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Applying the Lessons of Asia: The IMF's Crisis Management Strategy in 2008

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Abstract

The paper examines the recent European crisis management programs of the International Monetary Fund (IMF) to see how the lessons of Asia were applied. Compared to the Asian programs of 1997, the European programs of 2008 were better funded and their structural conditionality more focused. Other than these, the overall thrust of the programs was similar: fiscal and monetary tightening, coupled with banking reforms. The real difference, however, was not so much about content but about philosophy. Relative to the Asian programs, the European programs were characterized by more emphasis on ownership, greater collaboration among stakeholders, more realistic assumptions and greater transparency about the risks and the logic of policy actions, and more built-in flexibility of targets and policy options. This approach to crisis management, foreshadowing the major reform of conditionality in March 2009, incorporated the changes that had been made since the Asian crisis in the IMF's policies and procedures to manage capital account crises more effectively. Despite these recent changes in the way the IMF does its business, Asia appears to remain unengaged. The lesson Asia should draw from Europe is that it should build a strong regional institution to complement, and catalyze the involvement of, the IMF. Only then can the lessons learned in Asia over 10 years ago be applied back in Asia to benefit its own people.

JEL Classification: **E65, F33, F53**

Contents

1. INTRODUCTION

The paper examines the crisis management programs that the International Monetary Fund (IMF) adopted in 2008 in Europe to see how it applied the lessons of Asia. The Asian crisis of 1997 was a watershed event in the evolution of the international financial architecture designed to prevent, manage, and resolve a financial crisis. A number of initiatives have since been launched, including the 1999 establishment of the Financial Stability Forum (FSF),[1] the 1999 introduction of the Financial Sector Assessment Program (FSAP), and a number of less visible reform efforts within the IMF. Many of these reforms in the IMF's crisis-response policies, however, remained largely untested because the plentiful global supply of capital left little room for IMF financing during much of the 2000s.[2] The situation changed in late 2008 when the global financial crisis led to a sharp contraction of global credit and caused several European countries to seek financial support under the IMF's conditional lending facility.

This is an opportunity to examine how the IMF applied in practice the lessons it had learned from Asia over 10 years ago. The many criticisms of the IMF's crisis response in Asia can be grouped into three broad categories: (i) the IMF went ahead with underfinanced programs, (ii) its adjustment programs were ill-conceived in terms of macroeconomic conditionality, and (iii) it imposed structural conditionality in areas not relevant to crisis management. In this paper, I review the content of the IMF programs in Asia and Europe in each of these areas before attempting a broad characterization of the 2008 European programs in terms of how the IMF applied the lessons of Asia. The comparison is between the initial programs, which will allow us to consider program design issues abstracting from the issue of how the IMF may have responded to subsequent country-specific developments, including unanticipated events.[3]

Although more than a dozen countries concluded financing arrangements with the IMF between November 2008 and May 2009 (see IMF 2009b for details), I focus on the capital account crisis cases of Hungary, Iceland, Latvia, and Ukraine, to which the IMF provided exceptional access financing immediately after the onset of the global crisis. The choice of the four early European cases is motivated by three considerations. First, the IMF substantially changed the way it designs lending programs in March 2009. In what it calls the "modernization" of conditionality, the IMF attempted to reduce the "stigma" attached to IMF lending by increasing reliance on ex ante and review-based conditionality and discontinuing the use of performance criteria for structural measures; it increased the flexibility of standby arrangements by doing away with the presumption of quarterly phasing, raising the access limit, and permitting greater upfront disbursements (IMF 2009a). For these and other reasons, it would be difficult to examine the content of the succeeding programs to identify the lessons of Asia, separate from the innovations introduced at the urging of the G20 Leaders Summit in an extraordinary environment of worsening global economic and financial conditions.

Second, not all early arrangements (agreed prior to the March 2009 reform) were comparable in some important respects to those agreed with Indonesia, the Republic of Korea, and Thailand over 10 years ago. For example, though Pakistan was another early case (with the program approved in November 2008), it was not a bona fide capital account crisis case. The country had mismanaged macroeconomic policies and essentially faced a

[1] The FSF was reorganized as the Financial Stability Board (FSB) in April 2009 as part of international financial architecture reforms endorsed by the Group of Twenty (G20) Leaders Summit.

[2] The IMF country teams that worked on Russia, Brazil, Turkey, and Argentina in the late 1990s and early 2000s may have applied part of what they viewed as the lessons of Asia, but their response was not based on the institution's formal policies which were still evolving at the time.

[3] For this reason, unless noted otherwise, the numbers quoted in the paper come from the IMF documents for the initial programs even when they were subsequently revised.

current account crisis, with warning signs appearing already in mid-2007 (though the problem was exacerbated by the withdrawal of capital associated with the global financial crisis). There should be little disagreement that Pakistan in any case needed the conventional therapy of fiscal and monetary tightening. Likewise, the arrangements for Costa Rica, El Salvador, and Guatemala were precautionary (with no presumption that funds would actually be disbursed) and, unlike the situation in Asia, the countries did not face an immediate collapse of the exchange rate or depletion of reserves.

Finally, it is possible that the programs adopted in early 2009 already embodied the influence of the forthcoming innovations being discussed within the IMF at the time. There was then an increasing recognition that these countries were victims of the global economic turmoil, which may have influenced the way the financing programs were designed. In contrast, there was a greater perception that the crisis was largely homegrown (albeit exacerbated by the global crisis) in the first four European cases, with financial sector vulnerabilities playing a key role in three of them; the four countries also claimed the largest ratios of external liabilities to gross domestic product (GDP) among all the countries that received IMF financial assistance in recent months.[4] This may explain why the first four European programs envisaged the strongest external adjustment of all recent IMF standby arrangements (IMF 2009b). In these respects, these four cases share greater commonality with the Asian crisis cases than with the other recent ones. The upshot is that in order to see how the IMF may have applied the lessons of Asia in the context of the recent global financial crisis, it is both sufficient and helpful to focus on the early European cases of Hungary, Iceland, Latvia, and Ukraine.

The paper is organized as follows: Section 2 discusses the size of official financing in the crisis management programs of Asia (Indonesia, Korea, and Thailand) and Europe (Hungary, Iceland, Latvia, and Ukraine). Section 3 discusses the content of macroeconomic conditionality, including high interest rate policy, fiscal tightening, and the underlying assumptions. Section 4 compares structural conditionality between Asia and Europe, highlighting the evolution of the IMF's thinking over the past decade. Section 5 identifies the key features of the IMF's approach to crisis management in 2008, explaining how the IMF applied the lessons of Asia in Europe. Finally, Section 6 presents concluding remarks.

