World Scientific Asian Economic Profiles

IMF And The ASIAN Financial Crisis

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World Scientific
Singapore • New Jersey • London • Hong Kong

Preface

The Asian financial crisis came as a shock. The world, it seems, is neither as cosy nor as predictable as we had supposed. Despite a nation's best intentions and years of hard work, it is more evident now than ever that uninterrupted growth and prosperity can never be counted on. The value of money is merely an index of the world's confidence in a nation's economic fitness. As economic fortunes tumble, the loose change in our pockets — as has been demonstrated many times — can become worthless overnight. No wonder there remains a sense of confusion and even betrayal among many people in East Asia today — the latest victims of this apparent 'financial hegemony'. An almost dizzying succession of events of global significance (and consequence) have sprung from the financial troubles experienced by a number of Asian economies over the past 12 months. The original symptoms of disorder, which first appeared in what is (in global terms) a fairly minor South-east Asian economy, have developed into a pandemic and chronic international disease.

Though still a relatively youthful academic discipline, the power of economics in the modern world is now phenomenal. For the first time we are seeing economic dynamics acting as a correctional tool, if not a moral force, exerting influence over people's lives and behavior even where politics and religion fail to reach. Economic principles are not so tractable that they can be twisted in unnatural directions without the threat of lashing back into shape. Presidents and despots may be toppled by such mistakes; where once a certain level of corruption or even of human rights violations were seemingly acceptable, it is now revealed that a certain level of depreciation of a nation's currency is not. And while there are general rules at work that make perfect sense to everyone — both in the everyday world and in the simulatory models employed by academic economists — there are also subtle imponderables in operation. It takes more than hard work and the right economic climate to cultivate the grapes of economic prosperity; other, hazier indefinables affect the world's confidence in a nation's finances as a cloudy sky can affect the vintage.

The layman, especially a citizen of one of the afflicted countries, may be left wondering what exactly is going on. What recourse is there in such an unpredictable world? How can we prevent similar economic shocks recurring with wearying cyclical inevitability in the future? Step in, the IMF, an organization now in its 46th year, underpinned by some of the world's leading economists (though criticized by others). An International Rescue whose aid often comes at a price: financial reform, political change, fiscal tightening, and austerity measures.

A sort of natural selection is taking place: financial fitness (or frailty) is being ruthlessly exposed by internationally required standards of openness and accountability. Nations no longer find it so easy to operate according to many of their accustomed, cherished, but idiosyncratic systems. External forces in the shape of 'the market', foreign governments, and international agencies such as the IMF now all make heavy remedial demands upon individual economic systems. So who is really in control? And what of the power of those international agencies? Who, in particular, are the IMF? Where did this institution come from? Why is it necessary? What are its motives? From whence its authority? How far must its advice be followed?

With economics now asserting itself as such a correctional force in politics and society one may well be justified in asking, *quis custodes ipsos custodiet*? — whether these guardians of the world economy, functioning as a quasi-governmental force, themselves need guarding?

This book aims to introduce the IMF to the non-economist and provides a fair perspective on its increasingly significant role in world affairs. Some historical background to the IMF's inauguration and the economic context in which it operates is given, followed by a more detailed analysis of the institution's surveillance and assistance mechanisms. The development of the IMF in recent decades, especially in the light of the various economic crises it has had to deal with, is charted in Section 2, and its role in the Asian crisis is addressed in Section 3. Finally, some criticisms of the IMF, both old and new, are aired, together with some balancing counter-arguments. As both this institution and the current economic crisis in Asia (not to mention the more recent crisis in Russia) will no doubt be tenaciously featuring in our newspapers and on our television screens and radios in the near future — no matter in which country we live — such a discussion is intended to be both timely and helpful in making better sense of the modern world.

Contents

A Brief History of the IMF

The International Monetary Fund (IMF) needs no introduction. Its highly visible and sometimes contentious involvement in regional crises has attracted inordinate media attention, both positive and negative. On one end of the scale, it has been portrayed as an institutionalized financial messiah, whose mere presence alone is able to invigorate ailing economies and restore public's confidence. At the same time, it is sometimes regarded as a Western-dominated shibboleth whose measures have a placebo effect at best.

It is also commonly perceived (erronously) as a lending institution akin to a central world bank. Such disparate opinions are, however, the result of a common want of understanding of the primary aims and functions of the IMF. Despite the Fund's international prominence and its often crucial participation in rescuing floundering economies, its exact functions and operations, its deeper economic philosophy and the specific role it plays in the international economy, remain an enigma to many. In order to be truly appreciative or critical of the Fund and its international functions, knowledge of its founding purpose and its operations in the world's economy is necessary.

So what is the IMF? It has been said that its inception would not have been possible but for 'the coincidence of the hour and of the men', that it was in many respects a fortuitous creation of circumstances and time. A brief political and economic background of the world at that particular time follows.

