

2013

The Role of the International Monetary Funds (IMF) in the East Asian Debt Crisis of 1997

Yaro Sadek Tahirou
Minnesota State University, Mankato

Follow this and additional works at: <https://cornerstone.lib.mnsu.edu/jur>



Part of the [Asian Studies Commons](#), [Finance Commons](#), [International Business Commons](#), and the [International Economics Commons](#)

Recommended Citation

Tahirou, Yaro Sadek (2013) "The Role of the International Monetary Funds (IMF) in the East Asian Debt Crisis of 1997," *Journal of Undergraduate Research at Minnesota State University, Mankato*: Vol. 13 , Article 9.

Available at: <https://cornerstone.lib.mnsu.edu/jur/vol13/iss1/9>

This Article is brought to you for free and open access by the Undergraduate Research Center at Cornerstone: A Collection of Scholarly and Creative Works for Minnesota State University, Mankato. It has been accepted for inclusion in *Journal of Undergraduate Research at Minnesota State University, Mankato* by an authorized editor of Cornerstone: A Collection of Scholarly and Creative Works for Minnesota State University, Mankato.

The Role of the International Monetary Funds (IMF) in the East Asian Debt Crisis of 1997

By Yaro Sadek Tahirou

Minnesota State University, Mankato

ABSTRACT

During the East Asian Financial crisis in particular, the IMF has been criticized of promoting international cooperation because of the supervised enforcement of its rules. The purpose of this research is to find out how the IMF responded to the East Asian debt crisis and whether or not its responses were the best possible responses to this crisis. Through my research, I talked about the causes of the East Asian financial crisis, the role of the IMF in the international monetary system, and if the IMF responses to Thailand, South Korea and Indonesia were the best responses or not. After analyzing the IMF responses in this crisis, I found that the IMF policies need to be reformed in order to monitor and prevent future financial crises spill-over effects at the global and regional levels. I will analyzed 5 scholarly journals on the financial crisis in East Asia, 3 scholarly articles on the role of IMF in the East Asia financial crisis, and 1 novel called *POLITICS IN SOUTHEAST ASIA DEMOCRACY OR LESS* by William Case.

INTRODUCTION

Several financial crises have occurred in the world economy through the last decades. Some examples include the East Asian financial Crisis of 1997, the Latin American debt crisis of 1994-95, the Russian crisis of 1998, and the Brazilian crisis of 1998-99 which spread out to other areas also known as the “contagion effect”. During these crises, the International Monetary Funds (IMF) has been involved and known as a crisis manager. The IMF was created in 1945 after World War 2. The IMF is charged with overseeing the system of exchange rates and international payments that enables countries of the world and their citizens to buy goods and services from each other. The IMF played an important role in ensuring exchange rate stability, encouraging its member countries to eliminate exchange restrictions that hindered trade,

operating a system of fixed exchange in which all member countries' currencies are pegged to the dollar, and by acting as a lender of last resort when a member country faced an economic crisis. But, the institution (IMF) raison d'être collapsed after 1971 when the major currencies moved to a floating exchange rate system. Despite the IMF success in accomplishing its job in other crises, the IMF has been seriously criticized during the East Asian financial crisis of promoting international cooperation because of the supervised enforcement of its rules. The advent of the East Asian debt crisis marked a major turning point for the IMF's fortunes. Based on this thought, this paper proposes a detailed analysis of the causes of the East Asian financial crisis, and the role of the IMF during the financial crisis. Finally, this research paper will answer the question whether or not the IMF fulfilled its mission during the East Asian crisis and if the IMF responses were the best responses possible.

LITTERATURE REVIEW

Since 1990 there was a rapid buildup of short term external debt in the weak Asian financial market. Domestic banks were borrowing at a high rate, mostly in US dollars. Even though in a booming economy this does not pose a problem, the situation in the Asian economy was very different. The weaknesses of the Asian financial system were at the root of the East Asian financial crisis. The economies of Asian countries were performing well up until they experienced a huge and rapid capital inflow of foreign financial investments which exposed them to a financial crisis. Despite such success theories, Khan, Islam and Ahmed (2005) pointed out that, economists predicted that these economies will run into a phase of declining growth or diminishing productivity. The financial crisis has been seen by many other economists as one