2. SIZE OF OFFICIAL FINANCING

The successful management of a capital account crisis (caused by a sharp reversal of cross-border capital flows) often requires international financial support to limit net capital outflows. If capital were allowed to flow out of the crisis economy freely, the requirement of external adjustment would cause a sharp contraction of output in order to compress imports and thereby generate a narrowing of the current account deficit. International financial support is also useful in minimizing the negative balance sheet effect of currency depreciation. Before the Asian crisis, many in the economics profession held the view that the contractionary impact of a large capital outflow on output would be offset to some extent by the expansionary impact of currency depreciation on net exports. This did not turn out to be the case in Asia because the exchange rate depreciation exerted a negative wealth effect on the private sector that had net liabilities denominated in foreign currencies.[5]

[4] IMF (2009b) notes that, out of the 15 recent crisis cases considered, only in Iceland, Latvia, and Ukraine was the financial sector key in triggering or exacerbating the crisis.

[5] The negative wealth effect of exchange rate devaluation when there is net external debt in foreign currencies was first recognized almost half a century ago by Diaz-Alejandro (1963). Among development economists, the contractionary impact of currency depreciation was a well-known empirical regularity even at the time of the Asian crisis (see Edwards 1989).

The IMF provided exceptional financing both in Asia and in Europe (Table 1).[6] Relative to the standard metric of IMF quota, the European packages were about twice the size of the Asian packages (excluding the Republic of Korea whose quota was unreasonably small relative to the size of the economy). Relative to GDP, the European programs were as much as 3–5 times larger.[7] To some extent, this may be a reflection of the fact that the European economies are more open: relative to the value of imports, the size of the European packages was more comparable. Relative to the previous year's current account deficits, the European packages (especially for Hungary and Ukraine) were particularly large, indicating that they were better designed to deal with a capital flow reversal.

Table 1: IMF Financing in Asia (1997) and Europe (2008)

	IMF financing (US$ billion)[a]	% of:			
		IMF quota	Preceding year's GDP	Preceding year's imports	Preceding year's current account deficit
Asia 1997					
Indonesia	10	490	4.5	22.6	130.5
Rep. of Korea	21	1939	4.0	14.5	90.5
Thailand	4	505	2.2	6.3	27.2
Europe 2008					
Hungary	15.7	1015	10.7	17.0	231.7
Iceland	2.1	1190	10.2	34.0	65.8
Latvia	2.35	1200	8.1	15.9	37.7
Ukraine	16.5	800	11.7	27.3	278.4

GDP = gross domestic product.

[a] Excluding other official financing.

Source: author's estimates based on the IMF's initial program documents.

The difference between the Asian and European packages becomes more apparent when total official financing is considered (Table 2). Relative to GDP, the headline figure was 14.5%–35.7% for Europe, whereas the corresponding figure for Asia was 6.7%–12.6%. Total official financing for Latvia (35.7% of GDP) may well have represented a virtual bailout of the country.[8] For Iceland, however, the package (equivalent to 20% of GDP) may still have been insufficient given the magnitude of the problem. At the end of 2007, the size of the now defunct financial sector exceeded 1,000% of GDP, with the country's gross external liabilities estimated at 550%.

[6] Unless noted otherwise, the IMF "program documents" refer to the relevant Letters of Intent, Press Releases and, where available, Staff Reports that are published following the Executive Board approval of IMF-supported programs.

[7] This comparison appears to remain valid for a larger sample. The median access in 15 recent programs (2008–2009) was 7% of GDP, compared to 4% in past capital account crisis programs (IMF 2009b).

[8] According to the program documents, Latvia's gross external liabilities maturing within a year amounted to over 60% of GDP. The private sector's total net liabilities, however, were 70% of GDP (with the banking sector's short-term liquid assets amounting to 45%), and the public sector was a net external creditor.

Table 2: Official Financing under IMF Programs

(US$ billion)

	IMF	Other official	Total (% of preceding year's GDP
Asia 1997			
Indonesia	10	18 [a]	28 (12.6%)
Rep. of Korea	21	14 [b]	35 (6.7%)
Thailand	4	13.2	17.2 (9.5%)
Europe 2008			
Hungary	15.7	9.7	25.4 (17.3%)
Iceland	2.1	2.9 [c]	5 (19.3%) [c]
Latvia	2.35	8.02	10.37 (35.7%)
Ukraine	16.5	4.0 [d]	20.5 (14.5%)

GDP = gross domestic product.

[a] Excluding US$17 billion designated as the "second line of defense" and US$5 billion drawn from its own foreign exchange reserves.

[b] Excluding US$20 billion designated as the "second line of defense." The headline figure including the second line was US$55 billion.

[c] Financing needs indicated in the program document, excluding the cost of guarantees for the external liabilities of the failed financial institutions.

[d] This comes from Appendix I in IMF (2009b), which may not accurately represent what was expected when the program was designed. No figure is provided for other official financing in the documents for the initial program.

Source: author's estimates based on the IMF's initial program documents, unless otherwise noted.

The difference becomes even greater when what may be considered to be the *quality* of the financing (meaning both adequacy relative to need and the credibility of underlying numbers) is assessed. In Thailand, total official financing of US$17.2 billion was less than half the amount of short-term external liabilities (US$38 billion at the end of May 1997); the foreign exchange reserves were nearly depleted; and the monetary authorities had a forward contract to sell US$23.4 billion over the coming months. The financing package was based on the IMF staff's optimistic assumption that quick restoration of investor confidence would limit capital outflows and that the country's financing needs over 1997–1998 would only be US$14 billion.

The problem was more serious for Indonesia and the Republic of Korea. First, though the World Bank and the Asian Development Bank (ADB) agreed to provide US$18 billion to Indonesia and US$14 billion to the Republic of Korea, these figures included the amounts that had already been agreed on before the crisis. The amount of *additional* financing was not certain. Second, bilateral financing (US$17 billion for Indonesia and US$20 billion for the Republic of Korea) was designated as the second line of defense, and was to be activated only when financing from all other sources proved insufficient. The conditions under which these funds would be made available were not specified, causing the market participants to question not only their availability but also, given the lack of transparency surrounding the World Bank and ADB loans, the credibility of the whole official financing packages.

In contrast, Europe's official financing packages appeared to have more substance. First, except perhaps for Ukraine, there was a clear backing for the numbers from the outset. The program documents clearly stated the amount of financing needs and how the gap was to be filled. The documents further stated that several stakeholders, such as the European Union, the European Central Bank, the World Bank, and Nordic countries, had participated in the preparation of the programs, giving credibility to the amount to be provided by these entities. In Asia, the programs were negotiated almost exclusively by the IMF staff and the authorities of the countries concerned, with limited direct participation by other stakeholders.

