea, the loss was 65 percent. In the year to mid-January, holders with claims in Indonesian rupiah lost 70 percent of their value. The Thai baht, South Korean won, and Malaysian ringgit fell 40 to 50 percent in the same period.

## The Problem of Moral Hazard

What of the U.S., Japanese, and European banks? Their loans are in dollars, yen, and other hard currencies. They want repayment in full. The IMF and the principal governments lend money to the Asian governments so they can pay the interest on their existing bank loans or repay the principal. Extending new credit helps the Asian banks to avoid default, but the money goes to the foreign bankers. Instead of taking losses like the holders of currency, stocks, and bonds, the banks collect with relatively small losses. And, in exchange for extending repayment, the banks collect fees for renegotiating the loans. They demand government guarantees of the loans they made to banks, financial institutions, and private corporations.

This policy is the fourth mistake. I believe it is the greatest mistake of all, because it invites a larger financial crisis in the future. The Mexican bailout required \$40 billion. This time the IMF and governments of developed countries have promised South Korea \$57 billion, Indonesia \$34 billion, and Thailand \$17 billion, for a total of \$117 billion.

Capitalism without failure is like religion without sin. It doesn't work. Bankruptcies and losses, even the threat of bankruptcy, concentrate the mind on prudent behavior. Prudence is the missing element in the Mexican and Asian problems. In its absence, bankers and other lenders have taken excessive risks. They have no incentive to learn about how many loans borrowers have outstanding, how much borrowers have borrowed short to lend long, or how much currency risk has been assumed. The lenders don't care much, because they collect with little or no loss whatever happens.

The IMF's programs contribute to the large wedge between the social risk—the risk borne by the troubled country—and the private risk borne by bankers. This is one source of moral hazard, and one reason we have a crisis-prone system. A common argument in its defense is that Mexico repaid its loans to the U.S. government and the IMF. That argument misses the point. If banks and financial institutions had taken losses in Mexico, they would have exercised elementary judgment about risks in Asia.

Some bankers and Treasury officials defend more money for the IMF by citing loans to Mexico as a success for U.S. Treasury-IMF intervention. This is an extraordinary claim. It looks only to the repayment of the loan, achieved mainly by borrowing abroad. It ignores the effect on the Mexican economy.

Consider the record. The U.S. Treasury and the Federal Reserve have been "helping" Mexico since the 1930s. The IMF has been at it since the 1970s. Successive Mexican governments have learned that if they face a crisis, one or both of these friends will lend them money to make the immediate crisis appear less onerous. Investors have learned that they get bailed out, so they continue to invest. I believe that goes far toward explaining why Mexican policy has been erratic and undisciplined at times. The Bank of Mexico and the government take excessive risk and incur large losses for Mexican taxpayers.

The foreigners do not deserve all of the blame, by far, but they contribute. The results have been disastrous for the Mexican economy and its people. Despite enormous growth in the world economy in the past 20 years, Mexican real income in dollars was the same in 1996 as in 1974. The Mexican people have been on a bumpy road, but they have gone nowhere. In the same period, Mexican debt in constant dollars increased from \$40 to \$160 billion. Much of this is the price Mexico paid for U.S. and IMF assistance. Without the IMF and the U.S. Treasury, Mexico would learn to run better policies, would have less debt and, I believe, would have made more progress.

Frequently, the argument is made that moral hazard is not a problem because no government chooses to subject its economy and its people

to the losses experienced in Latin America in the 1980s, Mexico in 1995, or in Asia now. I believe this is true but irrelevant. The issue does not arise in that way.

A country may find it necessary to choose between offering guarantees to foreign lenders and facing large withdrawals of foreign loans. Mexico, Korea, and others have faced precisely this choice. The government may choose to guarantee the loans by issuing dollar-denominated securities, such as the Mexican tesobonos, or by promising to accept responsibility for private debts denominated in dollars, as in Korea. When the government offers the guarantee, it believes the default risk is manageable or bearable, just as the U.S. government believed that the risk in the saving and loan system was manageable. It is not necessary for the government to plan a debacle; the debacle is one possibility. The probability may be small at the time the crucial decision is taken. A finance minister faced with this choice will almost always prefer to avoid the crisis now, at the risk of a future larger crisis, than to accept the crisis now when many critics are ready to claim that the crisis is avoidable. And sometimes they are right.