event which started in the middle of 1997 and had a continued effect until the end of 1998. Therefore, economists depicted the crisis in two different stages. The first stage of the panic started in July 1997 and affected the “East Asian Tigers”: Thailand, Malaysia, Philippines and Singapore. The second stage of the crisis started in October, 1997 affecting Indonesia, Hong Kong, Japan. This second stage of the crisis also affected the world’s 11th largest economy, South Korea, and brought down their economy in December of 1997. The crisis was triggered first by Thailand’s large current account deficit and second by Japanese banks which are the largest lenders in Asia and one of Asia’s main creditors. The real seeds of the financial crisis, however, were sown during the early 1990s in the aftermath of the real estate¹ and stock market² bubble which severely damaged the balance sheets of Japanese commercial banks. When the crisis hit South Korea and Thailand, the Japanese commercial banks withdrew quickly their loans from Thai banks in 1997 and reduced their exposure in other Asian countries due to their need to avoid losses and to protect their capital base. (King, 2001, p.439) argued that, “Japanese banks had been severely weakened by the collapse of the real estate and stock market bubble in Japan in 1990. As the largest lenders in Asia, Japanese banks signaled the change in sentiment to other foreign commercial banks who also withdrew their loans. These capital outflows triggered currency devaluation in Thailand in mid-1997, but not in Korea until late 1997, due to the different exchange rate regimes in these countries”. This financial crisis had a huge impact on the world global economy causing stock markets to fall in the United States, Europe, Brazil and Russia and all over the world.

¹ Real estate bubble is a run-up in housing prices or values fueled by market demand and speculation

² Stock market bubble is when speculators and investors are pushing the overall value of a market beyond its proper or normal value

The earliest stages of the East Asian financial crisis started with the “Asian economic miracle”. The Asian economic miracle is defined as the attraction of huge foreign capital into Asian countries (Thailand, Malaysia, Indonesia, Singapore, Philippines and South Korea) which maintained a high rate of return due to their remarkable rate of economic growth and progress. During the Asian economic miracle, non-state actors (institutional investors, foreign banks) in particular, gained control over the East Asian states capital flow and started making huge investment decisions that full the Asian economy. King (2001) said that institutional investors were professional firms which direct flows of investment and credit on behalf of savers. This category included commercial banks, portfolio investors in equity and debts, and foreign direct investment by national multinational enterprises. But by 1990, the “Asian Tigers” (Thailand, Malaysia, Indonesia, Singapore and South Korea) were struggling with collapsing currencies, banks failure, and plunging stocks and assets markets.

However, the root and depth of the Asian financial crisis can be explained through a theory called, the ‘moral hazard’³ theory. According to this theory, the supply of bank credits to borrowers exceeded by far the existent investment opportunities without government guarantee. Khan et al. (2005) argued that financial intermediaries such as banks, stock exchange, insurance companies had excessive risky lending practices which sent the asset prices skyrocketing and had a false impression of having the government guarantee. Bank credit to the East Asian Tigers expanded rapidly from 1991 to 1996 at a rate of 10-30 percent per year. International bank loans to the Asian Tigers doubled from \$121 billion to \$261 billion. In South Korea and Indonesia for example, government urged banks to lend money to politically-connected businesses and large

³ Moral hazard refers to a situation where economic actors such as business investors, foreign firms make profit-maximizing but inefficient investments decisions because they are able to avoid costs associated with their conducts.

infrastructure projects. So when the bubble⁴ burst, a financial crisis was set in motion and went out of hands. After researching, economists found that two types of moral hazard were at work during the crisis: the Domestic moral hazard and the International moral hazard. Domestically, banks were encouraged to borrow short term loans from abroad which were invested in risky domestic ventures under the belief that these investments carried government guarantees. Internationally, foreign borrowers lend to Asian borrowers at an increase risks with the assumptions that they will be protected by an international bail-out in case there is financial crisis. Unfortunately, that was not the case when the crisis exploded. Based on the moral hazard theory, investors thought that they have made wise investments decisions by investing in Asian countries without even accessing the externalities⁵ created by these investments. So when the financial crisis hit Asia, investors were the one who beard most the costs of the moral hazard because the borrowers could not afford to pay back their credits. In addition to that, the borrowers did not have any government guarantees that will ensure a bail-out in case of a financial collapse. As a result both investors and borrowers could not avoid the consequences of the crisis.

Despite the moral hazard theory, crony-capitalism⁶ was a cause of the East Asian financial crisis. Crony-capitalism was highly emphasized in Indonesian and South Korea. The corrupt relationship between the conglomerates and financial institutions under Suharto's rule contributed to the spread of the Economic crisis in Indonesia. Khan et al. (2005) mentioned that, these corrupt relationships between the conglomerates and financial institutions sow the seeds of

⁴ A bubble is an economic cycle characterized by rapid expansion followed by a contraction.

⁵ Externalities are positive or negative consequences of an economic activity that are experienced by unrelated third parties.

⁶ Crony capitalism is a term used to describe a capitalist society based on the close relationships between businessmen and the state

the trouble and showed symptoms of “crony capitalism”. So in an atmosphere of tied and specific relationship between government and favorite companies, efficient market neither flourished nor developed.

The East Asian Financial crisis broke out on July 2nd 1997 when Thailand devaluated the baht by abandoning its exchange rate peg with the US dollar due to other foreign speculators and institutional investors. Since 1990, Thailand’s current account deficit (the sum of the country’s trade deficit and the interest on its foreign obligation) exceeded four percent of Thailand’s GDP, implying that Thailand had to attract more foreign capital each year to stop the account deficit decline. Unfortunately, Thailand’s account deficit ended up in a steady decline when foreign and local investors became aware that the borrowers would be incapable to pay their debts and therefore pulled out their investments. Even though Thailand’s large current account deficit persisted since the 1990s, investors still believed that Thailand might be different because much of its capital inflow came as a direct investment instead of an indirect investment by Japanese manufacturing firms and banks. Investors also derived confidence in Thailand’s high savings rate and large government budget surplus.