Second, in Europe, a type of private sector involvement (PSI) was attempted from the beginning. Especially in Hungary, Latvia, and Ukraine, foreign-owned banks constitute a significant share of the banking sector. In these countries, the programs were able to secure a commitment from the parent banks to maintain their exposure to the local subsidiaries (the participation of the Nordic authorities in Latvia's program negotiations was helpful in this regard). PSI was also tried in the Republic of Korea in 1997 and contributed to resolving the crisis quickly, but only after the initial program had failed; in Thailand, there was said to be an understanding that foreign banks would maintain their exposure during the crisis, but the commitments did not amount to much. In Europe, this was tried from the outset and, though the amount was not included in the headline figure, appears to have contributed to enhancing the credibility of the overall financing packages.

Finally, Iceland and Ukraine retained the restrictions they had introduced prior to approaching the IMF on capital outflows and payments for some current transactions; Latvia also retained the exchange control related to the frozen bank deposits.[9] Exchange restrictions related to current transactions (except those approved under the transitional arrangements of Article XIV) are in violation of Article VIII of the IMF Articles of Agreement, and are normally not permitted in IMF programs as "measures destructive of national or international prosperity" (IMF 2002: 2).[10] But they were permitted in Europe on the condition that they would be removed as soon as practical.[11] Though capital controls do not violate the IMF Articles as long as they do not restrict payments for current transactions, the IMF has generally taken a position unfavorable to any administrative measure that interferes with the free movement of capital.[12] Now the IMF appears to consider capital controls as a legitimate crisis management tool.[13]

3. MACROECONOMIC CONDITIONALITY

3.1 Monetary policy

There were two controversial components to the IMF's macroeconomic programs in Asia: high interest rate policy and fiscal tightening (Furman and Stiglitz 1998). The debate on high interest rate policy remains and is likely to remain unsettled. The interest rate defense of a falling currency has been a standard practice in many contexts, and has been successful in some cases, though not in others. In fact, there is some empirical evidence to show that high interest rate policy in the Republic of Korea had a stabilizing effect on the exchange rate (Cho and West 2000; Chung and Kim 2002). In a model of the war of attrition between speculators and monetary authorities, Gregori (2009) shows that the success or failure of an interest rate defense depends in a complex fashion on the interest rate, the associated private costs to both parties, and the rate of expected depreciation by the speculators when the defense fails. At any rate, in Asia over 10 years ago, no one would have advocated reducing interest rates when the exchange rate was falling drastically.

The debate in Asia can be summarized in terms of the following dilemma: high interest rate policy further damages the banking sector already weakened by the crisis, but unless

[9] It is possible that these capital and exchange controls contributed to the observed, reasonable stability of exchange rates during the first months of the IMF programs.

[10] As a result of the exchange controls, arrears on current obligations have emerged in these countries.

[11] Iceland removed all payment restrictions on current account transactions in late November 2008, allowing the foreign exchange market to reopen in early December.

[12] In 1998, many observers thought that the IMF was hostile to the introduction of a capital outflow control by Malaysia. See IEO (2005) for a general review of the IMF's approach to capital account liberalization and related issues.

[13] On the other hand, as EU member countries, Hungary and Latvia did not have the option to introduce capital controls.

interest rates are raised, a weaker currency would magnify the banking crisis in any event through the adverse balance sheet effect. In Asia, there was also a perception that the IMF had caused the unwilling national authorities to raise interest rates, a policy which would subsequently magnify the banking crisis and as a result prolong the economic stagnation.[14] The lesson of Asia does not necessarily concern the content of monetary policy conditionality itself. Rather, it is that the monetary authorities should pay sufficient attention to the potential negative impact of high interest rate policy on a weak banking sector and it is only the national authorities who can take the ultimate responsibility for the choice of high interest rate policy in view of its positive and negative consequences.[15]

In Europe, tight monetary policy was also the core element of all IMF programs. In Iceland, the policy interest rate was raised by 6 percentage points (to 18%) as a prior action for the program's Executive Board approval, and performance criteria were set on the provision of central bank credit to the government and the private sector. In Ukraine, although the stance of monetary policy had been tight prior to the crisis, the authorities in the fall of 2008 responded to the global tightening of liquidity by lowering the policy interest rate by 3.5%. What the IMF program did was to require that monetary policy be reversed back to the tightening stance of the pre-crisis period. In terms of the stance of monetary policy, the European programs differed little from the Asian programs over 10 years ago.

If there is any difference, it is about procedure. First, the documents for the European programs emphasized that high interest rate policy was the national authorities' preferred policy. For example, the Hungarian authorities had already raised the policy interest rate in early 2008, and the IMF program simply maintained the stance of policy already chosen. In Iceland, the authorities had been raising the policy interest rate (before the reversal in mid-October) and pledged to reform the Housing Financing Fund (as a way of containing the provision of credit). Here again, the IMF program simply held on to the previously chosen course of policy.

Second, the documents for the European programs specified the purpose and logic of high interest rate policy. In most cases, they stated that the purpose was to stabilize the exchange rate while noting the negative consequence of premature monetary easing for this purpose. At the same time, the documents also stated the need for banking sector restructuring as an objective of the program and, insofar as high interest rate policy conflicted with this objective, the need to manage monetary policy flexibly. In Ukraine, for example, the document stated the need for further monetary tightening but only after the pressing liquidity problem of the banking sector was resolved.

3.2 Fiscal policy

The more controversial aspect of IMF conditionality in Asia concerned the fiscal component. There is now broad agreement that fiscal tightening as initially programmed in Asia was unwarranted not only in view of a prospective deceleration of output, which did in fact materialize, but also because, as Ito (2007) and others have argued, fiscal balances were initially in surplus and fiscal prodigality was never a cause of the crisis. The programmed fiscal adjustments were significant. In Thailand, the adjustment amounted to 2.8% of GDP for October 1997–September 1998; in Indonesia, it was 1% and 2% of GDP, respectively, for 1997–1998 and 1998–1999. In the Republic of Korea, fiscal measures amounting to 1.5% of

[14] In practice, the Thai and Indonesian authorities had already begun to raise interest rates before they approached the IMF.

[15] Another dimension concerns the timing of the interest rate increases—rates should be raised early by a very large amount to help stabilize the external situation and in an ideal situation would be quickly reduced as external pressures ease.

GDP were programmed for 1998. As a result, the programs for these countries envisaged a small fiscal surplus (0.2–1.0% of GDP) in the subsequent calendar or fiscal year (Table 3).[16]

Table 3: Fiscal Balances under IMF Programs (% of GDP)[a]

	Preceding year, actual	Program year, projected or programmed	Following year, programmed
Asia 1997			
Indonesia	1.2	0.8	1.0
Rep. of Korea	0.3	-0.5	0.2
Thailand	2.2	-1.1	1.0
Europe 2008			
Hungary	-4.9	-3.4	-2.5
Iceland[b]	5.5	-0.2	-13.5
Latvia	0.7	-3.0	-4.9
Ukraine[b]	-2.0	-1.0	0.0

GDP = gross domestic product.

[a] Calendar or fiscal year, as indicated in the program documents.

[b] Excluding the cost of bank restructuring.

Source: IMF program documents.