The opportunity to take a (possibly small) risk of a later crisis instead of a certain, smaller, current crisis is the second source of moral hazard. To reduce the risk of future crises, it is necessary to reduce the chances of a finance minister having to make the choice I described.

IMF and U.S. Treasury lending to Asian countries continues this dangerous system. The risk of a bigger, future crisis increases. Too much of the world has become "too big and too indebted to fail." Neither the IMF, nor the development banks, nor the U.S. and Japanese governments can pay for all the errors, mistakes, and imprudent actions they help to create.

"Too big to fail" was a flawed idea when applied to U.S. savings and loans and to Swedish, Japanese, Latin American, and other banks. It is no less flawed when applied to U.S., Japanese, and European banks and financial institutions that have lent in Asia.

Secretary Rubin was right when he said in September 1997, "What we don't want to have is a situation where people can do unwise things and not pay a price" (reported in Wessel 1997: A2). But that is the system that Secretary Rubin and the IMF have created and sustained.

Many arguments are used to justify these policies. Some are misleading. Some are based on misunderstanding. Some are simply wrong.

### Arguments for IMF Intervention: A Critique

One common argument, repeated many times, is that South Korea is a large country, the world's 11th largest economy. This argument

sounds impressive and, indeed, growth of the Korean economy since 1953 is a remarkable achievement. But the inference is that a financial collapse in South Korea would be a world-shaking event. In fact, Korea has a GDP about equal to the GDP of Los Angeles County. It may be the 11th largest economy, but it is about 5 percent of the U.S. economy.

One of the most serious misunderstandings concerns the role of a lender of last resort. Historically the function of a lender of last resort is to prevent unnecessary financial failures during periods of panic. A lender of last resort functioned at its best in Great Britain after 1866, and at its worst in the United States during the Great Depression.

The role of a lender of last resort is not to bail out failed banks. Its job is to assure that solvent financial institutions do not fail because of lack of liquidity. The Asian central banks have the power to stem a domestic, liquidity crisis. The remaining problem is the need for foreign exchange to repay foreign currency loans.

The IMF offers two services. It lends foreign currency on condition of reform, called conditional lending, and it acts as a consultant to troubled countries. Unlike most consultants, it pays the borrower to take its advice by offering favorable terms for its loans. With interest rates in Korea above 20 percent, the IMF lends at less than 5 percent.

Asian problems do not require large international loans from the IMF and the developed countries. These loans are more likely to delay than to promote reform. The IMF may threaten to withhold payments, but its history shows that the threat is empty. The IMF has a stake in "successful recovery." Client governments understand that. They know that the IMF does not want a failure. They call its bluff, delay reforms, but they get the loan payments. Despite many attempts and much research, the IMF has not been able to demonstrate that countries meet the conditions they promise to fulfill. Some do; some don't, but some would have done more to reform without the loans.

Many critics of the IMF oppose the policies of fiscal stringency and control of inflation. I do not share those criticisms in all cases. In countries with inflationary policies, control of spending is essential.

That is not the problem in Asia. The present predicament was not caused by imprudent spending policies, excessive demand, and high inflation. Much of the problem arose because one of the principal markets for Asian products, Japan, has grown slowly and because China increased its share of the Japanese market after devaluing in 1994. I applaud the IMF for urging structural reforms to increase competition and reduce local cartels supported by government. How-

ever, I believe such reforms would come faster in this crisis without conditional loans.

The IMF errs when it urges Asian countries to reduce demand. What is needed is expanded demand, produced not by inflationary policies in each of the countries but by increased demand from Japan.