But, the primary reason that kept foreign investments coming to Thailand and local funds staying was the combination of high interest rates on Thai Baht deposits and a promise by the government that the baht’s value would remain fixed at 25 baht/1 dollar. Unfortunately, the baht’s fixed value could not be sustained any longer because the Japanese yen declined by 35 percent relative to the dollar. And since Japan was the major trading partner of Thailand, the rise in the value of the dollar implied the rise in the value of the baht which made Thai products more expensive and less competitive in the international market. This situation led foreign speculators to sell the Baths. According to Feldstein (1998), the Thai government secretly bought the baht to

support its value but eventually had to give up because they couldn't keep the promise of sustaining the baht. In 1996, the Thai stock market and the real estate market both declined. In order to assist distressed Thai finance institutions burdened by bad property loans, the government injected money into the Thai economy, imposed capital controls and forced their minister of finance to resign after failing to save Finance One, the largest Thai finance company. King (2001) argued that the finance minister paid a visit to the central bank and discovered that almost all of the country's \$30 billion in foreign exchange reserves had been committed in forward contracts, while another \$8 billion had been used by the central bank's Financial Institutions Development Fund to prop up struggling finance companies. Therefore, the finance minister did not have any choice but to renege on the government's promise to re-capitalize Finance One with public money, by allowing it to fail. Foreign and domestic investors as well as commercial banks saw this action as a betrayal of the government's promise that their investments would be safe and protected. The devaluation of the baht and the broken promises of the government over Finance One enabled foreign institutional investors to recheck the risks of investments in that particular region of Asia.

As a consequence to the Thai finance collapse, the dominoes began to fall. Japanese brokers such as Sanyo Securities and their largest security firms such as Yamaichi Securities and Hokkaido Takushoku bank filed bankruptcy. On the other hand, the crisis started expanding in Asia due to poor domestic conditions which forced Japanese banks to look for more profitable investments abroad. Japanese banks funded overseas loans and expanded their loans to Japanese manufacturers who moved their production facilities abroad in order to remain competitive in the international market and raise the value of the yen. Japanese banks were also the most powerful and largest suppliers of bank credit in Asia with \$275 billion of loans. This strong financial

position gave Japanese banks a key position in the market making them the key marginal lender. Being the marginal lender in the Asian market, Japanese banks reconsidered the risks of lending with the trouble that emerged in Thailand and at home. As a result, they could not afford to lose money and therefore stopped extending loans to Thailand and started withdrawing money from other Asian countries. Other foreign banks responded in the same fashion by withdrawing huge amounts of money from the Asian 5 which had a huge impact on the Asian economy. “By June 1998, commercial loans outstanding to the Asian-5 had declined to \$210 billion, an outflow over 12 months of \$65 billion or 7 percent of pre-shock GDP. Thailand lost \$23 billion or 33 percent of its foreign loans; Indonesia lost \$8 billion or 14 percent and Malaysia lost \$6 billion or 20 percent” (King, 2001, p. 449). Japanese companies were then forced to reduce their exposure in the Asia financial market due to the failing banking system, the decline of their equity and a rising number of bankruptcies within their economy which permitted the crisis to spill over to other Asian countries.

The spreading or the “contagion effect” of the crisis to Indonesia, Malaysia, and Philippines was also based on the fact that investors began to be worried about these countries large account deficits, the increase ratio of their foreign debt to local GDP, and the decline of their trade competitiveness. The Thai Baht collapse forced the peso in the Philippines to float, while Malaysia allowed its national currency the ringgit to downgrade. Due to this situation, Singapore let its currency depreciate forcing its neighboring country Indonesia to depreciate the rupiah on 14th August 1997. However, trade linkages among these countries tied their economies together which enabled the transmission of the crisis from one country to another. Also, economic changes are more likely to happen in a region if the countries of that region share the same macroeconomic policies, have similar financial institutions, and are connected to each

other through a pattern of mutual trade and investment. The weaknesses of the Indonesian economy that made it vulnerable to an attack on its currency were similar to Thailand's economy weaknesses. These weaknesses were: rising external liabilities, private sector debt, poor loan quality, lack in the government's ability to solve problems, excessive amounts of foreign investment, and overvalued currency pegged to the US dollar. According to Khan et al. (2005) "A nominal devaluation in the currency of one of the countries may put its trading partners, who are exporting similar goods to a common market, at a competitive disadvantage. For example, with the devaluation of the Baht, exports from its regional partners were at a disadvantage"(p.173). Although the Indonesian government attempted to stabilize the situation by defending the currency, using the Central Bank reserves, the situation continued to deteriorate due to the link between these economies. Nicola, Bello, and Mallhotra (1998) said that even though the Central Bank attempted to rescue the currency by raising interest rates; the rupiah hit the lowest value of 2682 rupiah/1 dollar, from a level of 2400 rupiah/1 dollar. Each market was then forced to abandon its fixed exchange rate policy and let the international market determine and fix their currency value. An analysis of trade flow among these countries is central to exploring the role of trade links in the spreading of the crisis

