

The International Financial Crisis of 1997-1998

By Roy C. Smith

Between May and December 1997, a financial firestorm spread throughout Southeast Asia and caused serious economic damage to the region. The area encompassed the much-praised Asian “Tigers”—Korea, Hong Kong, Singapore, and Taiwan—and the most promising developing economies of Indonesia, Malaysia, Thailand, and the Philippines. Currency values plunged relative to the dollar, with the Thai baht, the Indonesian rupiah, the Malaysian ringgit, and the Korean won each losing more than 40 percent of its value. Stock markets collapsed, interest rates soared, and credit markets dried up. The impact transferred quickly to the real economy, forcing severe contractions in gross domestic product (GDP) in all but the strongest of the developing economies in the region. The newly industrialized economies, including Korea, would decline by an average of 3 percent, but the developing economies such as Indonesia would contract by an average of 10 percent of GDP. The events shattered the confidence of foreign investors in all of the developing (or emerging market) economies, triggering sales of securities in Latin America and Eastern Europe.

The International Monetary Fund (IMF) intervened at the request of several affected countries, and by December 1997 it had organized unprecedented “rescue packages” totaling approximately \$100 billion for South Korea, Indonesia, and Thailand in exchange for promised reforms. The total amount of rescue funds was vastly more than any previous IMF-led rescue, and more than half of the money was going to just one country, South Korea (the world’s 11th largest economy). Despite the intervention, the countries in the region had to suffer the consequences of economic contraction and tightened credit. Bankruptcies increased sharply and included failures of important enterprises, and these exposed the many nearly fatal weaknesses of their banking systems. Calling in the IMF to administer draconian reforms was an admission of failure, and many of the governments in the region fell or were replaced at the next election. It was a very difficult time for all of the affected countries, yet by September 2000 signs of recovery were visible and the contagion that had been expected had not spread significantly beyond Southeast Asia.

Reason for Crisis

There were good reasons for the crisis. From the early 1990s on, huge investment flows were making their way from institutional investors in the industrialized world into high-growth Pacific Rim

economies. Capital controls no longer impeded these flows, and early gains in market values on the investments attracted further investments. But the bull markets were not to last as economic realities caught up with the euphoria. In most of the developing economies macroeconomic conditions had worsened appreciably, forcing fragile economic management systems to cope with problems beyond their capabilities. As bankruptcies increased, concerns grew about inappropriate government policy responses. The investors decided to get out before things got worse. As panic took over in one market, they abandoned the next—and conditions resembling a “run on the bank” took over. Concerns grew that the failures in the region could spread to Japan, where the underlying banking system was in terrible shape, then perhaps move on to the large industrial countries, threatening like dominoes the safety of the entire world financial system. Forecasts for world economic growth were lowered, and when the Russian government defaulted on its foreign debt in June 1998, the fears were immediately rekindled. This sharply affected financial prices and liquidity in markets for securities and commodities in all world financial markets, including the United States.

International financial “crises” are becoming common. Generally, they are of two types: those that are short lasting and those that may have significant long-term effects on the global economy. The short-lasting crises, like the 1992 devaluation of the pound that was forced on the British government by “speculators” such as George Soros, have only nominal effects on the world economy, even though government officials may be embarrassed and individual investors betting the wrong way may be wiped out. Longer-term crises, however, such as the Third World debt crisis of the 1980s (which resulted in a decade of economic contraction in regions such as Latin America) can also denigrate banks and other credit institutions in industrial countries and thereby weaken the world financial system.

After nearly two decades of deregulation, the effects of technology, and increased competition in financial markets, private sector financial flows in markets around the world vastly exceed the resources of the IMF or of individual governments seeking to stabilize them. The market value of all securities traded in the world exceeded \$50 trillion in December 1999, and the daily average trading volume in foreign exchange markets now exceeds \$1.5 trillion. These funds are capable of moving very quickly, far faster than the best prepared IMF-led interventionist effort could.

The IMF was established in 1944 to be the official international lender of last resort. The fixed exchange rate financial system has long since been abolished but the IMF has continued to be involved in many individual country rescue efforts in the floating-rate financial system. Nearly 70 of these efforts were still on the books in September 2000. The IMF did not intervene in a large, unified way in the case of the Third World debt crisis, which took nearly 10 years to develop and another 10

years to resolve. In view of the seriousness of that crisis, perhaps it should have taken action. The Fund intervened in the Asian crisis, however, not to prevent the devaluation of individual currencies—market forces had moved too quickly and powerfully to do so. Instead, the IMF hoped to shorten the economic response and recovery time, to force its preferred institutional reforms into political systems that previously had opposed them, and to protect the world banking system from another round of serial country defaults.

