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001. Memo	From Robert E. Rubin to POTUS; RE: Report on Asia Trip (2 copies) (4 pages)	7/9/98	P1/b(1) (c)
002. Note	RE: Changes from Previous Document (handwritten) (1 page)	7/8/98	P1/b(1) Unclass.
003. memo	Barry S. Newman (IMF) to Tim Geithner re: Staff Report (1 page)	01/12/99	P1/b(1) Unclass.
004. report	re: Summing Up by the Chairman Fund-Supported Programs in the Asian Crisis Executive Board Meeting, 12/21/98 (IMF document) (6 pages)	12/29/98	P1/b(1) Unclass.

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

March 26, 1998

The Honorable Spencer Abraham
United States Senate
Washington, DC 20510-2203

Dear Senator Abraham:

Restoring financial stability in Asia is profoundly in the United States' national security interest. Asia includes some of our most important strategic allies and closest economic partners and its continued growth and stability has direct consequences on the security and prosperity of the United States. History has shown that economic distress and financial instability can threaten political stability and security. Likewise, security breeds stability which, in turn, attracts investment and helps to create prosperity. A stable and prosperous Asia is more likely to be a peaceful Asia.

The Asian financial crises undermines not only the stability and growth in the countries affected, but also could undermine the strategic and political interests of the United States. Our central aim is to help these economies restore growth and market confidence as quickly as possible, to help ensure the political and social stability in the region and not undermine the profound interests the United States has in Korea, Indonesia and Southeast Asia as a whole.

The United States has critical national security interests in seeing a restoration of financial stability in Asia. For example,

- We have 100,000 troops based in the region, and 37,000 on the Korean peninsula alone, where we have spent 45 years keeping the peace and where North and South Korea have only just begun negotiating a possible end to their conflict.

- Indonesia has the fourth largest population in the world, spans important sea lanes and airways, and contains vital natural resources, such as oil and gas. In fact, fifty-one percent of the world's shipping goes through Indonesia.

- Thailand is one of our most important security partners in Southeast Asia, and has provided essential overflight clearance and use of airbases during the Gulf War and subsequent actions against Iraq. In addition, Thailand has been our most important partner in Asia on narcotics cooperation and interdiction.

The International Monetary Fund (IMF), which has 50 years of bipartisan support, has played a central role in helping to restore financial stability to affected Asian economies. With its expertise and technical resources, the IMF has the ability to shape effective reform programs. With temporary financial assistance, the IMF provides essential breathing space. Finally -- and critically important -- the IMF internationalizes the burden during a global financial crisis by using its pool of capital, instead of the United States having to bear that burden alone.

In the past fifty years our contribution to the IMF has not cost the taxpayer one dime. When the IMF draws on our commitments, we receive a liquid, interest-bearing offsetting claim on the IMF. There are no budget outlays. Our contribution does not increase the deficit or divert resources from other spending priorities.

Immediate support for our periodic pledge to the IMF for an augmented back-up facility, the New Arrangements to Borrow, which supplements the IMF's resources to deal with system-wide crises, is critical. We are asking Congress to approve both requests for the NAB and the Quota Increase because the IMF's resources are reaching an historically low level. This support is key to the IMF's ability to deal with the intensification or spread of this crisis, which we are all trying to avoid, and to deal with future crises that could dramatically affect the interests of the American people. Failure to provide this support could shake confidence at a time when it is critical to re-establishing stability in Asia and to protecting the interests of the American people.

Enclosed you will find materials on the IMF, the Asian economic crisis, and why it is in the U.S. national security to help bring stability to the region. As the world's largest economy, the United States has an indispensable leadership role in helping the IMF restore the financial stability which so profoundly affects our national economic and security interests. We look forward to working with you on this important issue.

Sincerely,

Robert E. Rubin

Robert E. Rubin
Secretary of the Treasury

Samuel R. Berger

Samuel Berger
National Security Advisor

U.S. National Security Implications of the Asian Financial Crisis

General Implications:

Ensuring the financial stability of the Asia-Pacific region is in the U.S. economic and national security interest. Asia includes some of our most important strategic allies and closest economic partners and its continued growth and stability has direct consequences to the security and prosperity of the United States.

These crises undermine not only the stability and growth in the countries affected, but also the strategic and political interests of the United States. Our central aim is to help these economies restore growth and market confidence as quickly as possible, not to bail them or foreign investors out. It is important that financial stability be restored as soon as possible and that the contagion not be allowed to spread further undermining the profound interests the United States has in Korea, Indonesia and Southeast Asia as a whole.

South Korea:

- South Korea is a key U.S. ally, where 37,000 American troops are stationed and have helped keep a fragile peace for 45 years. Economic stability in South Korea is vital to U.S. efforts to maintain peace and security on the Korean peninsula.

- Our partnership with Korea encompasses close military-to-military cooperation, including our joint defense against an attack by North Korea, a burden-sharing agreement for U.S. defense costs in South Korea, and Korean purchases of U.S. weapons systems. South Korea's commitment to implement the Agreed Framework with North Korea, including its commitment to fund a major portion of the costs of construction of two light-water reactors, is integral to our efforts to ease tensions on the Korean peninsula and stop the proliferation of dangerous weapons of mass destruction.

- We have no signs to date that the financial crisis will not affect the four-party peace process focused on moving from the current Armistice Agreement to a peace treaty and reduction of tensions on the Korean peninsula. Similarly, the South Koreans have expressed their intentions to uphold their host nation support obligations and maintain their defense capability.

Indonesia:

- Indonesia's size and location alone give it broad strategic value. It has the fourth largest population in the world and contains vital natural resources, such as oil and gas.

- Indonesia spans important sea lanes and airways. In fact, fifty-one percent of the world's shipping goes through Indonesia.

- As the largest member of ASEAN and the founding member of the ASEAN regional forum, Indonesia has played a constructive role in efforts to manage regional problems.

- Indonesia contributes to peacekeeping efforts in former Yugoslavia and Angola, supports nonproliferation efforts such as the Comprehensive Test Ban Treat, and joined the Korean Peninsula Energy Development Cooperation to help maintain peace and security on the Korean peninsula.

- A 1992 agreement to make Indonesian commercial ship repair facilities available to U.S. warships is an important component of our forward deployment strategy in the Asia-Pacific Region.

Thailand:

- One of the original ASEAN partners, Thailand is one of our most important security partner in Southeast Asia. We have very close military-to-military relations and access as needed to strategic airbases in Thailand. Thailand provided essential overflight clearance and use of airbases during the Gulf War and subsequent actions against Iraq. Our International Military Education Training (IMET) program in Thailand is one of the largest in the world. Until the financial crisis in 1997, Thailand was a major purchaser of U.S. military equipment.

- Thailand has also been our most important partner in Asia on narcotics cooperation and interdiction. The Thais have extradited an unprecedented 11 indicted traffickers to the U.S. since 1996. Thailand has facilitated the work of the Joint Task Force-Full Accounting Detachments, and serves as a hub for support activities for this important activity.