It is noteworthy that the Indonesian economy was embedded in a nepotistic system of money lending and deal making. Big project contracts were awarded to President Suharto's offspring and therefore benefited only the people of his family and not the population at large. According to Nicola Bullard et al. (1998), "Estimates of the family fortune vary wildly, from \$6 billion to \$40 billion, making it one of the world's largest family fortunes. Foreign companies hoping to do businesses in Indonesia often hire Suharto's sons as consultants to grease the wheels"(p. 515). The only exit option for Thailand and Indonesia was to contract their

current account deficit by increasing exports and reducing imports which required a reduction in public and private consumption and investments. They also found out that they needed to shrink their current account deficit by increasing exports and reducing imports. As the last resort, Indonesia and Thailand decided to refer to the traditional IMF cure tailored to each country. This particular cure is the combination of reduced government spending, imposed higher taxes, and tighter credit.

Unlike the other Asian countries, the Korean situation was much different. Three main factors appeared to be the causes of the crisis in South Korea. Bullard et al. (1998) argued that, the first factor was the government failure to invest significantly in research and development, the second was the massive trade blitz unleashed on South Korea by the US and the third was Korean membership to the OECD, which forced the country to adopt a more liberal stance towards foreign capital and finance. These were the factors that exposed the Korean government incapacity to prevent market failure which had been the main driving force of the country's economic success during the 'miracle decades'⁷. The Korean high-speed industrialization framework during the miracle decades was a strategic relationship between the private sector and the government. The government was picking specific industries which provided them with subsidized credit through a government directed banking system and protected them from international competition. The state nurtured industrial conglomerates called 'Chaebols'⁸ such as Samsung, Hyundai, LG that it pushed out into the international market. This strategy was really successful in the 1970s and became the foundation of South Korea industrialization and export growth. In the early 1990s, the tide turned against South and everything fell apart. Instead of

⁷ Miracle decades is a term used in reference to the highly developed economy growth of Singapore, Hong Kong, South Korean and Taiwan from 1960 to 1990

⁸ Chaebols: big industrial conglomerates created by the state

pouring money into R&D to turn out high-value added commodities and develop more sophisticated production technologies, South Korea's conglomerates went for the quick and easy route to profits which is buying up real estate or pouring money into stock market speculation, Bullard et al. (1998).

In addition, South Korea for a long time, kept its status of labor-intensive assembly point for Japanese inputs using Japanese technology. Most of the machines in industrial plants were imported from Japan. As a result, South Korea had a trade deficit with Japan and later, the US which was estimated to \$21 billion. Furthermore, competition with other East Asian countries with cheaper labor put high pressure on South Korea. Bullard et al. (1998) found that all of these elements, combined with over-expansion and over-specialization, meant that by 1996 the top 20 listed companies in South Korea were earning a mere 3% on assets, while the average costs of borrowing had risen to 8.2%. In a breakneck attempt to regain trust and profitability, the parliamentary government tried to enact a series of laws that will enable them to fire labor and reduce the workforce, similarly like the US style of cutting off extra labor and making the remaining workforce more productive. Unfortunately, the government decision was ineffective. The Korean banking became unable to neutralize the impact of foreign capital flows by directing the funds into safe lending which created an excess of liquidity that spilled over into risky and speculative investments. By October 1997, it was estimated that non-performing loans by South Korean enterprises and banking institutions had escalated to over \$50 billion. By November 1997, South Korea decided to join Thailand and Indonesia in the queue for an IMF bail-out.

The IMF's role in Thailand, Indonesia, and South Korea went far beyond its role defined in the Article of Agreement. The consequences of the IMF's experiences in earlier crises were proved in its unfolding role in the East Asian debt crisis. As before, the IMF has nicely

emphasized the internal roots of the problem but has deflected its attention from its earlier endorsement of these countries policies when they were growing. For example, the IMF was praising the Thai authorities in the late 1996 for their consistent and robust record of macroeconomic management policies. The IMF went further and promoted Thailand as a model of development for the rest of the Third world due to its high growth rate and its openness to foreign capital flows. These were the signs that fool the IMF and that was the reason why the IMF failed to predict the East Asian financial debt crisis. Kapur (1998) argued that, the IMF and the international market claimed that they were shocked to find that the East Asian regime impressive economic achievements were built on such unsafe foundations. Faced with the pressing rescue alarm from Indonesia, Thailand, and South Korea, the IMF decided to provide credit or offer a bail-out package to these countries instead of relying on private banks loans. In exchange, the IMF imposed a program requiring the Thai, Indonesian, and Korean governments to reform their financial institutions and to make changes in their economic and political structures. Based on this statement, Feldstein (1998) said that “The conditions imposed on Thailand and Indonesia were more like the comprehensive reforms imposed on Russia, including the recent emphasis on reducing Russian corruption, than like the macroeconomic changes that were required in Latin America” (p.24).