## Solving the Asian Problem

The key to the Asian problem is to end mistaken Japanese policies and reform the Japanese economy. Japan's problems are internal. It should restructure its financial system and end its deflation by increasing money growth. It has the power to do this without international loans. An expansive policy would benefit both Japan and Asia.

If Japan expands, Asian exports to Japan would expand demand in the troubled Asian countries. The principal beneficiaries will be those countries that restructure by breaking up government protected and subsidized industries. As those countries expand, others would benefit, and economic growth would be restored in Asia.

Since 1971, the IMF has been looking for new things to do. It has now solved its problem by creating moral hazard, allowing international banks to avoid the risks they undertake by imprudent lending. The IMF encourages the behavior that creates the problems. It engages in subterfuge by refusing to call the Indonesian cessation of payments a moratorium. To prevent an even larger future financial crisis, we must end this system and create very different arrangements in its place.

If loans denominated in foreign currencies are withdrawn suddenly, solvent borrowers with excellent long-term prospects are unable to repay their short-term loans on demand. Neither they nor their local banks may be able to obtain sufficient foreign exchange to prevent default.

One solution is to have a true lender of last resort. Unlike the IMF, a true lender of last resort does not subsidize borrowers. It charges a penalty rate—a rate above the market rate—and requires good collateral. It offers to lend at a penalty rate to anyone offering proper collateral.

These requirements are not arbitrary. They are essential. The penalty rate means that the lender of last resort will usually do no business. Borrowers will only come when they cannot get accommodation in the marketplace at market rates. Similarly, the requirement to offer good collateral induces banks and financial institutions to hold such assets. This reduces risk and encourages safety and solvency. Unlike the IMF, a true lender of last resort does not create moral hazard.

Would such a system work? The system is field-tested. It is the system used in Great Britain after 1866, when London was the center of the world financial system. It worked well through good times and bad.

The second proposal eliminates the main source of the problem. If banks were truly international in scope, they would operate in many countries. Local lending in local currency would be part of their mixed global portfolio. Banks would diversify currency risk within a global portfolio, lowering overall lending risk.

This reform is not an idealized, textbook solution. Citicorp, in particular, has tried to follow this strategy. Regulations to protect domestic banks in many countries from competition prevent Citicorp and other foreign banks from following this sensible strategy of relating risk to return within a diversified loan portfolio. The financial services agreement, accepted by members of the World Trade Organization last year, is an important move in this direction. In the proposed system, global banks would internalize the risk, or hedge the risk if they chose to do so.

## Conclusion

Let me close with an example. The U.S. financial system experienced many crises and failures. For most of our history, banks were local, often restricted by law to serving a local market. When the corn, wheat, or cotton crop failed, the bank often failed because its loans were not diversified. Eventually, after many bad experiences, the United States has moved toward a regional, and perhaps countrywide, banking system. Loan portfolios are more diversified than in the past. In addition, brokers group loans from a diverse group of borrowers and offer securities based on the loan portfolio. This permits banks to hold a diversified portfolio of mortgage, automobile, credit card, or other loans that were not previously available to them. Banks are safer because their loans are, at last, more diversified.

In the recent past, when semiconductor prices fell or, earlier, when its chemical industry posted large losses, Korean banks experienced large losses, much as local banks in Iowa, Minnesota, Texas, or Oklahoma suffered from a decline in agricultural prices in the 1920s and 1930s, or as Texas banks suffered from a decline in oil prices in the 1980s, or as Swedish and Swiss banks suffered from a decline in local property prices.

The United States has now strengthened its financial system by letting banks branch regionally. European banks are beginning to merge transnationally and to operate branches in other countries.

The next step is to strengthen the global system. IMF bailouts, and government-enforced restrictions on competition, impede this solution.

Financial crises in Latin America in the 1980s, Mexico in 1994–95, and now in Asia should alert governments to the need for fundamental reform. More money for the IMF delays reform of the international system, encourages moral hazard, and subsidizes risk. Fundamental reform begins with global banking and a true lender of last resort.

## References

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