The IMF and Recent Capital Account Crises: Indonesia, Korea, Brazil

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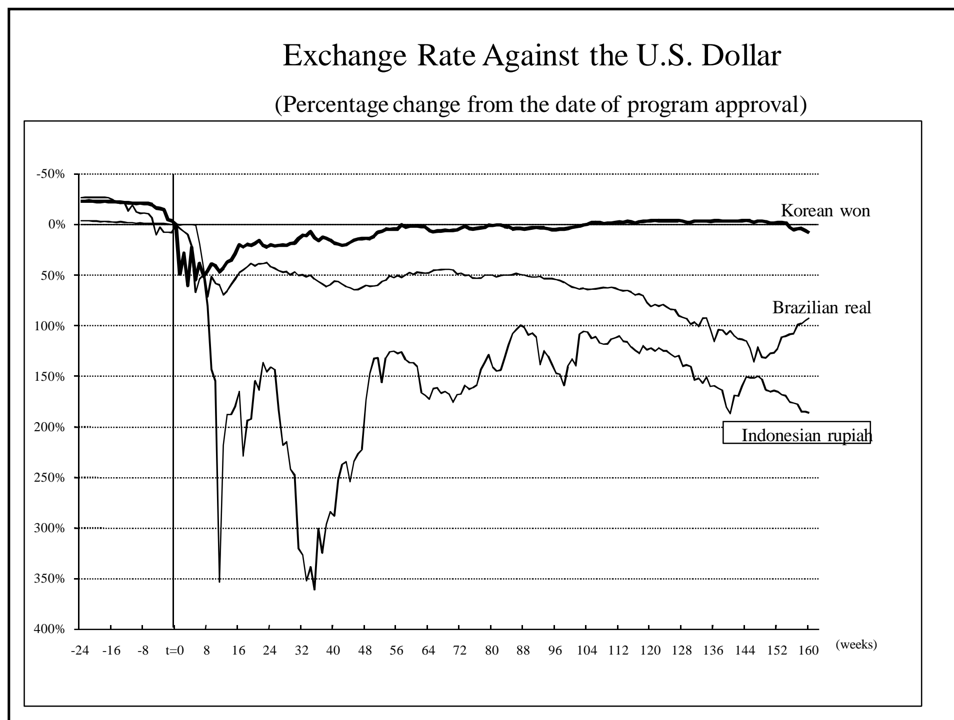
GDP growth (%)

	1997	1998	1999
Indonesia	4.7	-13.1	0.8
Korea	5.0	-6.7	10.9
Brazil	3.3	0.1	0.8



Indonesia

- Record of strong growth, but also “cronyism” and weak banks
- July-August 1997: Crawling peg bands widened, then abandoned
- November 1997: IMF stand-by arrangement, $10 bn (plus $8 bn from other sources)
- Bank closures mishandled. Central bank creates liquidity. Political crisis.
- January 1998: Detailed structural program signed, but never formally approved

Indonesia (cont.)

- March 1998: President reelected. New economic team
- April 1998: Revised program with tighter monetary controls
- May-June 1998: Political crisis worsens. President resigns.
- August 1998: Financing replaced by $6.3 bn Enhanced Fund Facility. Slow and uneven stabilization and reform.
- Overall: Severe collapse in growth and rise in poverty.

The IMF and Indonesia

- In pre-crisis surveillance, identified banking sector vulnerabilities, but underestimated severity and macroeconomic impact
- Political "ownership" of the program and resistance of vested interests underestimated
- Poor implementation of bank restructuring strategy
- Excessive structural conditionality

Rep of Korea

- Record of strong growth and macroeconomic stability.
- Economy dominated by large conglomerates, directed investment.
- Extensive short-term foreign-currency borrowing by banks.
- Unprecedented wave of bankruptcies of chaebol in early-mid 1997.
- End-October 1997: Speculative attacks on Hong Kong and Taiwan. Investors take a second look at Korea.
- Capital outflows and a run on the currency by mid-November 1997. BOK deposits hard-currency reserves in banks' overseas branches. Rollovers fall.

Korea (cont.)

- Early December 1997: IMF stand by arrangement: $21 billion from the IMF, $14 billion from other sources, c.$20 billion "second line of defense"
- After a few days, the won goes into free fall and reserves disappear.
- Kim Dae-Jung elected president, announces his support for radical reform measures.
- Christmas eve: major creditor banks announce coordinated rollover, willing to negotiate maturity extension.
- The government begins energetically implementing the reform package and cleaning up the banking system.
- 1998: V-shaped recovery.