In Thailand, the government negotiated an agreement with the IMF on 20th of August 1997. In exchange for a \$16.7 billion package, later raised to \$17.2 billion, the Thai authorities agreed to stabilization and structural adjustment programs with two principal component proposed by the IMF. First, the stabilization program would cut the current account deficit through the maintenance of high interest rates; increase the rate of the value-added tax (VAT) to 10 percent in order to achieve a small surplus in the public sector by 1998; cut government

expenditure in numerous areas; and cut subsidies on some utilities and petroleum products. The second part was the structural reform program of the financial sector. This program divided, suspended, and restructured unviable institutions, took immediate steps to instill confidence in the rest of the financial system, and imposed strict conditionality on the extension of the Financial Institutions Development Fund resources in order to restore a healthy financial sector. At the heart of the structural reform, the IMF stressed on the closing down of 42 finance companies considered as unviable institutions. This agreement also stated that the \$17 billion will be solely devoted to finance the balance of payment deficit and rebuild the official reserve of the Thai bank. In other words, this sum cannot be used to bail-out local institutions. Part of this program required the remaining financial institutions to strengthen their capital base which included a policy that encouraged foreign capital injection.

On October 1997, the Thai government finally came up with details of the stabilization program which underlined their commitment to generate a budget surplus equivalent of 1% of gross domestic product by imposing a series of taxes. These series of taxes included increases on duties on luxury imports, surcharges on imports not used by the export sector, and a gas tax of one baht per liter on fuel. On the government side, spending was cut by 100 billion baht bringing it down to 800 billion baht. On the financial sector reform side, the authorities came up with the creation of the Financial Restructuring Authority (FRA) to oversee the rehabilitation plans submitted by the companies that were suspended and closed. The FRA role was to determine whether or not these companies would be allowed to reopen or remain closed. The government established also an Asset Management Corporation (AMC) to oversee the disposal of the assets of the finance companies ordered to be closed. The government promised foreign investors to own up to 100 percent of financial institutions, tighten rules and provide full government

guarantees for depositors and creditors, and improve bankruptcy laws to allow creditors to collect their collateral faster. On December 7th, 1997 the Chuan government announced after the review of the FRA and AMC that all but two of the 58 finance companies would be closed. Finally, the IMF money was released. The Chuan government allowed foreign investors to own a big stake in Thai corporations and foreign banks began again to work out deals with Thai banks. Nicola Bullard et al. (1998) said that “The Japanese Sanwa Bank announced that it would take a 10% stake in one of the country’s biggest banks, Siam Commercial Bank, a move that would bring total foreign shareholding in that bank to 35%. Citibank declared that it would move to gain a 50.1% ownership share in First Bangkok City Bank”(p.512). After the implementation of all programs required by the IMF, the IMF’s Asia Pacific director Herbert Neiss in 1998 admitted that the Thai economy slowed down instead of getting back on track.

In South Korea, the IMF did not wait to respond to their call for assistance. In just one week after the call, The IMF mission came up with a rescue package of \$57 billion. Prakash (2001) explained that these stand-by credits are comprised \$21 billion from the IMF, \$10 billion from the World Bank, \$4 billion from the Asian Development Bank and a total of \$20 billion from leading industrial countries, including \$10 billion from Japan and \$5 billion from the US. Even with this rescue package, after a week, stock market and currency continued to fall. The IMF had to come up with a new kind of loan due to the country’s advanced economic state and tough negotiators. As a result, the IMF came up with a new deal that ensured that South Korea would avoid default on the \$66 billion of the total \$120 billion short term foreign debt. The other lenders (Japan, Germany, and USA) were relieved by the IMF condition imposed on South Korea because they too were not ready to accept a default given the state of their banking systems. The IMF invented a new kind of loan, the ‘Supplemental Reserve Facility’ to enable it

to bypass its normal ruling that financial packages are not allowed to exceed five times the recipient country's IMF quota, Bullard et al. (1998).