In Europe also, all program documents stressed fiscal tightening as the critical element of the program. In Hungary, for example, the documents explicitly stated that the objective was to implement "a substantial fiscal adjustment" and programmed a tightening that amounted to about 1% (2.5% in cyclically adjusted terms) of GDP from 2008 to 2009. The tax cut planned for 2009 was also scrapped. The government of Hungary had failed several times to raise funds in the market. A government that cannot borrow in the market cannot be expected to continue to run fiscal deficits. Surely, restoration of fiscal sustainability needed to be a primary objective of any crisis management program.

In Ukraine also, the program envisioned a fiscal tightening amounting to 1% of GDP. Ukraine had continued to run fiscal deficits amid strong capital inflows, and the need to tighten fiscal policy had been recognized as a priority task even before the onset of the crisis. In Latvia, fiscal tightening was essential, not only to maintain the peg by depreciating the real exchange rate, but also to achieve the national goal of joining the Euro Zone. The program documents stated that, with determined efforts, the Maastricht criteria for fiscal policy could be met by 2012. Under the IMF program, an adjustment equivalent to 7% of GDP was carried out for the 2009 budget (compared to the original budget).

Although all programs stressed fiscal tightening and placed performance criteria on fiscal deficits, however, the policy actually programmed was accommodative.[17] For instance, the programs allowed fiscal deficits to continue in 2009 except in Ukraine and, for Iceland and Latvia, permitted the deficits to increase from 2008 to 2009. This is probably a reflection of realism, not of the fiscal policy stance. Iceland, in particular, had experienced a virtual national bankruptcy, with the cost of depositor protection and capital injection into the banking sector estimated at 80% of GDP. With the expected recession-induced increase in fiscal deficits, gross government debt was expected to increase from 29% of GDP at the end of 2007 to 109% at the end of 2009. Programming a fiscal surplus under these circumstances would have only undermined the credibility of the program. In the event, a

[16] The actual outcome in all three countries was more expansionary than programmed because the IMF quickly relaxed the targets and automatic stabilizers came into motion.

[17] This appears to be true of all recent IMF standby programs adopted between November 2008 and May 2009 except for the program with Pakistan. Given the nature of the underlying problem, net fiscal tightening was programmed for Pakistan in a manner similar to the Asian programs. See IMF (2009b).

further deterioration of the global economy would cause the fiscal deficit targets to be revised upward for 2009, except in Iceland.

In short, the logic of fiscal conditionality in the European programs was that it would realistically allow deficits to remain or increase in the short run, but place fiscal consolidation as the central objective. The documents for Iceland explicitly stated that medium-term fiscal consolidation would formally commence in 2010. As a consequence of realism, the programs were flexible. The document for Ukraine acknowledged the possibility of relaxing the fiscal target for 2009 depending on the prevailing circumstances (which in fact did take place). In all four countries, the costs of bank restructuring (including depositor protection) were excluded from fiscal conditionality (whereas in all three Asian programs additional tightening was programmed to contain such costs). This would allow the countries to increase fiscal spending flexibly without violating the terms of conditionality.[18]

3.3 Underlying macroeconomic assumptions

In order to understand the logic of fiscal conditionality, it is necessary to review the underlying macroeconomic assumptions. The primary reason for IMF conditionality in Asia to include fiscal tightening was that the IMF did not fully appreciate the nature of a capital account crisis, with attendant sharp capital flow reversals, and the negative balance sheet effect of exchange rate depreciation. The capital flow reversals were far greater than anybody had supposed. The magnitude of the reversal from 1997 to 1998 was especially large in the Republic of Korea (12% of GDP) and Thailand (13%). Instead, the IMF staff underestimated the capital flow reversals the three countries would experience and assumed them to be only 0.5%–2.5% of GDP (Table 4).

Table 4: Current Account Balances under IMF Programs (US$ billion; % of GDP in parentheses)[a]

	Preceding year, actual	Program year, projected or programmed	Following year, programmed
Asia 1997			
Indonesia	-7.7 (-3.3)	-5.8 (-2.7)	-4.9 (-2.2)
Rep. of Korea	-23.7 (-4.9)	-13.8 (-3.1)	-2.3 (-0.6)
Thailand	-14.4 (-7.9)	-9.0 (-5.0)	-5.3 (-3.0)
Europe 2008			
Hungary	(-6.4)	(-6.2)	(-2.0)
Iceland	-2.9 (-14.6)	-1.8 (-10.7)	0.1 (1.0)
Latvia	(-23.8)	(-14.8)	(-7.3)
Ukraine	-5.9 (-4.2)	-13.4 (-7.1)	-21.9 (-9.8)

GDP = gross domestic product.

[a] Calendar or fiscal year, as indicated in the program documents.

Source: IMF program documents.

A large capital flow reversal could lead to a contraction of output because the current account needs to swing into surplus as a counterpart of the capital account deficit. Output contraction would be the surest way to compress imports and thereby generate the required current account surplus. The IMF underestimated the severe contractionary effect coming from the capital account and therefore failed to anticipate a possible negative output growth. It continued to believe that the Asian crisis countries would register positive output growth (Table 5).

[18] In addition, the program documents all referred to the need to protect the poor through a social safety net measure. The consideration of the social impact of a program was a response to the criticisms voiced at the time of the Asian crisis and such need has routinely been noted in all recent IMF program documents.

Table 5: Real Gross Domestic Product Growth under IMF Programs (% per annum)[a]

	Preceding year, actual	Program year, projected or programmed	Following year, programmed
Asia 1997			
Indonesia	8.1	5.0	3.0
Rep. of Korea	7.1	6.0	2.5
Thailand	6.4	2.5	3.5
Europe 2008			
Hungary	1.1	1.8	-1.0
Iceland	4.9	1.6	-9.6
Latvia	10.3	-2.0	-5.0
Ukraine	7.6	6.0	-3.0

[a] Calendar or fiscal year, as indicated in the program documents.

Source: IMF program documents.

Another reason for underestimating the contractionary impact of the crisis was the failure to understand the balance sheet effect of currency depreciation. As noted earlier, many at the time believed that devaluation was expansionary because it stimulates exports and raises the price level. According to Boorman et al. (2000), the IMF staff had initially expected the countries' exports to expand much more as the currencies fell in value. The sharp contraction of output in the crisis countries therefore came as a surprise. Part of this was the negative impact of increased uncertainty and reduced confidence on corporate investment, but there was also the negative balance sheet effect of currency depreciation, given the history of significant unhedged foreign currency borrowing.

In contrast, the European programs clearly recognized the contractionary impact of a capital flow reversal and exchange rate depreciation. Except in Iceland, all programs assumed net capital inflows for 2009 and give the impression that they were on the optimistic side. This may have reflected the assessment that there was sufficient external financing (both official and private through PSI) to keep the inflow of capital. Even so, the European programs envisioned a far greater reversal of capital flows (4%–12% of GDP) than initially assumed in the Asian programs (0.5%–2.5%).