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ISSUE BRIEF

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The IMF and U.S. National Interests

The sight of the Secretary of Defense testifying in January before the House Banking and Financial Services Committee was indicative of the many dimensions to the Asian currency crisis. Secretary Cohen accompanied Treasury Secretary Rubin and Federal Reserve Board Chairman Greenspan to urge that the Congress expeditiously approve increased funding for the International Monetary Fund (IMF). It is an indication of the apparent depth of Congressional unease with what might appear to be a relatively uncontroversial request by the Administration to provide additional resources for the IMF. Most importantly, however, Secretary Cohen's testimony was a striking example of how, especially since the end of the Cold War, economic, foreign and defense policies have become mutually reinforcing threads of our national security fabric.

What does the Administration seek? In January 1997, the U.S. and other key IMF members agreed to set up a new mechanism, the New Agreements to Borrow (NAB), to provide additional resources to deal with financial emergencies such as happened in Mexico in 1994, and is occurring in Asia today. The U.S. share of the $24 billion NAB is $3.5 billion. Separately, in September 1997, the U.S. and other members of the IMF agreed to increase its capital base by 45%, or roughly $90 billion. The U.S. share of this quota increase is $14.5 billion.

Administration officials argue that Congress should approve the funds lest the Asian financial crisis worsen and adversely affect our economic well-being. They also argue that how Congress votes will have a direct impact on important American political and security interests in the region. In addition, other countries are likely to interpret Congressional action on this issue as a clear signal of the role Congress sees for U.S. in the world -- i.e. continued engagement or creeping retrenchment.

Opponents of the Administration's request make two related arguments. First, they reject any obligation for America to take the lead, directly or

indirectly through the IMF, in resolving this crisis. They prefer to let the market sort out the winners and losers. Second, they argue that, in any event, the IMF has neither the mandate, institutional competence nor the correct prescriptions for dealing with Asia's current financial problems. Some go so far as to call for the IMF's abolition. What is going on and who is right? It is important to understand four things. First, the U.S. share of the quota increase and the NAB does not require a budget outlay; it will neither increase the deficit nor take funds from other programs. The Congressional Budget Office has determined that U.S. contributions to the IMF have no budgetary impact. Indeed, when U.S. funds are used by the IMF, the U.S. is given an interest bearing asset in return. As Secretary Rubin has pointed out, U.S. contributions to the IMF over the past fifty years have cost the U.S. taxpayer absolutely nothing.

Second, because of America's leading role in the IMF, other countries are unlikely to fulfill their obligations until the U.S. acts. Thus, delay on our part imposes real costs to the integrity of the international financial system, which, in turn, directly threatens the prosperity and well-being of Americans.

Third, the IMF has a good track record. The IMF has played a critical role in all the important international economic challenges of the recent past, e.g. the recycling of petrodollars in the 1970s, the Latin American debt crisis in the 1980s, economic reform in the former Soviet Union in the 1990s, as well as the Mexican peso crisis. These are clear successes that have been important to U.S. growth. Further, critics should recognize that the IMF has averted many incipient problems through its regular economic surveillance program with individual member countries.

Fourth, and perhaps most important, an international crisis requiring U.S. leadership is bringing to the surface a fundamental issue which has been on the back burner for some time. The end of the Cold War inevitably has raised the question whether the international security and economic institutions key to sustaining the triumphant Western ideals and policies -- the North Atlantic Treaty Organization (NATO), the United Nations, the IMF, the World Bank, the General Agreement on Tariffs and Trade (GATT and now the World Trade Organization, WTO) and the regional economic organizations such as the Organization for Economic Cooperation and Development (OECD), need a fresh look. Is the institutional status quo appropriate for the new era we are entering or is it time to change the mandate and role of at least some of these institutions?

NATO, the WTO and, to a lesser extent, the U.N. are undergoing significant modification. However, the international financial institutions (IFIs) have, by and large, not received the same attention. Initial efforts to think about their role and mandate in the post-Cold War world did not take root during the previous administrations. Leaders of the major industrialized countries (the G-7) did commit themselves to such a review during the 1993 Naples Economic Summit. But issues such as Iraq, Bosnia, Haiti, China, as well as important domestic matters, have preempted the attention of G-7 leaders. As a result, although most acknowledge that a thorough review of the IFIs is a big, important issue, it has not received commensurate attention from heads of

government and senior ministers. This has turned out to be a mistake. The issue is too important, with too many vested interests within member countries and the IFI bureaucracies, to be guided principally by those who administer the institutions.

That said, the middle of a crisis is not a propitious time to start a serious review of the IFIs. Indeed, crises rarely are a good time to formulate long term reform. This is particularly the case when the U.S. is not the only country involved. The lack of serious debate on the proper role of the IFIs now has collided with the need to provide resources for an immediate need. But the Congress should not confuse these two issues. Each needs to be addressed seriously, but separately.

Legitimate issues have been raised about the IMF's role. They deserve serious study in the context of re-examining the role and functions of all the IFIs. It would be appropriate for the Congress to require, and for the Administration to agree to press our G-7 partners for an expeditious, high level G-7 review of the IFIs. IMF Managing Director Camdessus has already laid out an interesting list of measures he believes would enhance the IMF's effectiveness. Meanwhile, the Congress should approve full, unconditional funding for the NAB and the IMF quota increase.

Why should Congress fund the IMF now, without any assurance that the required review will be undertake, and much less what it will reveal? The answer is that now is not the time for the Congress to take responsibility for putting the brakes on the IMF's credibility and on its ability to act. It is not an exaggeration to say that the credibility of the international financial system, and that of its principal architect – the United States – is at stake at a particularly delicate moment. For better or for worse, financial markets are looking to the IMF, strongly backed by the U.S., to advance solutions to the individual problems of Asian countries. For the Congress to reject a prudent funding request for the IMF -- when there is no credible alternative and when doing so creates no bugetary exposure -- would be seen as a vote of no confidence in U.S. leadership.

However imperfect, the IMF is the only institution that can lessen contagion between Asian economies and begin to restore confidence in a region which is vital to American growth. There is no next best option that avoids putting American taxpayers and our export-led growth at risk. Confidence is too fragile. Governments in Asia face difficult internal political and social conditions. With increasingly integrated global financial and economic markets, Asia risk is global risk – which not only can but <u>will</u> spread rapidly to Latin America, Eastern Europe and Russia, quickly reaching the manufacturer and worker on America's Main Street.

It would be risky in the extreme to tell Asian countries to work through their problems without the advice and financial support of the IMF and its key members. Should Asia deteriorate further after a negative vote in the Congress, America will not be able to avoid responsibility. To protect important U.S. national security interests in the region, as well as economic prosperity at home, we should do everything possible to avert this.

