CHAPTER 3

POLICY RESPONSE

Role of International Monetary Fund

The International Monetary Fund (IMF), which is charged with safeguarding the stability of the international monetary system, had a central role in resolving the Asian financial crisis. IMF's priority in handling the crisis was also clear, i.e.: to help restore confidence to the economies affected by the crisis (IMF Factsheet, 1999).

Under IMF financial assistance a member country with a payments problem can immediately withdraw from the IMF the 25 percent of its quota. However because of the magnitude of financial assistance required during the crisis, IMF created special facilities, including the Supplemental Reserve Facility (SRF), in December 1997 to provide short-term financing to members faced with a sudden and disruptive loss of market confidence (Korea was the first country to use the SRF)

In providing financial assistance IMF was guided by the principle that the member must demonstrate how it intends to solve its problems so that it can repay the IMF within its normal repayment period of three to five years (which in certain cases can be extended up to ten years). The logic behind these requirements was simple. A country with a payments problem is spending more than it is taking in so unless economic reform takes place, it will continue to spend more than it takes in.

Since the IMF has an obligation to the whole membership to preserve the financial integrity of its transactions, it lends only on condition that the member uses the borrowed money effectively. The borrowing country therefore undertakes to initiate a series of reforms that will eradicate the source of the payments difficulty and prepare the ground for "high quality" economic growth. Along with its request for a loan, the potential borrower presents to the IMF a plan of reform, typically undertaking to reduce government expenditure, tighten monetary policy, and deal with certain "structural" weaknesses which is referred to as a Letter of Intent.

The specifics of each IMF-supported adjustment program are drawn up with the advice of IMF. If the IMF is satisfied that the reforms will solve the problem, the loan is disbursed in instalments (usually over one to three years) tied to the member's progress in putting the reforms into effect. If all goes well, the loan will be repaid on time, and the member, with necessary reforms now in place, will come out of the experience economically stronger.

The IMF intervened to provide financial support for three of the countries most seriously affected by the crisis, i.e. Indonesia, Korea, and Thailand, and for these countries IMF dictated the policy response. Malaysia refused

IMF financial assistance and therefore could decide on its own prescription in overcoming the adversities of the crisis.

IMF's Policy Strategy

The strategy to address the crisis had three main components:

(i) *Financing* - some US$35 (as of 30.5.200) billion of IMF financial support was provided for adjustment and reform programs to Indonesia, Korea, and Thailand and another US$31 billion of financing was committed from other multilateral and bilateral sources (IMF Factsheet, 1999). These packages were provided to help restore confidence.

(ii) *Macroeconomic policies* - the use of monetary policy (at different stages in different countries) by reducing money growth as to increase interest rates to attract and reverse capital outflow. At the same time this was expected to prevent currency depreciation from leading into a spiral of inflation and continuing depreciation. If depreciation continued it would have imposed substantial burdens on both corporate and banking sectors which were already suffering from their over-exposure to foreign currency denominated liability. A flexible exchange rate policy was maintained with intervention only limited to smoothing operations. A tight fiscal policy was introduced to alleviate the burden on monetary policy and more importantly to cater for the prospective cost of financial restructuring.

(iii) *Financial Structural Reforms* - IMF supported programs centered on financial sector reform not only because financial sector problems were a root cause of the crisis but also because these structural measures were also necessary for macroeconomic policies to achieve intended stabilisation. The following essential elements were common to policies in all three countries:

- the closure of insolvent financial institutions, to stem rapidly accumulating losses and central bank liquidity support;
- the recapitalisation of potentially viable financial institutions, often with government assistance;
- close central bank supervision of weak financial institutions; and
- a strengthening of financial supervision and regulation, to prevent a recurrence of the fragilities that had led to the crisis, the objectives being to restore the health of financial institutions and bring supervision and regulation up to

international standards. But in all cases standards were raised gradually, in view of the trade-off between the need to make a convincing step forward and the concern that raising standards too quickly could shock a system already reeling from the crisis.

