International Monetary Failure?
The IMF’s prescriptions might actually make Asia’s financial turmoil worse

By Jeffrey D. Sachs, TIME, December 8, 1997

In a breathtaking turn of events, Asia’s economies have gone from miracle to meltdown in a matter of weeks. Many forecasters who recently predicted GDP growth of 6% in South Korea and Southeast Asia for next year are suddenly projecting zero or even negative growth. In the often-shortsighted world of international finance, a new conventional wisdom is quickly forming: that Asian economies are poorly managed and gravely ill. The moneymen insist that only the tough medicine of the International Monetary Fund, plus a good stiff recession, will bring the region’s economies back to health. In fact, they will be brought back much more quickly, and with far less pain, if we can look beyond the conventional wisdom to see the crisis for what it really is.

The metaphor of “meltdown” is actually a good place to start. The radioactive core of a nuclear power plant is designed to give off energy in a controlled nuclear reaction. If the core’s cooling system breaks down, however, the nuclear reaction can get out of hand in a self-propelled process, until the buildup of heat and energy can no longer be contained. A relatively modest problem—the breakdown of the cooling system—ends up in a full-blown disaster.

The East Asian financial turmoil also started with a modest problem that has exploded into a self-reinforcing crisis. In recent years, foreign and domestic investors in East Asia got a touch of what U.S. Federal Reserve Chairman Alan Greenspan has famously termed “irrational exuberance.” Encouraged by years of high economic growth in Asia, these investors poured billions of dollars of loans into the region, financing many worthwhile investments but also an unsustainable real estate boom.

This overinvestment need not have caused a crisis. A healthy reaction would have involved a gradual cutback in foreign lending, a gradual weakening of Asia’s overvalued currencies and a gradual shift of investments from boomtown real estate back to long-term export-oriented projects. Most short-term booms are brought down to earth without extreme crisis, and such an adjustment was the most likely scenario until this past summer.

In the event, Asia experienced a financial meltdown. A gradual withdrawal of funds from Thailand suddenly became a stampede. No doubt, Thailand’s government wasted time in responding to the overheating long after it had become apparent, and as a result squandered Thailand’s foreign exchange reserves in a misguided attempt to defend the overvalued baht. The stampede came when foreign creditors realized that Thailand had more short-term foreign debts than the remaining short-term foreign reserves. A “rational” panic began. Each investor started to dump assets simply to get out of Thailand ahead of other investors. Thailand couldn’t cope with the stampede out of its own reserves, and many Thai banks were suddenly pushed to the edge of default.

The IMF stepped in to support Thailand in July, providing emergency funds so that Thai financial institutions could meet the panicked withdrawals. But the Fund also contributed to the
stampede by insisting that dozens of financial institutions quickly close their doors. The IMF also unwisely put the public spotlight on several allegedly deep flaws in the Thai economy that it said needed urgent and tough repair. It called for tight credit and budget belt-tightening. The panic intensified. Rather than restoring confidence, the IMF’s intervention merely confirmed to investors that they were right to flee. The Thai stock market and currency continued to fall greatly after the IMF “bailout.”

Panic in Thailand soon spread to its neighbors. Nothing was fundamentally wrong with Indonesia, Malaysia or South Korea. But again, short-term debts were large compared with short-term assets. Even if the economies are fundamentally sound, investors reasoned, there was still a good case for getting their short-term funds out of the country, perhaps to return them later when the panic had eased. The chain reaction of nervous withdrawals led to a meltdown that now includes most of East Asia.

Perhaps the riskiest part of the self-feeding reaction at the moment involves Japanese banks. They are the most important creditors of the banks in Korea and Southeast Asia, and the value of Japanese bank capital has been sharply affected by the panic. The decline in their own capital values has caused Japan’s banks to liquidate their offshore Asian claims even faster. The result is veering toward a “debt-deflation cycle,” in which Japanese banks’ falling equity values contribute to the financial panic, which in turn reduces the banks’ values further.

Japan announced a couple of months ago that it would lead an Asia rescue package of up to $100 billion to stop the crisis. The Clinton Administration insisted instead that the IMF, strongly steered by the U.S., rather than Japan, should take the lead. This could be a costly decision. Now the U.S. is in the hot seat for East Asia’s economies, the IMF is assigned a responsibility it is currently not well equipped to fulfill and Asia itself could be aroused for an anti-U.S. backlash. Asia may face a recession, moreover, that is much steeper than necessary, and that could contribute to a surge of Asian exports to U.S. markets.

There is still a slight, though fading chance for Asia to escape the predicament of financial meltdown. The remedy would go as follows. First, the Asian countries would persuade the IMF to put aside its usual prescriptions for fiscal belt-tightening and high interest rates, since these will only reinforce the contractionary force of the financial panic. The name of the game should be confidence-mending, not orthodox austerity. Remember: the crisis came from the private markets and not government budgets. Second, the U.S. should help foster Asian leadership by encouraging Asia, and especially Japan, to help finance its own recovery. That would mean Asian-led financing and a new infusion of Japanese public funds into that country’s tottering financial system. Third, officials in the wealthy economies should rethink their support of unfettered short-term capital flows, since these have once again shown their great power to destabilize. The time has come to introduce international standards for banking and other financial markets, standards that can rescue global capitalism from its own inadvertent excesses. What we don’t need is more financial orthodoxy from the IMF, which would only make things worse.