Like all IMF bail-out agreements, the details of this new deal highlighted the tightening of fiscal and monetary policies, combined with the reform of the labor market, the opening of Korean financial sector to US banks and fund managers, the raise of interest rates from 12.5% to 21%, the control of money supply to contain inflation, the increase of the value added tax (VAT), and the opening of product markets to Japanese goods. In addition, the agreement included the establishment of an independent central bank which weakened the relation between the government and the chaebols. One of the outline objectives of the IMF was to destroy the chaebols which was the foundation of South Korea fabulous economic growth and increasing global presence. The closing of the chaebols created massive workers lay-off and a declining productivity which resulted in an anti-government backlash. Bullard et al. mentioned that the South Korean Confederation of Trade Unions (KCTU) said that it is the workers, not government officials or leaders that are responsible for the economic crisis and who will have to bear the blame of any IMF measures. The agreement also included the closing of bankrupted financial institutions and allowed foreign banks to establish subsidiaries. Other key reforms were the approval of foreign entry into the domestic financial sector; trade liberalization, the review of corporate governance and structure and the capital account liberalization. Just after the Korean government agreed on these terms, the first installment of cash was offered by the IMF and the US to the Korean government. Following few weeks after the agreement, the Korean government realized that the IMF rescue program will not solve the financial problem because the government was unable to meet its short term debt obligation. Conway and Fischer (2006) argued that Jeffrey D Sachs accused the IMF of secrecy and noted that, the IMF insisted that all

candidates had to immediately endorse an agreement they had no part in drafting which meant they had no time to understand and had no clue on whatsoever they were doing.

Unlike Thailand and South Korea, Indonesia has been reluctant to accept the IMF short term rescue package. Case (2002) mentioned that “Many elites and members of the middle class were offended by their country’s evident loss of sovereignty, indeed, the haughtiness with which conditions seemed to be imposed” (p.54). Despite this reluctance, Suharto’s government accepted a rescue package of \$23 billion from the IMF after agreeing on the loan terms (tight fiscal and monetary policies, closing of bankrupt financial institutions, liberalizing foreign trade and investment, reduce export taxes, open more sectors of the economy to foreign investment, and privatize public enterprises). The IMF bail-out package did little in slowing the falling of the rupiah and the flow of money out of the country. Bullard et al. (1998) found that the Indonesian market needed more than the IMF’s intervention to convince it that all was well in the state of Suharto. Faced with massive unemployment and a rapidly contracting economy, Suharto proposed a budget as a response to these circumstances. His budget stressed on the increase in subsidies for petrol, rice, fertilizer, an increase in government spending but did not mention when and how these subsidies would be abolished. As a result, both the IMF and the international market disagreed on his budget and decided to send money outside the country and sell off the currency which hit 17000 rupiah/dollar. The IMF responded to this situation by proposing a second agreement to Indonesia. In contrast to the first agreement which was set with macroeconomic objectives, this agreement specified microeconomic objectives. Prakash (2001) said that what the new deal lacks in macroeconomic targets is made up for in microeconomic directives which strike at the very heart of Suharto’s economic power, addressing in detail the dismantling of cartels, monopolies and taxes which directly benefit Suharto. The IMF demanded

liberalization of trade in agricultural products such as cloves, oranges, and vanilla. On January 2007, the government announced a temporary freeze on debt servicing by Indonesian companies along with a plan of closing down non-viable banks and sell their assets. Meanwhile, as a result of this second agreement, the Indonesian economy was burdened with a huge foreign debt estimated at \$140 billion in total, due to the IMF conditions and the collapse of the rupiah which unfortunately doubled the price of imported goods and food prices. “What was really needed, they suggested, was the rescheduling of business short-term loan obligations in order that it could restart production”(Case, 2002, p.54).

Again, Suharto in a desperate effort to attract foreign investors established the currency board which put him in conflict with the IMF. According to Bullard et al. (1998), the reasons that motivated Suharto to set up the currency board were those. First it allowed him and his people to wipe off their foreign debts at 5500 Rupiah rather than 10000 Rupiah. Second, it gave Suharto some breathing space to reassert his control over the economic policy after the humiliating acquiescence to the IMF earlier in the year. Finally, the currency board would have the effect of bringing back foreign exchange into the country from investors that are ready to reinvest as soon as the rupiah regained its market value. Unfortunately, the IMF disagreed on the currency board proposed by Suharto. Case (2002) argued that, even though the IMF had endorsed the currency boards in other crises, it demonstrated that it was inappropriate in Indonesia because of the country’s poor banking system and diminished foreign exchange reserve. During that time, Suharto reconsidered his idea of instituting the currency board because he did not want to break the IMF conditions. From the Indonesian case, there was clearly a power struggle between the IMF and Suharto over the settlement of the crisis. However, Suharto’s interest in protecting the Indonesian economy were the same as the IMF interest in

rebuilding the economy. The only difference between the two was the way each of them wanted to settle the crisis.

Following the IMF intervention in Thailand, Indonesia, and South Korea, it is worth calling into question the efficacy and appropriateness of the IMF's economic advice, as well as the way it operated in resolving the financial crisis. In analyzing the course of its actions in these countries, we can say that the IMF gave poor advice on how to resolve a private sector financial crisis such as: encourage lenders and others to lend more money during crises, promise creditors that they will not lose money, the combination of budget deficit reduction⁹ and tighter monetary policy¹⁰ which raise unemployment and bring down growth, and poor macroeconomic policies. In addition, the IMF acted in much the same it did during the Latin-American and the Russian crises even though the situation in the Asian countries was very different. Instead of urging the dissolution of capital controls, the IMF began calling for properly sequenced liberalization of government controls on money flows in and out of these countries. The public sector reforms (budget cuts, raise in taxes) imposed by the IMF were inappropriate for the circumstances of a private debt crisis. The public sector reforms in fact contracted the economies instead of bringing them under control. In Indonesia for example, detailed conditions related to the banking sector were imposed despite the fund limited expertise in this particular area. Although the IMF argued that these reforms were necessary to control inflation and stabilize currencies, the reforms that were implemented in Indonesia for example clearly accelerated the political and economic tailspin. Bullard et al. (1998) mentioned that, the currency crisis is not the result of Asian government profligacy. This was a crisis mate mainly in the private, albeit under-regulated, financial markets.