Of the Hour

In the absence of a common international unit of exchange, trading countries require each other's respective currencies. The present ease with which currencies are exchanged, however, belies a troubled history.

The need of the international economy to have some yardstick by which the various national currencies could be evaluated was satisfied, to some extent, by gold. Under the Gold Standard Act of 1870, the value of pound sterling was pegged to this precious metal. Other currencies were in turn fixed against the pound.

In the period leading to the Great Depression, the exchange rate of the pound proved to be unrealistic. The general economic situation — widespread unemployment and galloping inflation — caused deep fears about the worth of paper money. This gave rise to an unprecedented demand for gold far beyond that which central banks were able to supply, not least the Bank of England. In this atmosphere of economic gloom, the pound was found to be severely overvalued, affecting the British Empire's trade with the rest of the world. It was eventually forced to abandon the gold standard in 1931. Other currencies unhooked themselves from the pound and followed suit. World trade was crippled by these competitive devaluations and diminished by more than half between 1929 and 1932. Protectionism became the order of the day; high tariffs were imposed on imports, and 'export unemployment' accompanied the dramatic economic contraction. As a result, world trade came to a virtual standstill.

Furthermore, the abandonment of the gold standard by major players in the world economy left paper money in a dubious position. Not being able to gauge the value of this paper money dissuaded traders from using it, and currency exchanges between those countries which remained on the gold standard and those which did not slowed to a halt. This led to nations hoarding gold and currencies which were convertible. Exchange controls were also imposed to curtail the exchange of domestic for foreign currencies. The problem became so acute that certain trading countries even contemplated barter schemes. Moreover, economic desperation in the 1930s led other governments to deliberately devalue their national currencies in order to enhance the competitiveness of their respective exports. Consequently, this was met with retaliation in kind.

Such were the perils of an unregulated international monetary system and it was from the ashes of this demolished global economy in the 1930s that the IMF emerged.

After the bitter lessons of the two world wars, geopolitically, the world emerged from a period of isolationism. There was strong political will for establishing international organizations to rebuild the post-war world, and to work toward a new world order of political and economic co-operation on a hitherto inconceivable scale worldwide. On the economic front, this paved the way for the IMF, GATT, FAO, and the World Bank.

Of the Men

A series of unsuccessful monetary conventions which attempted to resolve the economic impasse was held. Only in the 1940s were concrete and viable proposals to reinstate economic order conceived.

In the UK, John Maynard Keynes, and in the US, Harry Dexter White envisaged permanent international financial institutions as opposed to the numerous ad hoc conventions which so characterized the 1930s, and which often had come to nothing. To deal with the related problems of competitive devaluation and protectionism which greatly emasculated world trade, any institution would possess the financial resources to support its members through the difficult periods of balance of payments deficits.

The Keynes plan, however, was more ambitious and went several steps further. Keynes proposed the creation of an international central bank, with which member states were obliged to maintain an account. It would possess the authority to create money and in this manner provide financial assistance to countries in dire straits. To prevent countries from needless devaluations, their respective exchange rates were to be fixed to an international unit of exchange called the 'bancor', which this bank would be able to issue and against which currencies of the world would be measured. Subsequent exchange rate changes would be subject to the approval of this institution in order to ensure a healthy balance of payments. Although forestalled at the inception of the IMF, the idea of the bancor was adopted in 1968 in the form of Special Drawing Rights (SDR).

In contrast, White advocated that the institution's finances be provided by contributions from member countries, and that financial assistance to troubled economies be drawn from this. It was intended that this would give the institution a more co-operative character and at the same time secure for it a greater supervisory role over a country's economic policies in order to ensure repayment.

These two suggested frameworks for international monetary systems were passionately debated during the war years. In general, it was White's plan which was eventually adopted.

Establishment

In July 1944, delegates from 45 countries convened at Bretton Woods in New Hampshire, USA, to negotiate the final provisions of the IMF charter known as the Articles of Agreement. Consensus was reached remarkably quickly and the IMF came to pass on 27 December 1945, with 29 governments ratifying the Articles of Agreement.

Not only did this 'act of faith' mark a turning point in the history of international economics, it was a beacon marking the fresh confidence of a scarred generation in working toward the building of a more peaceful and prosperous world. This is perhaps best exemplified by the partial surrender of sovereign control over economic policies, particularly in the areas of international trade and currency exchange rates. Henceforth, exchange rates were to be determined only after consultation with other member states under the auspices of the IMF.