As to the balance sheet effect, the IMF staff had acquired a tool (the "balance sheet approach") to analyze the implications of currency and maturity mismatches in the balance sheets of various sectors in an economy. In fact, the balance sheet approach may well be the single most important analytical development of the past decade within the IMF (see, for example, Allen et al. 2002; Rosenberg et al. 2005). As a result, all program documents in Europe acknowledged the negative wealth effect of the exchange rate depreciation observed up to that time.

In Iceland, where the currency had depreciated by 70% against the US dollar (and 50% against the euro), serious recession was forecast for 2009–2010. In Latvia, the justification for maintaining the peg included the argument that, given the large balance of foreign currency debt (amounting to 70% of GDP) and extensive dollarization in domestic financial transactions, the balance sheet effect of allowing the currency to depreciate would be simply too large. The documents then argued that, given the decision to maintain the peg, deflationary pressure would emerge, making economic recovery a difficult and prolonged process. In all countries, the programs saw negative economic growth for 2009.

4. STRUCTURAL CONDITIONALITY

Two opposing views have been expressed on structural conditionality in the Asian programs. One view holds that some of the structural reform measures were unrelated to the immediate problem of crisis resolution and distracted attention from the core macroeconomic and financial issues; and they were felt to be an encroachment into domestic decision making, creating an unnecessary opposition, and may have damaged investor confidence by signaling to the markets that the situation was worse than they had feared (Feldstein 1998; Radelet and Sachs 1998). The other view argues that restoring market confidence requires the demonstration of a will to tackle the structural causes of crisis vulnerabilities in the economy (Summers 1999; Goldstein 2002). The issue will never be fully resolved, though the balance of opinion has shifted to the former view, especially within the IMF.

As noted, in March 2009, the IMF Executive Board discontinued the use of structural performance criteria (the observance of which was required to disburse the funds) in all IMF programs. In coming to this decision, "most" Executive Directors are said to have stated that "structural performance criteria are perceived as reducing national ownership of Fund-supported programs" (IMF 2009a). In what follows, however, I will interpret structural conditionality not in the narrow sense of structural performance criteria but in a broader sense of structural reforms envisioned in the program, including in the form of structural benchmarks (which are not linked to the disbursement of the funds). I am not so much interested in the legal aspects of conditionality as in understanding the IMF's perception of structural measures that are needed, within the context of a crisis management program, to address the underlying vulnerabilities and to restore market confidence.

In Asia, weaknesses in the financial sector were central to the crises, and tackling these was crucial not only to resolving the damage done by the crisis but also to regaining market confidence. Thus, they were correctly a major focus of the programs. In fact, structural conditionality in the Thai program included little else (the other measures were relatively minor).[19] In Indonesia and the Republic of Korea, too, financial sector restructuring received major emphasis. In Indonesia, the government closed down 16 banks as a prior action for the IMF program (though, given implementation difficulties, the measure failed to calm the market). In the Republic of Korea, the government had suspended nine insolvent merchant banks on the day before the IMF program was approved; under the program, the authorities closed down or forced consolidation of institutions that failed to meet the minimum solvency requirements.

Structural conditionality in Indonesia and the Republic of Korea, however, went beyond addressing the critical problems of the financial sector (Table 6). The Indonesian program was particularly extensive and included a large number of additional structural reforms related to cronyism and corruption (though most of them were benchmarks rather than performance criteria). In the Republic of Korea, too, the agenda of reform was broader than financial sector restructuring, covering also trade liberalization (especially, the termination of the so-called import diversification program), capital account liberalization (allowing greater foreign ownership of Republic of Korea firms), corporate governance, and labor market reform.

[19] The Thai authorities had already announced the suspension of 16 finance companies in June (before the onset of the full blown crisis) and an additional 42 companies in early August (before they concluded the program with the IMF). Under the program, the government recapitalized, merged with other partners, or liquidated these 58 finance companies as well as nationalized 6 commercial banks and 5 finance companies.

Table 6: Major Structural Conditionality Measures[a]

Asia 1997	
Indonesia	• Financial sector restructuring (including the closure of 16 banks, with a partial deposit guarantee, as a prior action; intensified supervision of remaining weak but viable banks; strengthening, including privatization, of state and regional development banks; improved prudential standards; and capital market development) • Governance (including greater transparency and more competitive bidding for public sector procurement and contracting) • Trade and investment liberalization • Domestic deregulation and privatization (including phasing out of agricultural and domestic marketing monopolies)
Republic of Korea	• Financial sector restructuring (including central bank independence, consolidated financial supervision, improved corporate accounting standards, closure or recapitalization of troubled financial institutions) • Trade and capital account liberalization • Corporate governance and corporate restructuring (including chaebol reforms) • Labor market reform • Data provision
Thailand	• Financial sector restructuring (including easing of restrictions on foreign equity participation in troubled financial institutions) • Corporate restructuring (including the privatization of state-owned enterprises; and greater private sector participation in transportation, power and other key sectors) • Civil service reform
Europe 2008	
Hungary	• Financial sector restructuring (including legislative action for financial support to banks and resolution of troubled banks) • Passage of fiscal responsibility law
Iceland	• Financial sector restructuring (including a capital injection into three banks and improved financial sector supervision) • A medium-term framework for fiscal consolidation
Latvia	• Financial sector restructuring • Medium-term fiscal system reform • Framework for wage restraint designed to strengthen competitiveness
Ukraine	• Financial sector restructuring (including legislative action for financial support to banks, strengthened central bank independence, improved financial sector supervision, and resolution of troubled banks)

[a] Initial programs.

Source: IMF program documents.

During the course of post-crisis debate, consensus emerged within the IMF on the need to "streamline" structural conditionality in a limited number of "macro-critical" areas. Following up on the interim initiative of 2000,[20] the IMF's new conditionality guidelines and associated documents (issued in 2002) stated: "conditions that are not of critical importance for achieving the macroeconomic goals of the program…are to be avoided" (IMF 2002). The IMF's internal review of conditionality, comparing structural conditionality in IMF programs between 1995–1997 and 2001–2003, noted that major shifts had occurred in the direction of "greater focus on criticality" (IMF 2005). Had such a policy been in place before 1997, structural conditionality in Asia would likely have only included measures to restructure and strengthen the financial sector. Although banking sector reforms were central to the program

[20] "The Interim Guidance Note on Streamlining Structural Conditionality," 18 September 2000. IMF (2005) explains that, the 2000 requirement that a conditionality measure be in the IMF's core areas of competence (macro-relevant) was changed in 2002 to the requirement that it be critical to the success of the program (macro-critical).

objectives, the focus was diluted, at least in Indonesia and the Republic of Korea, by measures imposed in a number of other areas.