⁹ budget deficit reduction: raise taxes and cut government spending

¹⁰ tighter monetary policy: high interest rates and less credit availability

I think the IMF applied measures that were designed to control and command government spending instead of focusing on the real issue which was the revival of private-sector. In Thailand and South Korea for example, currencies continued to devalue even after the IMF interventions which simply means that their economic policies were not tackling the real problem. The continued expansion of the IMF's power and mandate is bad for debtor nations and for the global financial system because the increasing scope of loan conditions means that during financial crisis, the IMF will take over a country's decision-making process without any accountability of the country's government which can be considered as the violation of the country's sovereignty. Further, the IMF did not have a perfect solution to the "moral hazard" problem that created the crisis. In order to solve this problem, both the borrowers and creditors should be punished for their unwise investments decisions, but as we have noticed in the Asian financial crisis only the borrowers were punished and not the creditors. And that is the main reason why many economists accused the IMF of perpetuating the problem. According to Wang (2001), the IMF was accused of creating the problem of moral hazard, because both creditors and debtors who make unwise investment choices are saved from the consequences of their bad decisions, thus making it more likely that they will reoffend in the future. In Thailand for example, part of the structural adjustments program required financial institutions to strengthen their capital base which included a policy that encouraged more foreign capital injection. Another part of the rescue package was devoted to service the country's foreign debt incurred by international private banks. So, we can say that the IMF applied tight fiscal and monetary policies which were unequally distributed between domestic and foreign interests. In Thailand and Indonesia for example, domestic firms were left at the mercy of the international market. The IMF asserted that the bankrupted firms could not be bailed-out but rather closed instead. In

South Korea, the IMF imposed the closure of chaebols (Hyundai, Samsung) which spearheaded South Korea's growth. Feldstein (1998) said that the tight fiscal and monetary requirements deepened the crisis by squeezing domestic credit and pushing up interest rates which together depressed growth and raised unemployment. On other words, the IMF permitted foreign investors the rights to ownership by liberalizing the financial sector and opening more the economic sector to foreign investors.

It is also important to note that the role of the IMF is to develop a rescue program for a country in need and not initiate these programs by enforcing economic structural changes and the notion of institutions. But following the IMF operations in this crisis, it has exceeded its mandate as defined in the Articles of Agreement and played the role of economic policeman. Feldstein (1998) said that "the Fund should not use the opportunity of countries being down and out to override national political processes or impose economic changes that however helpful they may be, are not necessary to deal with the balance-of-payments problem and are the proper responsibility of the country's own political system" (p.28). In other words, nothing about trade and investment liberalization, privatization, and public sector austerity were mentioned in the objectives of the institution but have become central when dealing with the Asian financial crisis. Additionally, the IMF surveillance should not only point to domestic vulnerabilities, but should also focus on the spillover effects of risks at regional and global levels.

However, the objectives that were mentioned regarding the IMF role of promoting high levels of employment and real income and the development of productive resources of all members, we can conclude were failed to be achieved in South Korea, Thailand and Indonesia. In contrary the IMF initiatives raise unemployment and the poverty rates. I think the IMF should act as a good monitor to emerging countries by providing its own funds as an indication of its

support to these emerging countries rather than as a bailout of international lenders in time of crises. The IMF should also work with emerging countries that have not reached a financial crisis yet in order to bring them under control by providing good, accurate, and sustainable solutions to “regional or homegrown crises”. The IMF have to put in place a mechanism to monitor, regulate and control international financial flow in order to prevent further crises. A concise system should be established by the IMF for the effective resolution of private sector debt crises based on clear rules and bankruptcy procedures. This system will give full responsibility to countries to assume full responsibility for unrecoverable private sector debts. Feldstein (1998) argued that, the IMF should work with countries that have not yet reached a currency crisis in order to prevent the large current account deficits or the excess short-term debts that could later precipitate and quicken a financial crisis.