(iv) *Other Structural Reforms* - these reforms (Australian, Department of Foreign Affairs and Trade, 1999) were to remove features of the economy that had become impediments to growth such as-

- Trade liberalisation policies to eliminate monopolies, trade barriers and import diversification programs.
- Capital account liberalisation by increasing the ceiling on aggregate and individual foreign ownership in the equity market by 20 to 40 percent. Allowing foreign banks to purchase equity in domestic banks and allowing foreign investors without restriction to invest in domestic money market instruments and corporate bond market.
- Corporate governance was emphasised to improve the transparency of corporate balance sheets, including profit and loss accounts by enforcing accounting standards in line with generally accepted accounting practices.

- Corporate restructuring involved the reduction of the high debt-to-equity ratio of corporations and capital markets will be developed to reduce the share of bank financing by corporations.
- Labour market reforms to improve labour market flexibility through new employment insurance to facilitate the redeployment of labour.
- Information provision whereby all important data will be published regularly such data on foreign exchange reserves data on financial institutions including non performing loans, capital adequacy, ownership structures and etc.
- Social reforms included efforts to shield poor and vulnerable sections of society from the worst of the crisis, by deepening and widening social safety nets and (notably in Indonesia) devoting substantial budgetary resources to increasing subsidies on basic commodities such as rice, fuel and etc.

Such a comprehensive policy was needed principally because of the interdependence of reforms in different areas. For instance, if macroeconomic stabilisation had been attempted without dealing with weak and insolvent financial institutions, monetary policy would have been thwarted by the need for liquidity support to these financial institutions, while fiscal positions would have been burdened by mounting liabilities associated with pervasive government guarantees. But dealing with weak institutions without establishing sound ground rules for financial supervision and regulation would have invited a repetition of the crisis and financial re-structuring would have made little progress without effective mechanisms for working out corporate debt, which in turn required the establishment of effective bankruptcy procedures. For this reason, the programs required moving quickly across a broad and in some areas, uncharted front.

An example of IMF agreement (summary) on the various policies and reform described above with Korea can be seen in Appendix A.

Malaysia's Policy Response

Malaysia was more successful in reducing the impact of the crisis compared to Korea Indonesia and Thailand. The Malaysian economy was fundamentally strong just prior to the crisis. In the first two quarters of 1997, real GDP continued to grow at about 8 percent. The government continued to record fiscal surplus and very importantly the level of external debt was low at 43.2% of GNP (Table 4).

Table 4 - External Debt (US$ billion)

	1992	1993	1994	1995	1996	1997
Indonesia						
Total external debt	88.0	89.2	107.8	124.4	129.0	120.7
Short term	18.1	18.0	19.5	26.0	32.3	16.3
Private non-guaranteed	16.3	14.0	24.4	33.1	36.7	50.8
Korea						
Total external debt		43.9	56.8	78.4	104.7	120.7
Short term		19.2	30.4	45.3	61.0	51.2
Private non-guaranteed						
Malaysia						
Total external debt	20.0	26.1	29.3	34.3	39.8	42.9
Short term	3.6	7.0	6.2	7.3	11.1	10.2
Private non-guaranteed	4.0	5.7	9.5	11.0	13.0	25.9
Thailand						
Total external debt	41.8	52.7	65.6	83.2	90.8	59.9
Short term	14.7	22.6	29.2	41.1	37.6	28.6
Private non-guaranteed	13.8	15.3	20.2	25.1	36.2	66.8

Source: World Bank and IMF Data, Global Development Finance 1998.

The current account deficit was reduced to 5 percent of GNP in 1996 from 10 percent in 1995 and was expected to improve further. Inflation had moderated to its lowest level to 2.1 percent in July 1997. Measures to slow down the pace of bank lending were directed towards making domestic demand more compatible with the level of output, as well as to contain the development of any asset bubble. Therefore, as at end June 1997 the fundamentals of the economy had strengthened further. Economic growth was achieved against a background of lower inflation and an improved balance of payments position.