The crisis in Asia is largely discussed in economic terms. But risks to American interests are not measured in dollars or jobs alone. This is also a political, social and, potentially, a security crisis. Significant political and social dislocation in the region may impede the important work of rebuilding U.S. security ties there. With over 100,000, troops and at least that many American civilian expatriate, and many of billions of dollars of direct investment, we cannot permit the region to be gripped by chaos or even the threat of chaos. That is why the Secretary of Defense was testifying in support of what might seem to be an "economic" proposal.

This crisis is the most serious test of U.S. interest and commitment to Asia since the end of the Vietnam war. Asian leaders will draw their own conclusions about our reliability based on whether and how we respond.

If the United States cannot mobilize the international community through the IMF, then we will be left to deal with Asian economic problems ourselves or suffer the profound consequences of inaction. Either alternative sets America up to fail.

The international community is looking to the U.S. for leadership. The immediate task is to restore confidence while, at the same time, setting a clear course to more open, transparent systems throughout Asia. The Congress can help by providing the IMF with the necessary resources -- or it should begin to prepare for the consequences of a lengthy collapse of confidence in Asia.

Principal Author:

Eric D.K. Melby is a Senior Fellow at The Forum for International Policy. He was on the National Security Council staff from 1987-1993 and has also served with the Department of State and Agency for International Development.

THE WALL STREET JOURNAL TUESDAY, MARCH 17, 1998

A2

NAM Expects 'Major Hit' From Asia On U.S. Exports and Economic Growth

ECONOMY

By CARL QUINTANILLA
Staff Reporter of THE WALL STREET JOURNAL

CHICAGO – Predicting a "major hit" from the Asian financial crisis, the nation's top manufacturing lobby said its members expect a significant slowdown in U.S. export sales this year, as well as slower economic growth overall.

The National Association of Manufacturers, in a survey of 2,000 members, said 40% of those polled expect economic weakness in Asia to cut U.S. exports "marginally" or "significantly." Nearly two-thirds believe the effects of the crisis won't be offset by faster growth in Europe.

The trade group also said 60% of its members believe overall economic growth in the U.S. will slow to an annual rate of 2.5% or lower by the third quarter, primarily because of the Asian effects.

"Manufacturers are bracing themselves," said Earnie Deavenport, chairman and chief executive of Eastman Chemical Corp., who serves as chairman of the NAM.

While the news isn't terribly surprising, given the attention that has been devoted to Asia's troubles in recent months, the survey offers a comprehensive view of manufacturers' economic outlook. The NAM is the largest broad-based industrial association in the U.S., with 14,000 member companies. Most of those companies are small- to medium-size manufacturers that are sensitive to even incremental changes in the economy.

The manufacturers association used the results to renew its call for the Federal Reserve to cut interest rates. The group said it would like to see the federal-funds rate, now at about 5.5%, lowered by one-half percentage point. The NAM said a decline in the rate, which is what banks charge each other for short-term loans, would generate financial liquidity and credit, helping companies offset the effects of the Asian crisis.

The NAM said manufacturers are seeing fewer exports to Asian countries, the result of Asian weakness and the rising value of the dollar. At the same time, many firms expect cheaper imports from Asia, putting pressure on prices and trimming profits for U.S. companies.

"A lot of goods are going to come into this country trying to find a home," said Mr. Deavenport, speaking at a news conference at National Manufacturing Week, an industry trade show in Chicago. About 40% of NAM's members said they expect earnings growth to decline if U.S. growth slows to an annual rate of 2.5% or less.

Despite the nervous tone of the survey, the NAM pointed out that American manufacturing continues to face a positive economic picture. The domestic economy is humming. And with most manufacturers having improved operating efficiency, U.S. manufacturers are "the envy across the world," Jerry Jasinowski, NAM president, said.

The NAM said its top priority as a trade group this year is to help members recruit qualified workers. Many firms are having trouble attracting employees because of the tight labor market. In a recent survey, nine out of 10 said they experienced some level of difficulty in recruiting workers.

And job growth continues to be strong: Some 40% of NAM members said they plan to increase their number of full-time, permanent jobs this year. Only 5% said they would cut back. "We find our ability to compete will increasingly depend on our ability to find qualified employees," Mr. Jasinowski said.

FINANCIAL TIMES WEDNESDAY FEBRUARY 25 1998

5

Warning over Asia 'bloodshed'

By Nancy Dunne in Washington

Stuart Eizenstat, US undersecretary of state, yesterday warned that failure by the US to take leadership in the Asian financial crisis could result in instability and bloodshed in the region.

Vital US interests were at stake in the Asian financial crisis, including Washington's ability to mobilise future support for human rights and democracy in the region, he said.

Mr Eizenstat, who testified yesterday before a key House subcommittee, is one of many administration figures on Capitol Hill pushing for the passage of a $17.9bn US contribution to the International Monetary Fund. His role was to convince a reluctant Congress that vital US interests are at stake.

A South Korea weakened by economic troubles could invite "miscalculation" by North Korea, leading to "conflict on the volatile Korean peninsula", he said. Indonesia's problems could "exacerbate social tensions and rekindle nationalistic excess". The Philippines remains "vulnerable to continued turmoil".

He added that the success of Asean (the Association of South East Asian Nations) should not be taken for granted. "The peace and progress it has helped to bring to south-east Asia may seem natural. But go back to the mid 1960s – there was tension, there were bloody insurgencies, there were shooting wars... there were communal killings.

"The changes since then have been astounding, but prolonged economic crisis and the attendant joblessness, impoverishment and despair could revive internal instability and provide fertile ground for extremism."

Guest workers may be sent home from the ailing economies, and the flow of economic refugees could increase. "In a region where old suspicions and ethnic rivalries persist, the risk of instability spreading is real."

Mr Eizenstat said the countries hardest hit were among the US's most vital allies. The crisis could strain the ability of South Korea and Japan to share the financial burden of maintaining forces in the region – including 37,000 US troops on the Korean peninsula.

Ms Charlene Barshefsky, US trade representative, stressed the new business opportunities being opened up by IMF programmes.

Thailand has made commitments to restructure public enterprises and accelerate privatisation in key sectors. These will allow foreign competition into energy, transportation, utilities and communications. South Korea has agreed to improve market access for many products, while Indonesia has agreed to eliminate government support for its national car programme, a project the US has been challenging in the WTO.

Eizenstat: fears turmoil

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The Washington Times MONDAY, MARCH 16, 1998

A12

Piracy jumps during financial crisis in Asia

By Peter Montagnon
LONDON FINANCIAL TIMES

SINGAPORE — Piracy in Southeast Asian shipping lanes has increased since the outbreak of Indonesia's economic crisis, say officials in Singapore and Malaysia.

There has also been a surge in the number of illegal immigrants fleeing Indonesia for Malaysia and Singapore.

Tony Tan, Singapore's defense minister, said all three countries have stepped up surveillance because piracy has increased in recent months.

Mr. Tan declined to give details of recent incidents or to say who Singapore thought was behind them. But he said the threat to the large volume of shipping passing through the Strait of Malacca in the event of a breakdown of law and order in Indonesia is a great worry.