It was felt that the enlightened intentions of the Bretton Woods conference ought to be enshrined in a code of good conduct. Articles IV and VIII of the agreement, apart from committing states to pursue sound domestic monetary and fiscal policies, also spell out the general obligations of the member states in relation to each other, specifically in the arena of international trade (see Appendix). Here, the imposition of restrictions on current payments and the manipulation of exchange rates in order to gain unfair leverage over other countries were explicitly proscribed. It was a shared experience of the member states that the period of 'competitive devaluations' of the 1930s had adverse repercussions on their respective domestic economies and that world trade as a whole had suffered.

As a result of the wild and uncontrollable fluctuations during the period leading up to the Second World War, the general feeling was that a regime of fixed exchange rate pegged to gold would be the best alternative in the promotion of world trade. Members were therefore required to establish a gold standard or a gold standard exchange and to maintain the determined rate within margins of 1% on either sides of parity. After the war, the USA maintained the price of gold at $35 to 1 ounce until 1971. The gold standard regime, coupled with the code of conduct of lifting exchange restrictions and the promotion of multilateral trade, was considered the best basis for progress in world trade and investment. This in turn could be translated into full employment and real economic growth for the member countries.

In pursuing these fundamental objectives and principles, the architects of the Fund were acutely aware of the need for financial relief in order to rectify payment imbalances. Since it was the cataclysmic disequilibrium in the balance of payments that had given rise to these crippling trading practices in the first place, it was intended that the large resources of the Fund were to be made accessible in times of payments difficulties, in order to ensure that the adherence to the code of conduct was effective.

The purposes of the IMF are described in Article I of the Articles of Agreement (see Appendix).