In Europe, structural conditionality was essentially limited to reforms in the banking sector and the fiscal system. In all countries, bank restructuring met the requirement of macro-criticality, especially in Iceland, where three major banks holding about 85% of total deposits failed and were nationalized. In Hungary, where more than half of all outstanding housing loans were denominated in foreign currencies, international investors decided to pull out of the country's banking sector when they saw the large balance sheet mismatch. In Latvia, the drying up of liquidity associated with the global financial crisis caused the currency peg to be challenged and led to a precipitous run on the banking system. Details differ, but bank restructuring was closely connected with the eventual resolution of the crisis in all countries. Except for Ukraine, conditionality also included the introduction of a rule-based fiscal framework to ensure medium-term fiscal sustainability.

Structural conditionality was more extensive in Latvia, in view of its decision to maintain the peg. In addition to banking sector and fiscal system reforms, structural benchmarks were placed on the development of a comprehensive debt restructuring strategy, an amendment of the Insolvency Law, and the establishment of a framework of wage restraint in the form of a committee in the National Tri-Partite Council. The framework of wage restraint was designed to depreciate the real exchange rate when the nominal rate was fixed and thereby to restore international competitiveness. Although not part of formal conditionality, Latvia's letter of intent also included measures to "promote the development of new products and technologies, increase labor market flexibility," and strengthen "the business environment." These measures, because of the government's commitment to the peg, were considered to be macro-critical reforms.

The IMF Managing Director called the streamlined conditionality of the European programs as "targeted conditionality."[21] This refers not just to the structural conditionality that is largely limited to the banking sector, but also to the targeting of overall conditionality, including macroeconomic policy prescriptions, to a few critical areas deemed important for the program to be successful. The 2002 conditionality guidelines refer to this as the "principle of parsimony," which requires "program-related conditions" to be "limited to the minimum necessary to achieve the goals of the Fund-supported program or to monitor its implementation" and "the choice of conditions" to be "clearly focused on those goals" (IMF 2002: 9). The March 2009 reform of conditionality was only a short step from such a concept.

5. CHARACTERIZING THE IMF'S CRISIS MANAGEMENT STRATEGY IN 2008

I have observed that, compared to the Asian programs of 1997, the European programs of 2008 were somewhat better funded and that their structural conditionality streamlined and focused on the macro-critical area of bank restructuring. Other than these, the overall thrust of the programs was similar: fiscal and monetary tightening, coupled with banking reforms. To the extent that currency crises share common causes and consequences, this may not be so surprising.

Careful comparison of the program documents between Asia in 1997 and Europe in 2008, however, reveals that the difference was not so much about content but about philosophy. It is in the approach to crisis management that lessons were learned from the Asian crisis, and the European programs reflected the changes that had since been made in IMF policies and procedures. As a result, relative to the Asian programs, the European programs had the

[21] "Transcript of a Press Conference by IMF Managing Director Dominique Strauss-Kahn on the Launch of a New Facility for Emerging Markets Hit by Crisis," 29 October 2008, available at: www.imf.org/external/np/tr/2008/tr081029.htm.

following features: (i) more emphasis on ownership, (ii) greater collaboration among stakeholders, (iii) more realistic assumptions and greater transparency about the risks and the logic of policy actions, and (iv) more built-in flexibility of targets and policy options. I explain each of these features in turn.

More emphasis on ownership

To demand a policy measure to which a government (and the society it represents) cannot fully commit itself, no matter how desirable the policy may be to the national economy, would increase the chance of program failure and might end up undermining market confidence. This is a lesson of the Asian crisis. The documents for the European programs emphasized that the choice of any policy measure was the authorities' and that the IMF was simply supporting that choice. This is what is called national or country ownership in the literature.

Ownership is not a new concept. At least in principle, all past IMF programs have been the "IMF-supported programs" of government-owned policies. But the Asian crisis led to a serious reflection on ownership as an essential element of any successful IMF intervention in member countries. The IMF has stated that streamlining of conditionality was in part meant to strengthen national ownership of IMF programs, by making conditionality more efficient and transparent, and increasing "flexibility and domestic control in program design and implementation" (IMF 2001b). It was also to strengthen country ownership that, in March 2009, the IMF discontinued the use of structural performance criteria.

The IMF defines ownership as "a willing assumption of responsibility for an agreed program of policies" by responsible officials in a borrowing country (IMF 2001a: 6). In this broad definition, an adopted policy may or may not be homegrown; it can be a product of negotiation between the country concerned and the IMF. In the recent European programs, however, ownership seemed to carry even greater substance: many of the policies had been the authorities' willing choice, often before they approached the IMF. Latvia's choice to keep the exchange rate peg is a case in point. With choice comes responsibility. As the program documents noted, the authorities accepted the resulting need for "exceptionally strong domestic policies" and understood the "possibility that recession could be protracted."

Greater collaboration among stakeholders

The resources of the IMF can never be adequate to deal with a crisis caused by a capital flow reversal. This is also a lesson of the Asian crisis. When investor confidence is totally lost, no financing is adequate because not only foreign investors but also domestic residents could take money out of the country by liquidating assets and converting the proceeds into foreign currencies in the foreign exchange market. In this sense, IMF financing can only be catalytic. Its objective is to induce international investors to stay in the country (or better still to bring additional money into the country) by presenting a program worthy of their confidence.[22] What this requires is not simple volume but quality of financing. The lesson of Asia is not necessarily that the programs were underfinanced, but that one cannot restore investor confidence with dubious numbers.

This is where IMF programs can be strengthened by collaboration with other stakeholders. The need to collaborate with other multilateral institutions has been well recognized by the IMF since the Asian crisis. The 2002 conditionality guidelines clearly state that the IMF's "program design… and conditionality will, insofar as possible, be consistent and integrated with those of other international institutions within a coherent country-led framework" (IMF 2002). Strengthening the IMF-World Bank collaboration in particular has been a constant theme (see, for example, IMF 2004a). In Europe, the IMF's new collaborative approach went even further, as it included not only multilateral institutions but also regional bodies and bilateral donors.

[22] Cottarelli and Giannini (2002) and Mody and Saravia (2003) provide empirical evidence on the effectiveness of the IMF's catalytic finance.

Except for Ukraine, the documents clearly stated that the programs were an internationally coordinated effort of several stakeholders. The participation of the European Commission may have been a legal formality in the case of the two European Union member states, given that part of national sovereignty had been transferred to the supranational institution. However, not just the European Commission but also some Nordic countries (not to mention the World Bank) appear to have participated in the preparation of the financing programs. Such a possibility was unthinkable during the Asian crisis. Even the participation of the World Bank in the program negotiations was more limited. One reason that the IMF received criticism was the suspicion that it had incorporated the views of the United States in a non-transparent way (even though the country did not offer a penny in the case of Thailand).