Criticisms of IMF

These were worthy objectives and on many levels the intervention appears to have been successful. But nonetheless, the Fund has been strongly criticized by academics, journalists, and political commentators as: (1) being too late or otherwise unnecessary, (2) imposing wrong-headed, out-of-date policies that made problems worse, and (3) giving a free ride to speculators who were “bailed out” by loans made to governments to repay private sector debts. Some also point out that good money was used to support regimes that applied bad policies, and market forces alone could be relied upon these days to apply the necessary discipline to straighten things out at no cost to taxpayers. Michel Camdessus, the IMF Director at the time of the Asian crisis, was personally criticized as being out of date and out of touch. Under pressure Camdessus announced his resignation unexpectedly nearly three years before the end of his term, and so was out of office as well.

When international financial crises arise, they pose three essential questions for the President of the United States and his economic team: (1) knowing when a set of events are truly a crisis deserving intervention (most probably they are not), (2) knowing what sort of plan to follow that can achieve the desired results, and (3) knowing how to execute the plan selected to achieve maximum results as quickly as possible. In the 1994-1996 Mexican case, the U.S. Secretary of the Treasury was able to lead the effort that was undertaken, and to act quickly and forcefully (despite significant opposition by Congress) to manage the intervention successfully. The intervention was effective, and the crisis was resolved (and the United States was paid back) almost before anyone knew it. In the Asia crisis, the case for intervention was much less clear. It was a region, not a country, and intervention after the collapse of foreign exchange rates would affect financial but not macroeconomic factors. The price tag was huge, exceeding the resources available to the IMF. The crisis forced the Fund to forge a large, unwieldy consortium, consisting of the World Bank, the Asian Development Bank (such loans were not within their mandates, however), and 12 industrial countries including America. There were a lot of side issues involved also, such as whether the United States and other countries would support a Japanese plan for Asian recovery. The overall project was difficult to coordinate, its intended results were vague, and the time by which the goals could be achieved was unclear. The consensus was that it would take at least several years to get the IMF's money back.

An intervention of the Asian variety is vastly more complicated (and difficult to justify) than one involving a nearby neighbor that has asked for help. In general, the IMF is the only entity capable of handing such an intervention, but the Fund is often highly unpopular among client governments and political parties that do not wish to take the medicine prescribed. Direct American interests in failing Third World economies are remote to U.S. voters, although concerns about world economic growth and financial solvency are important. It cannot be in America's interest to aspire to the role of the IMF, especially that of international lender of last resort. Yet if the Fund is ineffective, that role may be presented to the United States despite its wishes. It is therefore in the interest of the United States for the IMF to be strong, effective, and respected. America, of course, as the largest shareholder of the IMF, has considerable influence—but only when it is persuasive among the other G-7 countries. The U.S. government is most likely to be persuasive in periods between crises when open discussion of the changing IMF role and modus operandi can be conducted unthreateningly and out of the public eye. The change of U.S. Administrations can present uncommon opportunities for accelerated rethinking of the missions and roles to be supported.

Lessons Learned

International financial crises can be expected to appear periodically, and their potential size, cost, and complexity make them important to the United States. Indeed, a large crisis could become hugely important to world economic and political stability, equaling perhaps the order of magnitude of the threat posed by the Cold War. The next President is likely to face one or more of these international financial events, and when he does he will be expected to provide effective leadership. The President will need to know when not to condone intervention, as well as when to do so. It may then be necessary to support or oppose the IMF in its effort to control the situation. The future global financial influence of the United States depends upon its being able to manage this interaction with the IMF, and other world economic institutions, effectively through the President's appointed representatives. To be effective, the representatives need to understand the issues well (including the nature and massive power of market forces), and to be on good (but independent) terms with the IMF. Although the Clinton Administration was able to do this, it did not do much to resolve the important question of the future role of the Fund—and how and when it should intervene in crises. Left entirely to its own devices, the IMF may envision a larger role and mission for itself than many in the United States might like. It will be important and necessary for the new President to participate in the debate, and influence its outcome. This will be an early test of the President's international financial leadership, one that is likely to have consequences throughout his Administration.