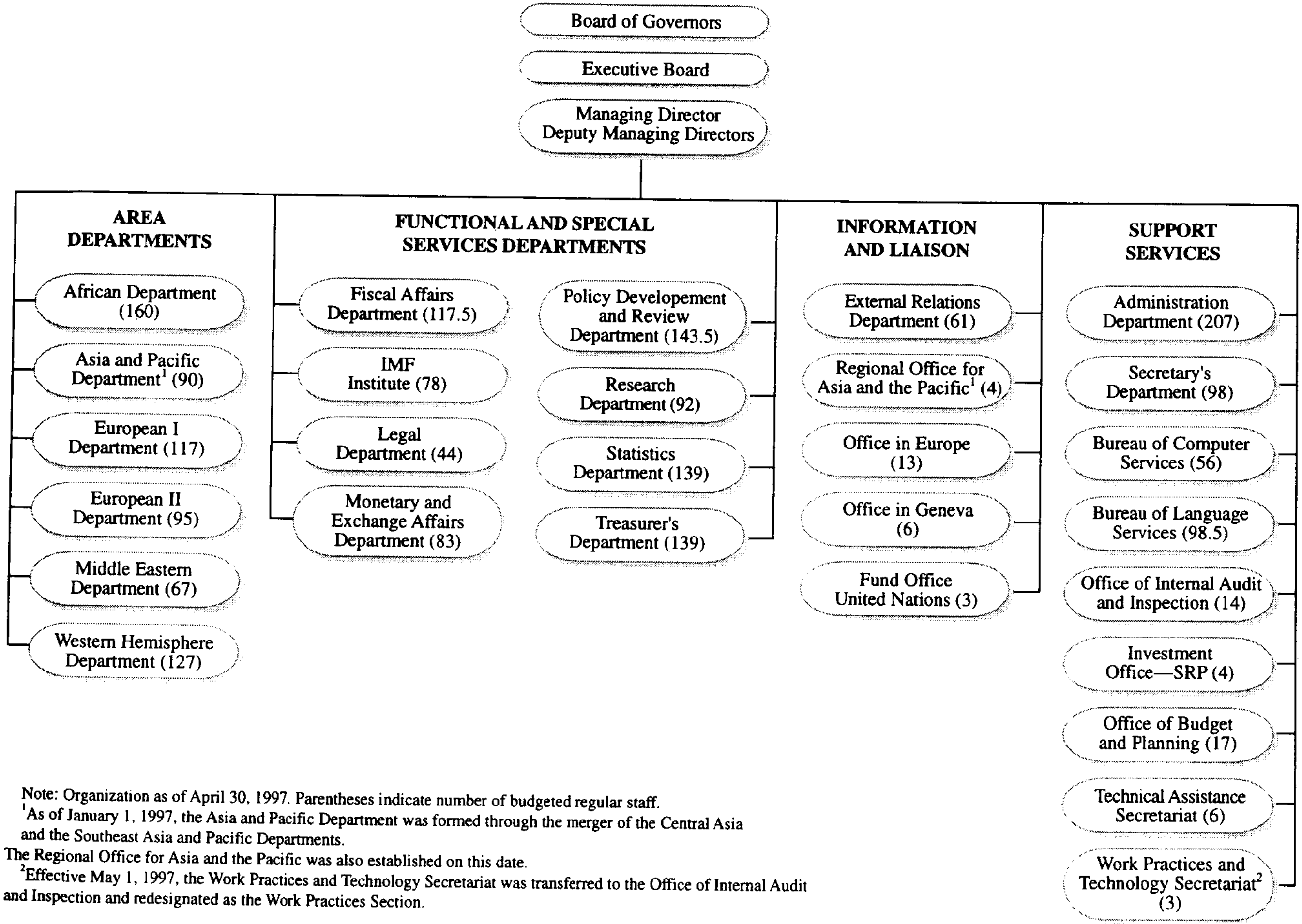
Structure of the IMF

The IMF has about 2,300 staff members. Unlike the World Bank, it has no affiliates or subsidiaries. Most of its staff members are located at its Washington headquarters, although three small offices are maintained in Paris, Geneva, and at the United Nations in New York. Its professional staff members are mainly economists and financial experts.

The administration of the IMF is directly governed by the will of the member states. In other words, the Fund does not, as popular perception may assume, operate as an independent administrative body dictating economic decisions and instructions to its members. Rather, it is the members themselves who are ultimately in control of decision-making. The Fund thus acts only as an intermediary between the will of the majority of the membership and the individual member country. This arrangement is apparent from the constitution and structure of the organisation (see Chart on page 8).

Board of Governors

At the apex of the hierarchy sits the Board of Governors, composed of one representative from each member state. In addition, there is



Note: Organization as of April 30, 1997. Parentheses indicate number of budgeted regular staff.

[1]As of January 1, 1997, the Asia and Pacific Department was formed through the merger of the Central Asia and the Southeast Asia and Pacific Departments. The Regional Office for Asia and the Pacific was also established on this date.

[2]Effective May 1, 1997, the Work Practices and Technology Secretariat was transferred to the Office of Internal Audit and Inspection and redesignated as the Work Practices Section.

also an equal number of Alternate Governors. Both Governors and Alternate Governors are almost invariably ministers of finance or heads of central banks from their respective countries, and therefore speak authoritatively for their governments. The Board convenes only during annual meetings for the administration of IMF matters, taking into account the commitments and responsibilities each representative has already in his own country. However, between annual meetings, a Governor may take votes by mail or other means. Assisting in the decision-making process of the Board are the Interim Committee and a joint IMF/World Bank Development Committee. The former provides general advice on the functioning of the international monetary system, whilst the latter advises on the special needs of poorer countries.

Executive Board

At the second tier in the IMF's chain of command is the Executive Board. Many of the Executive Board's duties are delegated from the Board of Governors, and it is responsible for overseeing the everyday operations of the Fund. There are 24 Executive Directors, eight of whom represent the individual countries of China, France, Germany, Japan, Russia, Saudi Arabia, the United Kingdom, and the United States. The rest are regional representatives of the remaining countries. The Executive Board acts as a liaison body between the IMF and the individual Governors during the rest of the year when the Board of Governors are not meeting. Governors communicate their respective countries' agendas to the Executive Board which will then, convening at least three times a week in formal session, supervise the implementation of related policies. Country-specific policies are thus often handled at this level. Each Executive Director wields a certain number of votes, largely in proportion to the contribution of the member state being represented. However, in making decisions, the Executive Board rarely resorts to the process of formal voting but relies on the formation of consensus among its members.

IMF Staff

The Chairman of the Executive Board, appointed by the Board of Governors on a five-year renewable term, is also the Managing Director of the IMF, and heads the rest of the 2,300 strong staff. The staff is largely comprised of economists, statisticians, research scholars, experts in public finance and taxation, linguists, writers, and support personnel from around the world. Roughly a quarter of these deal directly with its membership on a jurisdictional basis and another quarter deal with overall Fund concerns on a functional basis.

Jurisdiction is divided along five quasi-continental areas: Africa, Asia, Europe, the Middle East and the Western Hemisphere. Areas of functional speciality include: Legal, Central Banking, Fiscal Affairs (FAD), Exchange and Trade Relations (ETR), and the Research and Treasurer's Departments. Other staff fill a variety of support and administrative functions. Finally, there are also independent international civil servants not representing national interests.

Membership

IMF membership is open to every country that conducts its own foreign policy and is willing to adhere to the IMF charter of rights and obligations. All major countries are now members of the Fund, and at the last count, the membership roster numbered 182 countries. Members can of course leave the Fund on the same voluntary basis upon which they joined.

The implication of joining the IMF is that a member country undertakes to cooperate in the furtherance of the Fund's goals. This includes the obligation to maintain transparency in its arrangements for determining the value of its currency in relation to the currency of other countries; to refrain from restricting the exchange of its currency for foreign currency; and to pursue sound economic policies that will be constructively beneficial for both its own national wealth and that of the whole membership. While the IMF, being a voluntary