CONCLUSION

The IMF responses to the East Asian financial crisis were not the best possible responses. It appears that the IMF has failed in its mission of helping countries in financial distress. Its role went far beyond what it was supposed to be (lend to countries with balance of payments difficulties, keep track of the global economy and economies of member countries). The crisis tested the effectiveness and relevance of the International Monetary Fund responses and we can say that the IMF policies overall accelerated economic contraction, did not stabilize currencies as wished and did not restore market confidence. The crisis also demonstrates that the IMF surveillance framework should be adapted to include economic, political, and social changes that take place around regions because governments are no longer the main borrowers, private capitals ventures are more dominant. I personally think that the IMF should go back to its

original role which is a supportive organization that helps countries in financial distress rather than changing their political structures and imposing economic reforms. I also think that the IMF needs to improve their framework for assessing financial market stabilities and reinforce early warning capabilities in emerging markets countries¹¹ (EMC). The global effect of the crisis recalls the IMF role to improve the monitoring of cross country spill-over effects¹². The IMF should also provide technical assistance on how the debtors can improve their current account balance. Feldstein (1998) noted that in deciding whether to insist on a reform, the IMF should ask two questions: Is this reform really needed to restore the country's access to international capital market? Is this a technical matter that does not interfere unnecessarily with the proper jurisdiction of a sovereign government?

↓

¹¹ Emerging market economies are financial markets that are in the transitional phase from developing countries to developed ones

¹² Spill-over effects are positive or negative externalities of economic processes that affect those who are not directly involved

Bibliography

1. Yunjong, W. (2000). The Asian Financial Crisis and Its Aftermath: Do We Need a Regional Financial Arrangement? *ASEAN Economic Bulletin*, 17(2), THE ASIAN FINANCIAL CRISIS: Hindsight, Insight and Foresight, 205-217. Retrieved from <http://www.jstor.org/stable/pdfplus/25773629.pdf>
2. Case, W. (2002). *POLITICS IN SOUTHEAST ASIA DEMOCRACY OR LESS*. New York: Routledge Curzon Taylor & Francis Group.
3. Michael, R. K. (2001). Who Triggered the Asian Financial Crisis? *Review of International Political Economy*, 8(3), 438-466. Retrieved from <http://www.jstor.org/stable/pdfplus/4177393.pdf>
4. Saleheen, K., Faridul, I., & Syed A., (2005). The Asian Crisis: An Economic Analysis of the Causes. *The Journal of Developing Areas*, 39(1), 169-190. Retrieved from <http://www.jstor.org/stable/4192995>
5. Devesh, K. (1998). A Cure or a Curse? *Foreign Policy*, 114-129. Retrieved from <http://www.jstor.org/stable/1149382>
6. Aseem, P. (2001). The East Asian Crisis and the Globalization Discourse. *Review of International Political Economy*, 8(1), 119-146. Retrieved from <http://www.jstor.org/stable/pdfplus/4177376.pdf>
7. Bullard, N., Bello, W., & Mallhotra, K. (1998). Taming the tigers: the IMF and the Asian crisis. *Third World Quarterly*, 19(3), 505-555. doi:10.1080/01436599814370
8. Patrick, C. Stanley, F. (2006). The International Monetary Fund in a Time of Crisis: A Review of Stanley Fischer's "IMF Essays from a Time of Crisis: The International Financial System, Stabilization, and Development. *Journal of Economic Literature*, 44(1), 115-144. Retrieved from <http://www.jstor.org/stable/pdfplus/30032299.pdf?acceptTC=true>
9. Kutan, A. M., & Sudjana, B. C. (2003). Investor reaction to IMF actions in the Indonesian financial crisis. *Journal Of Policy Reform*, 6(3), 181-190. doi:10.1080/1384128032000175780

10. Feldstein, M. (1998). Refocusing the IMF. *Foreign Affairs*, 77(2), 20-33. Retrieved from <http://web.ebscohost.com/ehost/pdfviewer/pdfviewer?sid=3722e55c-6753-4961-bfc5-3bb98b51ca1f%40sessionmgr12&vid=9&hid=9>
11. Xafa, M. (2010). ROLE OF THE IMF IN THE GLOBAL FINANCIAL CRISIS. *CATO Journal*, 30(3), 475-489. Retrieved from <http://web.ebscohost.com/ehost/pdfviewer/pdfviewer?sid=3722e55c-6753-4961-bfc5-3bb98b51ca1f%40sessionmgr12&vid=11&hid=9>

Student Author

My name is Yaro Sadek Tahirou. I am originally from Togo, a country situated in West Africa. I started my college career in 2010 at Suffolk University in Senegal (Dakar) and joined MSU (Mankato) in 2011. I am currently a senior majoring in International Relations with a double minor in Political Science and Economics, and a certificate in Non-Profit Leadership. The next step in my professional career is to earn a master in Information Technology Management due to the passion that I have for technology.

Faculty Mentor

Abdalla Battah holds a Ph.D. in International Relations from American University, Washington, D.C. He has taught at Minnesota State University since 1993. Prior to coming to MSU, Dr. Battah taught at several colleges and universities, including the University of Minnesota, Twin Cities, University of St. Thomas, and Winona State University. Dr. Battah's teaching and research cover IR theory, international conflict resolution, Arab-Israel peace process, and the Arab spring. Dr. Battah is founding executive director of the Arrowhead Model UN Association and of Petra Crown Academics, LLC.