The IMF's position was different in Europe: it allowed anybody who was willing to provide financing to participate in the preparation of the programs. This is why the headline figure for official financing was more credible than had been the case in Asia. At the same time, all stakeholders were made to assume responsibility for the outcome of the programs. For example, Dominique Strauss-Kahn, Managing Director of the IMF, in announcing the staff-level agreement with Hungary, stated that the, "the success of the policy package will be a shared responsibility between all stakeholders in the country and the international community."[23] Such a view reflected the position that the IMF was only a member of the international community; it was no longer the fire department for the whole world but the coordinator of a group of fire fighters. It was also a reflection of the more open culture of the institution.

More realistic assumptions and greater transparency about the risks and the logic of policy actions

Not disclosing information can give surprise to the market and may end up undermining the program. This is also a lesson of the Asian crisis. Thus, compared to the Asian programs, a far greater amount of information was disclosed to the public about the European programs, from the initial stage of the negotiations to the announcement of the approved programs.[24] Transparency has increased in many public institutions throughout the world over the past decade, with the IMF being no exception. In the context of IMF programs, transparency has also been considered to be a vehicle of enhancing ownership through deepening the "base of support for sound policies among a country's domestic interest groups" (Drazen and Isard 2004).

As a reflection of transparency, the European programs were more realistic and forthright about risks. For example, the program documents indicated that recession was inevitable in Latvia; and 2009 would be a tough year for Ukraine, with the likelihood of a prolonged recession. As noted, the forecasts for capital flow reversals and economic growth were more realistic than had been the case in Asia over 10 years ago. Behind this approach is the philosophy that, when there is bad information, it is better to disclose it at the outset than to hide and let the market discover the information at a later time. In the end, it is not unfounded optimism but honesty that pays off in terms of enhancing the probability of success. Although the public will never know if all unfavorable information was disclosed, downside risks were sufficiently spelled out in the program documents to dispel any impression that the IMF was trying to be overly optimistic to sell the program.

Nor does it help to create doubt. Loss of investor confidence in the program may result unless policies that can become controversial, such as fiscal tightening, high interest rate policy, and the defense of an exchange rate peg, are fully explained and understood. For this reason, the programs for the European programs tried to explain the logic of all core policy measures. For example, in Iceland, the program documents explained that the focus

[23] As quoted in IMF, Press Release No 08/261, 28 October 2008.

[24] In Thailand, the IMF pursued a different type of transparency policy by requiring disclosure of its forward foreign exchange position, but the timing was not helpful in restoring market confidence.

of conditionality was initially placed on bank restructuring but would shift to medium-term fiscal consolidation once market confidence was restored; the documents then explained that, despite the goal of fiscal consolidation, the fiscal deficit would widen in 2009 because automatic stabilizers would come into play. In Hungary, the program documents explained that fiscal tightening would reduce financing needs in the short run and reduce the size of the public sector in the medium term.

More built-in flexibility of targets and policy options

Although the success of a crisis management program depends to a large extent on how international investors react, it is difficult to predict their behavior. As economic conditions that influence their behavior change frequently, an inflexible program may eventually become self-defeating. For this reason, the European programs appeared to incorporate a high degree of flexibility. For example, the program documents for Ukraine, while targeting a balanced budget for 2009, stated that the target could be adjusted flexibly in view of prevailing conditions.[25] The biggest uncertainty in all of the programs concerned the costs of banking sector restructuring. Thus, they were excluded from fiscal conditionality in all of them. Flexibility also applied to policy options. In Iceland and Ukraine, the programs included provisions to retain not only capital outflow controls but also some exchange controls for current payments. In this respect, flexibility can also be thought of as a condition for and the outcome of greater national ownership.

6. CONCLUSION

The paper has examined the IMF's recent crisis management programs in Europe to see how it applied the lessons of Asia over 10 years ago. I have observed that, compared to the Asian programs of 1997, the European programs of 2008 were somewhat better funded and that their structural conditionality was more focused. Other than these, the overall thrust of the programs was similar: fiscal and monetary tightening, coupled with banking reforms. To the extent that currency crises share common causes and consequences, this is not surprising.

Instead, the paper has argued that the difference was more about philosophy than about content. In particular, relative to the Asian programs, the European programs were characterized by more emphasis on ownership, greater coordination among stakeholders, more realistic assumptions and greater transparency about the risks and the logic of policy actions and more built-in flexibility of targets and policy options. It was in the approach to crisis management that the IMF applied the lessons of Asia. This approach, foreshadowing the March 2009 reform of conditionality, reflected the quiet changes that had been incorporated over the past decade in the IMF's conditionality policies and the associated procedures.

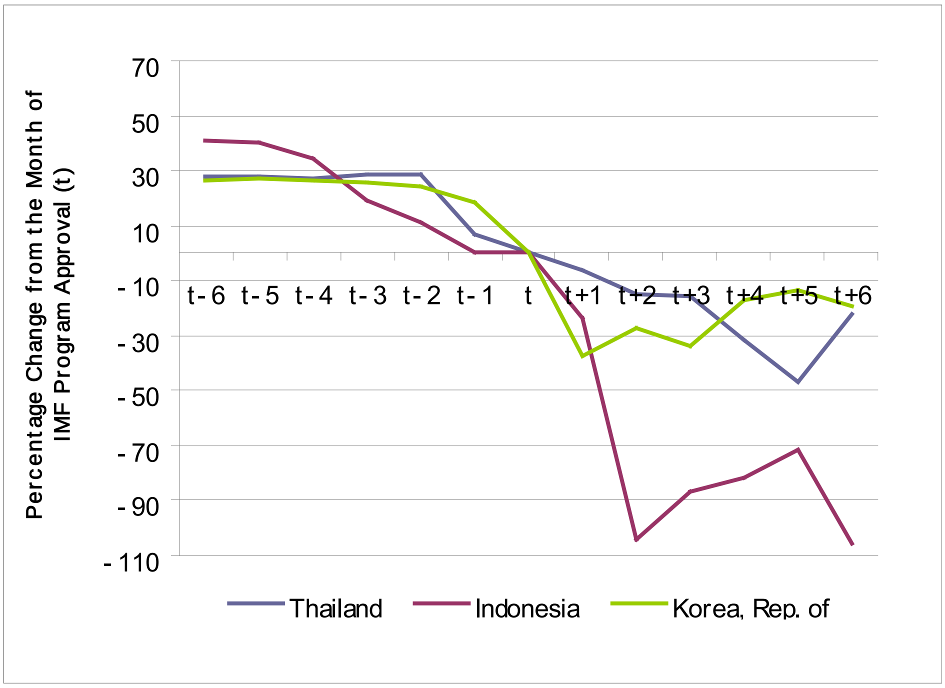
The success of crisis management programs, far more than conventional adjustment programs, requires the restoration of investor confidence. Attempts were thus made to enhance credibility and prevent surprise to the market, including by being realistic about assumptions, forthright about risks, and flexible about targets and policy options. Country ownership of policy measures was emphasized to affirm national authorities' commitment; collaboration among various stakeholders, with the IMF serving as coordinator, gave credence to the amount of official financing. When policy measures were of the type that could cause controversy, the rationale was fully explained. For the most part, these philosophies appear to be shared by all recent IMF programs, including those approved after the March 2009 reform (IMF 2009b).