In the banking sector, structural reforms that had been undertaken since the mid-1980s had strengthened the banking system. By international standards, the banking system was already subject to stringent prudential standards since the late 1980s. Stringent guidelines were implemented on single customer limits, large loan limits and a prohibition on connected lending (i.e. loans to directors and staff as well as loans in which the banks had other interest in). At the end of June 1997, just before the start of the financial crisis, the average risk-weighted capital ratio (RWCR) of the banking system was at 12 percent, higher then the internationally recommended minimum level of 8 percent as laid down in the Bassle Accord (Bank Negara Malaysia 1999). Net non-performing loans (NPLs) were only 2.2 percent of total loans and the ratio of loan provisions to NPLs was close to 100 percent. At the same time the approval process for external loans was stringent. Corporations and banks, therefore, did not have unhedged exposure to foreign currency borrowings.

Given the strong macroeconomic and institutional fundamentals at the outset of the crisis Malaysia had greater flexibility in responding to the crisis. While there were structural imbalances present such as the current account deficit, asset inflation and high credit growth, policies were already in place to address these weaknesses and positive results had already begun to emerge.

There were significant differences in the economic structure and management of Malaysia and the other crisis affected countries. Malaysia did not have problems such as high short-term debt and relatively fixed exchange rate. Ringgit has been floating since 1973. Just prior to the crisis the ringgit actually appreciated to RM2.47 to the US dollar in the first quarter of 1997 from 2.53 at the beginning of the year. Herd behaviour however led market participants to view Malaysia as having the same common problems those faced by her neighbouring countries in the region despite having stronger fundamentals. The contagion effect spread to Malaysia and the ringgit came under severe speculative attack whereby between June 1997 and end December 1998 the ringgit depreciated by 33.6 per cent against the US dollar. Whilst the rupiah depreciated by 70 percent, baht by 29.4 per cent and won by 25.5 per cent.

Initially Malaysia did follow some of the standard IMF prescriptions adopted by the other three countries but subsequently chose a different route. Malaysia approach was undoubtedly unorthodox and had drawn significant debate. Macroeconomic policies focussed on addressing key areas of vulnerabilities in particular containing inflation and excess domestic demand (manifested through high credit growth) and reducing the current account deficit. At the same time, attention was also accorded towards maintaining the standard of living and export competitiveness. Policies were directed to strengthen the financial sector so as to avoid systemic risks.

Given these objectives, the policy of monetary restraint in place before the onset of the crisis was continued. High interest rates to contain speculation against the ringgit were adopted initially. When it proved ineffective, interest rates were restored to pre-crisis level and were maintained till September 1997. Thereafter, interest rates were adjusted to reflect higher rates of inflation to ensure a positive real rate of return to savers. As higher interest rates were detrimental to the real sector, a credit plan was introduced to moderate loan growth.

The selective exchange controls measures were a necessary part of the efforts to stabilise domestic financial markets. Unlike other regional currencies the ringgit was significantly traded in the region in particular in Singapore. The substantial onshore-offshore interest rate differential attracted ringgit funds abroad. Banks in Singapore offered ringgit deposits rates as high as 20-30 per cent. While the cost of borrowing ringgit was high the profits on short selling was even higher. This trend affected Malaysia's ability to conduct an independent monetary policy based on domestic considerations. It limited the scope for monetary policy to be eased further to avoid more severe economic contraction.

The selective exchange control measures implemented were designed to achieve specific objectives. These controls were aimed specifically at eliminating access to ringgit by speculators by reducing the off shore market in ringgit and limiting the supply of ringgit to speculators. In addition the measures were also aimed at stabilising short-term capital flows.

In addition to the selective exchange controls which were imposed on the 1st of September 1998 the government decided to fix the exchange rate at RM3.80 to the US dollar on 2nd September 1998. This represented 34 per cent devaluation from the level prior crisis. The fixed exchange rate accorded business with a degree of predictability under which they can plan their business.

In essence, irrespective whether the countries that adopted IMF policies or like Malaysia which had the liberty to choose their own set of policies, the primary policy objective was common to all that was to bring back growth and to restore confidence in the dwindling economies. The various spectrum of policy response to address the various issues will be dealt with in detail in the subsequent chapters. Policy measures were undertaken taking in view of the socio-economic backgrounds, political and other elements.