"This is a major sea lane for international maritime traffic, and this would be of concern to the whole world," he said, though he added he is confident Indonesian authorities would be able to maintain order.

The hazardous Strait of Malacca is notorious for piracy. In one attack in 1992, pirates boarded a container ship, killing the captain and his first mate. In another incident, pirates boarded a supertanker, tied up its crew and left it cruising, unpiloted.

Indonesia, Singapore and Malaysia have tried to fight the pirates, but their efforts have been hampered by regional sensitivities and questions of sovereignty. Ship owners have rejected proposals for a toll to finance keeping the region's seas safe, saying security is the responsibility of the states.

The Indonesian crisis has also provoked an increase in the flow of illegal immigrants trying to enter Singapore in small boats or by other means, Mr. Tan said. Singapore, which is only about half an hour by boat from the closest point in Indonesia, has been able to capture and repatriate them and has not seen a large influx.

His remarks come shortly after Malaysia said more than 3,000 foreigners, mostly Indonesians, had been caught trying to land on its coasts during the middle two weeks of February.

The figure is "very alarming," and police have stepped up coastal patrols, Yusof Said, deputy internal security director, told reporters in Kuala Lumpur.

• *Distributed by Scripps Howard*

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EDITORIAL COMMENTARY

THOMAS G. DONLAN

A Necessary Institution

The IMF acts as the strong arm of the marketplace

Remember the Trilateral Commission? Back in the Eighties, the international talkathon for big shots was demonized into an international conspiracy against the proper order of things. Like the Third International, the Masonic Order and the Illuminati, the Trilateral Commission served for some as the grand explanation for everything that seemed to be going wrong in the world.

Fortunately, the commission has gone out of paranoid fashion and returned to the unobtrusive status it always deserved. Unfortunately, the next bugaboo is turning out to be the International Monetary Fund. This could be more serious: Although flawed, the IMF actually is an important institution. Also, its flaws are diminishing while its importance is growing.

Fear of the fund goes back many years. As part of the Bretton Woods agreement that set up the new world financial order after World War II, the International Monetary Fund was established as a global lender of last resort. When a country and its financial institutions become so overextended that private institutions run away, the IMF runs in to dispense cash, but on severe terms. Who could like an agency like that? Does a wastrel student like the terms his parents impose for paying his debts?

The cash bothers some people. It's a bailout. Worse, it's a bailout of the international banks that lent unwisely, for projects that were unnecessary or worse. But these bailouts are no more than the international equivalent of bankruptcy. In the same way that bankruptcy is better than debtors' prison, even for lenders, so an IMF bailout is better for the taxpayers of the world than collapse in even a small profligate nation.

The IMF arrives early, when a debt crisis can be contained. In Britain and Italy in the Seventies, in the Latin American debt crisis of the Eighties, in the nations of the former Soviet Bloc, in the Asian countries of the current debt crisis, the IMF arrives when circumstance has forced governments to listen to its advice.

A Dose of Realism

It's the advice, however, that worries more and more people. The IMF usually prescribes devaluation, monetary contraction and fiscal discipline. These are the counteragents to the overvalued currencies and other easy money policies that put its subject countries into trouble. In quick succession come high interest rates, economic contraction and high unemployment. General misery balances the former general elation.

The IMF's advice would not do for every country. Some, like the United States, are so favored by their natural and human resources, by good timing in their business cycle and by their stable political institutions that they ought to have strong currencies and low taxes. From this truth, it is easy to imagine that the IMF's advice need not be followed anywhere. It is a little more difficult to imagine that the IMF deliberately dispenses bad advice. It is harder still to imagine that international bureaucrats are deliberately impeding economic growth to make poor people suffer.

Yet such imaginings are becoming ever more popular. The notion that IMF officials advise devaluation only in order to protect their advisory jobs even finds its way onto the editorial pages of great newspapers. So does the equally loopy idea that the IMF exists to hold down wages and pollute air and water in poor countries for the benefit of rich "transnational" companies.

Starting with the Mexican crisis of 1994-95 and even more strongly in the current Asian crisis, otherwise sensible people are claiming that the cure is worse than the disease — that devaluation, tight money and strict fiscal policies replace little problems with bigger problems.

Jack Kemp, for example, offers this: "The IMF is giving bad advice. In every instance, they say 'soften your currency, devalue it, raise taxes,' and the combination of soft money and high taxes is the problem in every country the IMF has visited. I think it [should give] the opposite advice and that Congress should not give a dollar of replenishment to the International Monetary Fund until they start giving good advice."

In fact, the typical IMF prescription is simple realism: A country in trouble must accept the consequences of its mistakes. An overvalued currency must float to its market value; the government must either stop creating money faster than the market wants it or stop hiding the dirty secret of a bulging money supply; it must stop borrowing faster than it can tax to pay debt service. This is not bad advice, this is the facts of life. If the IMF did not advise this discipline, the market would impose it in a much more painful way.

Once a crisis has reached the point where national leaders insist put their old policies behind them, the IMF makes suggestions for economic reforms. Here, the organization is much improved. Where once it espoused the capital controls and nationalist socialism inspired by the British Labour Party, the IMF now pushes open markets and capital mobility with an intensity that could put many Americans to shame.

Providing Courage

In America, two symbolic issues currently dominate discussion of the International Monetary Fund. The more abstract is the IMF's opposition to a currency board in Indonesia, the more tangible is the Clinton Administration's request to Congress for an $18 billion capital contribution to the fund.

A currency board system backs every unit of suspect local money with a unit of trusted foreign currency. In Argentina, for example, every peso in circulation is matched by a dollar in the central bank. Individuals know the government can maintain that exchange to the last peso or the last dollar.

The IMF doesn't want a currency board in Indonesia. It says it believes the Indonesian government must retain monetary flexibility or see its banks collapse. But that's wrong. The Indonesian government should n't print money to shore up its banks; it should inspire confidence in its money and its institutions so the IMF and private investors will lend them more capital. Whether it does that with a currency board or some other mechanism ought not to be the issue.

Whatever will be believed will work. In Hong Kong, a currency board carried the credibility needed to protect the local dollar despite the general crisis and the specific uncertainty of the former colony's relationship with China. In Taiwan, solid prosperity and a heap of foreign exchange reserves were equally credible.

A currency board is just another word for courage. Or, considered another way, it is another form of the promise to peg exchange rates. Either way, a country better known for borrowing than for paying back promises to spend every last dollar of its foreign exchange reserves defending its currency.

There's nothing wrong with courage, and there's nothing wrong with keeping promises. But money is just paper. Just as the country that promises to defend its exchange rate can abandon that promise, the country that creates a currency board can dismantle it.

Either way, markets judge each country's promises and test the resolve of any mechanisms that declare value. All currencies, even those protected by secrecy or lies, even those backed by gold, float against each other, against gold, against other commodities.