[25] In the event, the first review of April 2009 did allow the fiscal target to be revised downward from balance to a deficit of 4% of GDP.

To be sure, there can be alternative explanations of the distinguishing features of the recent European programs. For example, the differences articulated above between the Asian and the European programs could reflect: (i) the perception that the European countries were innocent victims of an unprecedented global crisis, (ii) the recognition of a much more unfavorable external environment for the European countries going forward, (iii) the IMF's desperate desire to attract clients for its lending programs, and (iv) outright favoritism shown by the senior officials of the institution towards the European countries. There may well be an element of truth in some, if not all, of these additional explanations. The point of the paper is that, irrespective of whether there are additional factors at play, the features of the 2008 European programs were consistent with the changes introduced in the IMF's policies and procedures over the past decade, namely, the lessons of Asia.

It is still premature to make a firm judgment on the effectiveness of the IMF's new crisis management strategy. With negative economic growth forecast over the short term, the implicit objective of the programs appears to be that of moderating the inevitable adjustment process, which inherently makes it difficult to evaluate success or failure.[26] If exchange rate stability in any way reflects the restoration of investor confidence, however, the European programs of 2008 may be said to have achieved some measure of initial success. While the exchange rates of the three crisis Asian countries continued to fall after the programs with the IMF had been agreed (Figure 1), the exchange rates of the four crisis European countries remained much more stable following the conclusion of the IMF programs (Figure 2).[27] Capital and exchange controls might have contributed to this outcome in some cases, but it is well to remember that such measures are now part of the IMF's strategy that is both realistic and flexible.

Figure 1: Monthly US Dollar Exchange Rates of Asian Crisis Country Currencies

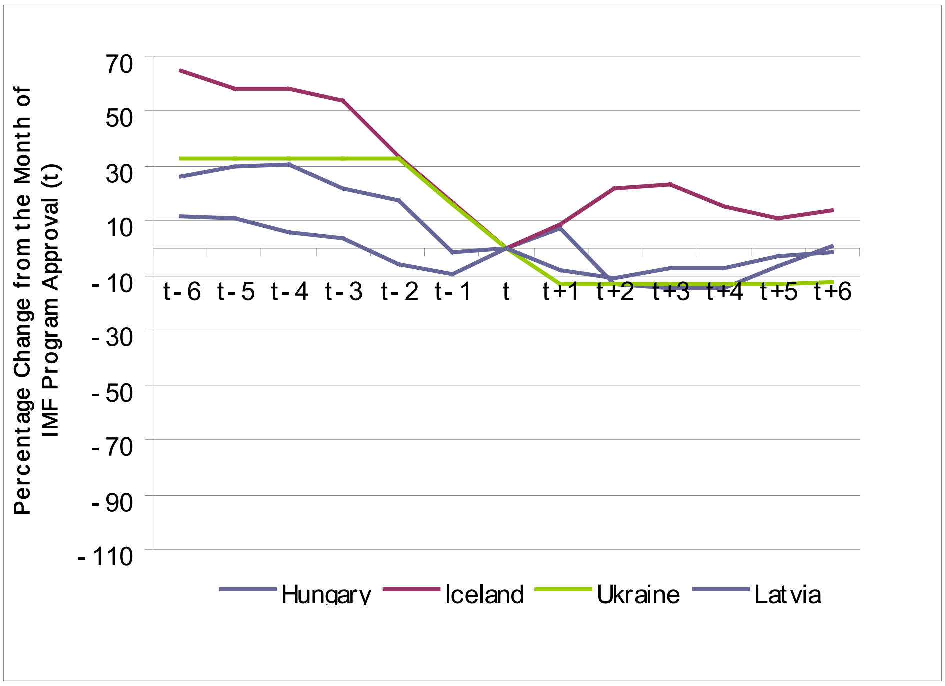


Source: IMF, International Financial Statistics.

[26] According to the IMF document on program design (IMF 2004b), the primary focus of an IMF program designed to deal with a capital account crisis is placed on "preventing excessive, and achieving orderly, external adjustment."

[27] The US dollar exchange rate of the Latvian lat simply reflects the movement of the dollar against the euro, to which it is pegged. The point here is that Latvia has been able to maintain the peg as long as it has after the onset of the full-blown crisis.

Figure 2: Monthly US Dollar Exchange Rates of European Crisis Country Currencies



Source: IMF, International Financial Statistics.

Applying a lesson learned a while ago to a problem at hand is the implicit admission of a past error, but it is not the same as apology. Perhaps the discerning officials of finance ministries and central banks can see a repentant IMF and its new way of doing business, now loudly codified in the conditionality reform of March 2009. Does the Asian public know? Have they forgiven the IMF? The recent decisions of the Republic of Korea to approach the US, People's Republic of China (PRC), and Japan for currency swap arrangements and of Indonesia to secure standby credit from a group of multilateral and bilateral donors prove that the problems of the past are not easily forgotten.[28] This is a reminder that going to the IMF for financial assistance is still politically not acceptable for several Asian countries.

This is a curious state of affairs—the IMF has learned lessons from Asia and is applying them to benefit other regions of the world, but Asia wants to have little to do with the innovations that came to light recently. Asia should now learn a lesson from Europe: it was the regional institutions that catalyzed the involvement of the IMF even when the countries themselves were reluctant to approach the IMF. The recent experience of Europe shows that regional institutions, far from being competitors, can in fact be partners with the IMF in complementing resources and expertise. Another lesson of Europe is that no institution, regional or global, has sufficient resources to deal with a large crisis. There is room for everyone in this world, even including bilateral donors.

Asia then might as well continue to strive to build strong and viable regional institutions, especially a structure to multilateralize the Chiang-Mai Initiative with adequate resources. As an entity in which they see greater voice and ownership, the public and their governments would be less reluctant to approach and work with a regional institution in times of need. As part of working out a solution together, the IMF could then be invited to join in the

[28] In late 2008, the Republic of Korea agreed with the Federal Reserve on a currency swap arrangement for US$30 billion and with the PRC for about US$28 billion, and agreed with Japan to increase the existing yen-won arrangement from US$3 billion to US$20 billion (the amounts with the PRC and Japan were outside the commitments under the Chiang-Mai Initiative). From late 2008 to early 2009, Indonesia received standby credit lines from the Asian Development Bank (US$1 billion), the World Bank (US$2 billion), Australia (US$1 billion), and Japan (US$1.5 billion) for a total of US$5.5 billion.

cooperative efforts. Only then can the lessons learned in Asia over 10 years ago be applied back in Asia, to benefit its own people.

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