The IMF and Korea

- Surveillance missed the relevance of uneven financial liberalization
- Gaps in data: reserves, private debt
- Uncertain status of the “second line of defense”
- Crisis coordination role – but with a delay?
- Initial fiscal tightening unnecessary, but quickly reversed
- Financial sector restructuring ultimately achieved impressive results

Brazil

- 1994: The Real Plan brings disinflation, large fiscal deficits, overvalued exchange rate.
- August-September 1998: Capital outflows after Russia/LTCM.
- December 1998: IMF financing of $18 bn (plus $24 bn from other sources) to support the crawling peg. Pressure on real continues.
- January 1999: Currency floated.
- March 1999: Revised IMF program, based on inflation targeting. Voluntary rollovers of interbank lines and trade credit.
- Inflation is lower than expected; positive growth.

The IMF and Brazil

- Key vulnerabilities were identified, but downplayed
- Had little impact on policies pursued by authorities
- Too concerned about contagion?
- Transition to inflation-targeting managed well

Some similarities

- Change in market sentiment causes reversal in capital flows
- "Exceptional" IMF access, supplemented by other sources
- Initial programs did not restore confidence, but subsequent responses more successful

Some differences

- Indonesia and Korea had balanced fiscal accounts and a history of low inflation; Brazil did not.
- Indonesia and Korea were “twin crises”; Brazil was not.
- Political commitment was strong in Korea and Brazil (after initial uncertainty), weak in Indonesia.

Pre-crisis surveillance

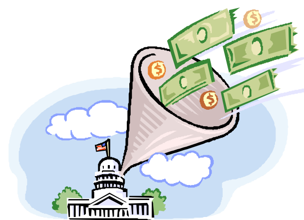
- Good on macro vulnerabilities.
- Not as good on extent of/implications of:
  - Financial sector balance sheets
  - Corporate balance sheets
  - Governance issues
- Information provision by authorities
- Impact on policies generally limited
- Confidential advisor role?

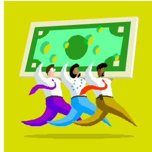
Program design: Macro framework

- Projections were too optimistic in Indonesia and Korea; too pessimistic in Brazil.
- In all three cases, this led to mistakes in fiscal policy.
- Projections missed currency depreciation, balance sheet effects, implications for private investment.

Program design: fiscal policy

- Indonesia and Korea: Mild tightening initially, soon relaxed.
- Brazil: Strong tightening, but not sufficient to stabilize debt/GDP ratio.





Program design: Monetary policy

- In all three countries, initially tight.
- In Indonesia, money supply expands rapidly.
- In Korea, gradual easing – too gradual?
- In Brazil, more rapid easing.
- Possible conclusion: high interest rates were necessary for stabilizing exchange rate, but not sufficient.

Program design: Financing and Private Sector Involvement (PSI)

- Korea: Ambiguity over "second line of defense" was damaging.
- PSI important for Korea and (to a lesser extent) Brazil. IMF played a role in coordination, information provision.
- Credible program needed for effective voluntary PSI.

Program design: Bank closure and restructuring

- Important in Indonesia, Korea; not Brazil
- Need a comprehensive and well-communicated strategy
- Partial vs blanket guarantee?

Program design: Structural conditionality

- Indonesia and Korea: Extensive conditionality
- The financial ones were probably necessary, the non-financial ones not
- Quantity vs quality
- Brazil: Fewer conditions, mainly fiscal

Program design: Communications strategy

- Need to explain the logic and strategy of the program to the public and the markets.
- All three cases: Didn't do so.

IMF internal governance

- Lack of candidness. Judgments became less sharp as they went up to Executive Board level.
- Coordination across departments.
- Role of major shareholders.
- Coordination with World Bank, other MDBs.

Recommendation 1. Surveillance should take a stress-testing approach.

- Staff reports itemize the major potential shocks the economy could face
- Explore real and financial consequences
- Discuss response plans with authorities
- Can reveal:
  - Information gaps
  - Balance sheet mismatches
  - Political constraints on policy making

Recommendation 2: Improve impact of surveillance, through greater candidness, transparency.

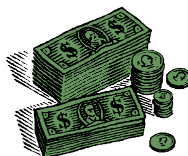
- Escalated signaling
- Second opinions from outsiders
- Presumption of publication of Article IV staff reports, country-related working papers
- Institutional incentives for candid staff assessments

Recommendation 3. Comprehensive review of program design

- More attention to impact of balance sheet interactions
- Allow for flexible response
- Review use of quantitative performance criteria
- Avoid imposition of reforms that are not critical to crisis resolution
- Communications strategy

Recommendation 4: Financing should be sufficient and credible

- Terms for parallel official financing should be clear
- Terms for involvement of other institutions should be specified at the outset



Recommendation 5: The IMF should be proactive as a crisis coordinator

- Management should be frank with board and shareholders about probability of success
- No political interference in technical judgments of staff
- Identify circumstances where PSI could be useful, through such means as dialogue with the private sector

Recommendation 6: Better promotion and utilization of staff expertise

- Key areas: Country-level expertise, political economy, crisis management
- Ensure that resources are maintained and ready to respond to crises
- Review role of resident representatives
- Protect those who raise uncomfortable issues
- Develop critical mass of staff with country experience