An Indonesian currency board will not be more credible than any other promise extended by the Suharto family-government. IMF funding for Indonesia's bankruptcy should focus on the country's credibility, not on whether it creates a currency board.

Investing for Profit

If the IMF didn't exist, it would be necessary to invent it. Everybody wants a free lunch. Governments have a natural tendency to profligacy. Banks have a natural urge to lend and borrow and lend again, even to governments. Bust and bankruptcy follow boom and hyper-investment. The world's financial institutions cannot prevent such mishaps, but the IMF can contain them, limit the damage, teach the lessons that should be learned and move on to the next cycle.

If the world had to invent the International Monetary Fund now, it would probably be a private institution, drawing on capital invested by banks around the world and paying a nice return on investment. We would prefer a world in which it did raise private capital and gain strength from the power of markets. But while it's an instrument of governments, the U.S. should be an investor.

An odd coalition of labor, protectionists, gold bugs and environmentalists opposes more U.S. funds for the IMF, but they don't serve their country's interests.

The most important capitalist country, which is also the world's largest trading nation, should realize that the wealth of its citizens depends in large part on a world system that punishes bad policies and forces incompetent governments to improve. ■

Thomas G. Donlan receives E-mail at tg.donlan@news.barrons.com.

Secretary of Defense William S. Cohen
Security Implications of Asia's Economic and Financial Crisis
House Committee on Banking and Financial Services
January 30, 1998

"When Krakatoa blew apart in 1883 in one of the world's most cataclysmic explosions, it took three months before the first evidence of the eruption off Java was visible in America, in the form of brilliant sunsets created by volcanic ash circling the globe.

"When the rupiah melted down, it took only minutes to feel the reverberations."

This recent comment in The New York Times vividly illustrates how much the world has shrunk, making it impossible for the United States to retreat to a continental cocoon and requiring us to be engaged internationally so that we can influence those matters that can affect us.

Mr. Chairman, in order to understand how the current Asian economic and financial crisis might affect our security, it is necessary to first understand our national security strategy, both of today and of the last half century.

At the end of the Cold War, it was commonly said that security was being displaced by economics as the measure of national strength and the arena for the exercise of power. This was not only analytically shallow, it was historically hollow.

Throughout the Cold War, our international security and economic policies were interlocking.

In fact, the international economic and trading system the United States created in the wake of World War II was established before we developed our network of security alliances around the world, and the two systems were mutually reinforcing.

As Paul Nitze described in our national game plan for the Cold War, NSC 68, our strategy was "designed to foster a world environment in which the American system can survive and flourish. It therefore rejects the concepts of isolation and affirms the necessity of our positive participation in the world community."

It went on to note that this really involved two distinct policies. One was to contain the Soviet Union. The other was "to develop a healthy international community ... which we would pursue even if there were no Soviet threat (and which) is the long-term constructive effort in which we are engaged." And intrinsic to both was our international economic policy.

It is precisely this same long-term constructive effort in which we are engaged today, after the end of the Soviet threat, in order to foster an international environment in which America can survive and thrive.

This is not an argument I have produced for today's hearing. It is at the heart of our defense strategy.

Last year, the Department of Defense undertook the most fundamental and comprehensive review ever conducted of our defense posture, policy, and programs. The Quadrennial Defense Review (QDR) examined the national security threats, risks, and opportunities facing the United States today and out to the year 2015.

Based on this analysis, we designed a defense strategy with three central elements that we summarize as Shape, Respond, and Prepare.

The first of these is perhaps the most crucial – to shape the international security environment in ways favorable to US interests by promoting regional stability and reducing threats.

A key element of shaping, although by no means the only one, is our economic engagement in the world. This is central to our current strategy, but it has in fact been a constant of American policy for half a century.

As NSC-68 described it, "foreign economic policy is a major instrument ... which can powerfully influence the world environment in ways favorable to the security and welfare of this country."

We are the beneficiaries of the wisdom of the generation who preceded us and who created this international system.

The success of their policy has been truly astounding, as America and the world experienced prosperity scarcely imaginable to earlier generations, and as nations destroyed by war experienced economic miracles that solidified their nascent democratic institutions and made them powerful allies.

A defining characteristic of this international system has been steadily growing interdependence – not only between countries, as Secretary Rubin has described, but growing interdependence between economics and security.

A simplistic but useful logic train is that:

- Security breeds stability.
- Stability attracts investment.
- Investment promotes prosperity.

And this virtuous cycle builds on itself as prosperity further enhances security and stability.

With this overview of our defense strategy, let me turn to its application to the current crisis that is afflicting Asia and affecting other regions of the world.

I have just returned from visiting seven East Asian capitals where I discussed the impact of the crisis with senior leaders and several conferences of leading thinkers. The buoyant Asian pride so evident on my many previous trips to the region is gone. The sense of vulnerability and loss of confidence is palpable.

And below the surface lies what one of our ambassadors described as the "active memory" that many in the region have for an earlier period in which armed confrontation rather than economic cooperation marked regional relations.

It is truly a crisis, a "turning point" in the original Greek meaning of that word. Across Asia, major reassessments are being made.

This can be favorable to us. During my travels, officials in the region were more open than ever to working with the U.S. on many fronts, including security.

But if we pull back from such engagement at this critical juncture, we will not only damage current relations, we may adversely affect an entire generation's attitude toward America.

It is clear to me that we must remain engaged – not because it is in Asia's interest, but because it is in America's interests.

Secretary Rubin can better describe how America's economic future is deeply entwined with that of Asia. I would like to emphasize that our interest goes beyond trade and investment – it is strategic.

Southeast Asia, for example, has been our fastest growing market and our fourth largest market. But it also is home to some of the most strategic sea lines of communication and navigation choke points in the world, the arteries through which the lifeblood of modern economies flow.

And working with our strategic partners in Southeast Asia will be key to managing the emergence of China.

Our enduring strategic interest in the security and stability of Asia is reflected in the three wars we have fought there in this century, at the cost over 100,000 American lives.

It is also reflected in the extensive efforts we have been making to strengthen our alliances and other security ties in the region and re-orient them to the challenges of the future.

We should not underestimate these challenges:

- Asia has a concentration of competitive states with the world's largest militaries, some of which are nuclear armed.

- Ancient rivalries, hidden beneath the rising tide of prosperity in recent decades, may re-emerge if the waters of affluence recede.

- Unresolved disputes over borders and strategically located islands could become flashpoints.

- Deep-seated ethnic tensions could increase perceptions of unfair economic burdens, leading to social unrest and political turmoil that could spill over borders or entice adventurism.

- And on the Korean peninsula, the crisis raises concerns that the North could mistakenly conclude that this is an opportune time to act against the South.

Especially during this period of uncertainty, it is very important for the United States to continue the stabilizing role that only we can play – through our military, political and economic engagement.

A perception that the United States is not committed to remaining fully engaged in the region could trigger a series of actions by regional players, the outcome of which would be hard to anticipate – or to stop, once initiated.

Accordingly, I intend to continue DOD's vigorous engagement efforts throughout East Asia, including Southeast Asia. During my recent trip, we reached concrete agreements under which:

- Singapore is building a carrier-capable pier for our use;

- our forces once again are able to visit and train in the Philippines;

- we have established mechanisms to implement our revised defense cooperation guidelines with Japan;

- American and Chinese operational military officers will begin direct talks for the first time; and

- we will initiate a strategic dialogue with Indonesia.

But military engagement alone will not ensure stability in the region. Even more than during the last five decades, our military, political and economic strategies must be integrated if they are to succeed.

That is why I fully support the President's proposals to contribute our share of resources to the IMF and to the New Arrangements for Borrowing.

Secretary Rubin has explained the key role the IMF is playing in promoting the restoration of financial stability and the development of more transparent, open economies – and how that benefits us.

He has also explained the immense leverage we gain for our resources when we work through the IMF.

I would merely add that, because there are no outlays associated with the appropriations Secretary Rubin is requesting, it will pose no risk to our defense program, nor for that matter does it pose a risk to any domestic program.

The real risk lies in failing to act – which could, through a series of unpredictable events over time, cost not only American dollars and American jobs, but possibly even American lives.

For five years following the fall of Berlin to the Allied Powers, we struggled as a Nation to find our footing during the post-war transition between two eras. Significant initiatives were pursued – the Bretton Woods system, the Truman Doctrine, the Marshall Plan. Yet enveloped in the "fog of peace," these actions were like a series of peaks poking through a carpet of clouds that obscures the terrain which connects them.

Only with the Korean War was the fog lifted and the true landscape revealed, allowing a conceptual consensus to develop that America was engaged in a Cold War.

For eight years after the fall of the Berlin Wall, we have talked of being in "the post-Cold War era," a nomenclature awkward because it defines a period by what it is not, rather than by what it is. Far from being an era, "post-Cold War" describes a transition period between eras.

It is quite possible that those who follow us will look back on the choices we make in the midst of this crisis and see it as the defining moment of a new era.

In broad terms, we must choose either to withdraw from the world in the mistaken belief that our interests abroad are minimal, or that those interests will somehow be protected through benign neglect.

Alternatively, we can choose to be engaged, recognizing that we have ever-increasing interests abroad and must actively protect and promote those interests.

While a decision must be made, I would argue that there really is no choice at all.

If we are to meet our responsibility to the next generation, as the War generation did for us, then we must remain engaged – politically, militarily and economically.

19[redacted]8-SE-006768

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

May 29, 1998

The Honorable Newt Gingrich
Speaker
United States House of Representatives
Washington, D.C.

Dear Newt:

The continuing financial turmoil in Asia raises serious concerns that I think warrant our attention and discussion. The reason for my telephone calls was to update you on the situation there and in other emerging markets, and to outline what I believe to be the implications for U.S. interests and policy. Given the urgency of the situation, I would strongly suggest we discuss these issues in the near future, as I have with other leaders in both parties.

Many of the countries affected by the financial turmoil in Asia are our longtime allies and are important to our strategic interests. This region has also been integral to U.S. economic growth, consuming roughly thirty percent of U.S. exports.

While there have been some encouraging signs of stabilization in a few of the key Asian countries, these countries still face many difficult challenges. As you have seen in the press in recent days, there is serious concern about these issues in the financial markets. All of this could represent a renewed threat of financial instability not only in Asia, but in other emerging markets as well. As Chairman Greenspan noted in our joint appearance before the House Agriculture Committee last week, "there was and is, a small but not negligible probability that upset in East Asia could have unexpectedly large negative effects on Japan, Latin America, and eastern and central Europe that in turn, could have repercussions elsewhere, including the United States."

While these are complex issues, the direct and indirect effects of such financial dislocations on American export markets, financial markets and overall economic health could be very serious. In my view, a view Chairman Greenspan also expressed last week, the risks implicit in these events, although small, make it more important than ever that we make every effort to see that the international community has sufficient resources to respond effectively to help protect American economic and national security interests.

I look forward to hearing from you.

Sincerely,

Robert E. Rubin

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Date July 7, 1998

MEMORANDUM FOR: ☒ SECRETARY ☐ DEPUTY SECRETARY ☐ EXECUTIVE SECRETARY
☐ ACTION ☐ BRIEFING ☐ INFORMATION ☐ LEGISLATION
☐ PRESS RELEASE ☐ PUBLICATION ☐ REGULATION ☐ SPEECH
☐ TESTIMONY ☐ OTHER

FROM: Under Secretary Lipton

SUBJECT: Memorandum to POTUS re Asia Trip

REVIEW OFFICES (Check when office clears)

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  - ☐ Domestic Finance
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- Prepared by David Lipton (Todd Crawford/Sonal Shah)

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- changes made 7/9/98
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Bernetta -
Will you ~~take these over to~~ put these with the file copy of the POTUS memos
Thanks
-VC

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1998-SE-010082

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

ASSISTANT SECRETARY

AUG 28 1998

MEMORANDUM FOR SECRETARY RUBIN
DEPUTY SECRETARY SUMMERS
UNDER SECRETARY LIPTON

FROM: Timothy Geithner TG
Assistant Secretary, International Affairs

SUBJECT: Treasury's Next Steps in Asia

The existing approach for addressing the Asian financial crisis has been reasonably successful in stabilizing the financial situation in Thailand and Korea and now appears to be bearing some fruit in Indonesia. It is nonetheless clear that real output is still declining, necessary restructuring processes are moving forward only slowly and there is a real risk that the current consensus between the IMF and Asian governments on appropriate policy measures will erode given the absence of tangible signs of economic recovery.

In order to start to address this risk, this memo reviews some proposed modifications to the current strategy and some possible new initiatives that may help to address the situation. Our initial conclusions about some modest strategy adjustments follow, but given the speed with which events in the world are currently moving, we will continue to consider more radical shifts in the current policy approach.

- **The current macroeconomic policy framework advocated by the Fund in Asia appears to be broadly appropriate, although there may be some scope for additional easing of fiscal policy, particularly in 1999.** We continue to believe that a more aggressive easing of monetary policy beyond what has already occurred will primarily undermine currency stability and will fail to have a major stimulative effect given the insolvent banking systems and over-leveraged corporations in the region.

- **It is important to accelerate the current pace of bank and corporate restructuring, which has thus far been too slow, with important costs for economic recovery. We therefore are exploring more aggressive approaches to bank recapitalization and mechanisms for increasing the incentives for corporate debt restructuring. While this can be accomplished under the current case-by-case restructuring framework, we will also continue to consider whether a more systemic framework for restructuring is necessary to break the logjam.** There are nonetheless a number of important technical and legal difficulties which will need to be worked through before we could advocate such an approach. In the meantime, we will continue to press for incremental improvements to expedite the restructuring processes.

- We should support **a new initiative led by the multilateral development banks (MDBs) to provide additional resources to strengthen social safety nets in Asia. This**

is critical to efforts to mitigate the effects of the crisis on the poor and unemployed and to maintain social cohesion.

- **We are also exploring use of innovative credit enhancement and guarantee programs by the MDBs and perhaps other developed countries that would allow countries affected by the crisis to raise money from private capital markets even in the current adverse market environment for emerging market borrowers.** Beyond this, we don't think there is a strong case for a substantial increase in IFI or other types of official financing at this juncture, although we are likely to face the need for additional money for Indonesia sometime early next year as it considers its budget for the next fiscal year.

Macroeconomic Framework: The macroeconomic frameworks currently in place in Asia generally combine maintenance of a relatively tight monetary policy to control inflation and stabilize currency values and looser fiscal policies to allow automatic stabilizers to operate and provide additional funding to cover expansion of social safety nets and restructuring costs.

- The primary alternative to current policies would be an even more aggressive easing of interest rates designed to jump-start economic growth, either ignoring the consequences for exchange rates or imposing exchange controls to limit this impact as much as possible.

Despite the vociferous criticism of the Fund for its supposedly doctrinaire macroeconomic approach to the crisis, it has actually shown considerable flexibility in adapting programs in the key crisis countries. Significant budget deficits have been accommodated to finance social safety net expenditures and to provide some fiscal stimulus, while interest rates have been eased aggressively in Korea and Thailand as currencies stabilized. Nominal interest rates in both countries are now at or below pre-crisis levels and real interest rates are not excessively high.

	Fiscal Deficit (% of GDP)		**Overnight Interest Rates**		**Projected '98 Inflation**	
	Initial IMF Program	Latest Reviews	Dec 1997	'8/20/98	Dec 1997	July 1998
Indonesia	0.5	-8.5	32.4	64.6	10.7	73.4
Thailand	1.0	-3.0	25	11	4.6	10.4
Korea	1.5	-5.0	35	9.5	5.1	9.2
Malaysia	n.a.	n.a.	10.8	9.3	9.0	7.6

Sources: IMF (fiscal deficit), Bloomberg (interest rates); Asia Consensus Forecasts (inflation).

- **We should be open to further easing of fiscal policy in Korea and Thailand during the last quarter of this year and in 1999, if sensible programs and a source of financing can be identified.** This would provide additional stimulus for domestic demand and increased financing for social safety net expenditures necessary to alleviate the impact of the crisis on the poor and unemployed and maintain the political consensus underlying the continuation of economic reforms. Both countries have undershot their deficit targets thus far, however, raising questions as to whether they can effectively expand or implement programs designed to stimulate the real economy.

- **In contrast, we continue to believe that further easing of monetary policy is likely to be counterproductive to stabilization efforts, particularly given the unsettled external environment.** Expansionary monetary policy is likely to have only a limited effect on growth until bank and corporate debt restructuring have advanced to a much greater degree, thus allowing credit flows to resume. Capital that can flee these countries probably already has, so the primary effect of exchange controls would be to discourage the return of foreign or flight capital.

- In the medium-term, affected countries will also need to identify and adopt successor exchange rate regimes and will need our help in figuring out what these should be.

Indonesia: While the Indonesian government is already planning to target costly subsidies more carefully in order to bring its fiscal deficit (a forecast 8.5% of GDP) under control, it will most likely continue to require substantial external budgetary support in the next fiscal year starting in April. Monetary policy will need to remain tight in order to bring inflation (70% yoy in July) back under control. There is nevertheless some prospect of easing interest rates as inflation peaks and bank restructuring reduces the need for continued liquidity support.

Korea: The fiscal deficit targeted under the IMF program has increased from a surplus of 1.5% of GDP under the original IMF program to a deficit of 5% of GDP during the August program review. This has been done largely to provide for additional social safety net expenditures (i.e. expansion of unemployment benefits and public works programs) and cover the increased cost of bank restructuring and weaker tax revenues, although the Korean government has thus far undershot its deficit targets. Interest rates have been eased aggressively and overnight rates are now below pre-crisis levels (8.8% versus 14.2% in October 1997). The government has been jawboning banks in an attempt to stem further appreciation of the *won* and maintain a competitive advantage *vis a vis* Japan.

Thailand: Fiscal policy has shifted toward a more stimulative stance, with the projected government deficit now amounting to 3% of GDP (excluding the interest cost of financial restructuring totaling 1.5% of GDP), compared to a 1% of GDP surplus in the initial Fund program. Through June, however, the budget deficit was undershooting Fund targets, suggesting there may be limits to the government's ability to implement expansionary fiscal policy. Money market interest rates have eased significantly in recent months, falling from above 20% to 10-12% more recently. There may be further scope for easing if the baht remains stable and inflation slows from current levels.

Malaysia: While Malaysia does not have an IMF program in place (and will undoubtedly continue to try to avoid having one), the government's desire for large-scale structural adjustment lending from the World Bank and ADB raises the question of whether a sound macro framework is in place. The rapid easing of monetary policy during August, while not necessarily a cause of major concern for the IMF given the limited pass-through to inflation, is unlikely to significantly boost growth prospects and has only heightened market concerns that Mahathir is now firmly in control of economic policy. The government is also attempting to ease fiscal policy significantly, but for now has abandoned plans to tap international capital markets to help finance bank restructuring and infrastructure investment. It now plans to tap domestic sources (the Employee Provident Fund and Petronas, the state-owned oil company) to finance the bank restructuring program and may be looking to the MDBs to finance infrastructure projects via the SALs.

Philippines: While the Philippines has fared better than other affected countries, growth is likely to be flat this year and export growth, which has been robust to date, is starting to slow. The fiscal deficit is forecast to increase from 1% to 3% of GDP this year. Markets do not have a high level of confidence in the new Estrada administration, which has sent out mixed signals on monetary policy. Plans to raise $1 billion in global capital markets have been postponed, and it is unclear whether it will be able to finance the increasing deficit in the domestic bond market.

Financial Sector Reform and Corporate Restructuring: Critical to the task of restoring growth in these countries are the closely linked processes of financial sector and corporate debt restructuring. Lending activity will not resume to support economic growth unless banks are

recapitalized and the debt burdens of corporations are assessed and then reduced. Merely restarting credit flows without a fundamental change in the practices of banks, corporations and regulators, however, carries with it significant risks that the mistakes of the past will be repeated again, with corporate debt/equity ratios and bank non-performing loans continuing to rise.

Progress under the current case-by-case, voluntary framework for restructuring has been exceedingly slow in most cases; it is unclear that there are sufficiently strong incentives in place (for both debtors and creditors) to accelerate the pace of corporate restructuring. Bank recapitalization is proceeding only at a gradual pace.

- The primary alternative to the current approach is a more centralized, systemic strategy that would force more rapid restructuring of debts, most likely including significant across-the-board haircuts for creditors and write-downs of existing equity.

- **We continue to believe that it is premature to favor a more centralized systemic framework involving massive government intervention in order to force the pace of corporate and bank restructuring.** There is a significant danger that a more government-driven, less market-based restructuring process would be politicized and lead to the rebirth of government practices (i.e. directed lending, crony capitalism, intervention in management) that IMF reform programs are attempting to eliminate. It will also be exceedingly difficult to craft a plan that will be broadly acceptable to both debtors and creditors given the diverse condition of corporations in the region.

- **There is scope, however, for accelerating the pace of restructuring by adopting more aggressive approaches to bank recapitalization and strengthening market-based incentives under the current case-by-case restructuring framework.** Both Thailand and Indonesia either have or are in the process of taking some steps in this direction. Work also is in progress in most countries to strengthen or augment the existing approach by removing tax and legal impediments to restructuring and improving coordination mechanisms. We will continue to follow these efforts closely, looking for ways to further strengthen existing restructuring frameworks.

- We nonetheless will continue to intensively explore alternatives to the current case-by-case approach should a more radical approach become necessary.

Our proper role in this area should be to continue to provide the IFIs and governments in the region with the encouragement necessary to motivate them to strengthen existing frameworks for restructuring, not necessarily to attempt to micro-manage the processes or design them ourselves. We will, however, continue to make sure strategies being pursued are broadly sensible and effectively implemented and that the various parties involved in the process are coordinating their efforts.

- In addition, we can and will provide technical assistance for both financial and corporate debt restructuring, if requested and assuming it can usefully be deployed.

Thailand has proceeded furthest with its plans for bank and debt restructuring, and appears to be making progress both in recapitalizing its banking sector and moving forward with necessary corporate debt restructuring. It has recently adopted a new program providing incentives designed to encourage banks to restructure corporate debt and promote new lending, and the success of this scheme should be watched closely.

Indonesia is augmenting its existing framework for corporate debt restructuring by easing restrictions on different types of restructuring and has recently initiated action to address problems in its banking sector by closing three banks, nationalizing four others and merging four state-owned banks. Considerable restructuring of the banking sector is still needed. Also, the scale and scope of the debt problems facing Indonesian corporations raises questions about whether a case-by-case approach can be successful given the existing framework for dealing with these issues and the potential lack of sufficiently strong incentives for restructuring.

Korea is relying on domestic banks to force corporate sector restructuring, but its elaborate plans lack clear incentives for banks to carry through with this task and largely ignore the five largest chaebol. Little significant progress has been achieved to date. Anecdotal information suggests corporate debt/equity ratios may still be rising, due as much to new borrowing as to equity price declines.

Malaysia's plans for bank restructuring have taken shape over the last two months, but we remain skeptical about the likely success of the plan given its unclear funding situation and the lack of clarity in the plan on key issues such as disposition of bad loans, treatment of existing shareholders, and tightening of prudential regulation. Details of its corporate debt restructuring plan also remain elusive. In both cases, there are concerns that restructuring plans will be a vehicle for channeling government help to politically-connected individuals and corporations.

Social Safety Net: Strengthening social safety nets in Asia in order to alleviate the impact of the crisis on Asia's most vulnerable and poorest citizens should continue to be an important priority of the MDBs (see separate memo). While our push to emphasize this type of lending at times has run against cultural biases in some Asian countries, these programs can play a critical role in alleviating poverty and maintaining social cohesion and the consensus underlying necessary policy reforms.

We believe the MDBs should undertake a new initiative to strengthen and expand social safety nets in Asia. We will continue to press the MDBs to reallocate (and where possible expand) existing portfolios away from capital-intensive infrastructure projects and instead focus on program and project lending targeted at social safety net expansion and labor-intensive projects with greater employment generation possibilities. We will also continue to ensure that the MDB pipelines and U.S. bilateral humanitarian assistance flow in a timely manner.

- We also need to underscore to Korea the important role that the social safety net, including unemployment compensation, can play both in sustaining domestic demand and creating an environment in which labor will be more willing to accept the layoffs necessary for successful corporate restructuring.

Financing Issues: While insufficient foreign reserves in Korea and Thailand were a critical factor at the start of the crisis, a lack of official financing no longer appears to represent a major constraint on the reform programs being pursued in the Asian countries most deeply affected by the crisis. Indonesia is perhaps the most obvious exception. Financing of even larger fiscal deficits in other countries would also tend to require greater official financial support given the sharp deterioration in access to private capital markets in recent months.

- **We do not believe additional program lending is the missing link in the quest to restore confidence in the region. There nonetheless may well be scope for innovative financing and credit enhancement schemes that would help to regularize access of these countries to international capital markets or help to energize the processes of bank or corporate debt restructuring.** While the ideas that have been presented to date raise a number of significant problems for us, we are continuing to explore modifications to these proposals that would be more broadly acceptable.

- **We will also encourage governments to raise private financing on international capital markets as soon as market conditions make that feasible.** We strongly encouraged several countries in the region to raise private financing earlier this year. The sharp widening of emerging market spreads since that time has led several countries (Thailand, Philippines, Malaysia and Korea) to abandon these plans at least temporarily.

IFI Financing: While there have been delays in disbursement of some IFI financing, particularly to Indonesia, it does not appear that insufficient IFI financing can be blamed for the slow pace of recovery from the crisis. Thailand and Korea have been able to successfully rebuild or expand reserves, while international financial support for Indonesia has expanded markedly in the last two months to enable it to finance a sharp rise in its budget deficit. Other than efforts to strengthen social safety nets, we do not believe increased IFI funding is now the key to recovery.

- We also will consider greater use of MDB guarantees or credit enhancements if this will be effective in tapping additional private sector financing or overcoming incentive problems in bank and corporate restructuring (see below).

Indonesia will undoubtedly require additional external financial assistance next year, as it will require significant external support in order to finance necessary restructuring and social safety net expenditures in the period ahead. IFI financing, along with renewal of a quasi-Paris Club agreement for the next fiscal year, are the most likely candidates for providing this additional support. Korea still has another $5 billion of planned program lending from the World Bank, while Thailand's program remains fully financed. Malaysia raises important issues given its lack of a Fund program which we will need to address as the World Bank and ADB bring additional program lending to their executive boards for consideration.

Trade Finance: **The unwillingness of domestic financial institutions to take on new corporate credit risk, even for relatively safe trade finance transactions, appears to be the major constraint limiting growth of Asian exports, not the availability of official trade finance from EXIM or other ECAs.**

- EXIM has just $32 million remaining of its $750 million short-term trade insurance facility for Korea, although this is scheduled to be increased by an additional $250 million in the next week or two once the National Assembly approves a $2 billion medium- and long-term direct loan program with a sovereign guarantee.

- While EXIM has announced short-term trade insurance arrangements with both Indonesia and Thailand, neither of these programs is operational yet, as details are still being ironed out with Indonesian and Thai authorities.

- While Indonesia has announced a scheme to effectively cover banks against default on trade finance transactions, the details remain sketchy and the plan does not appear to be operational.

Credit Enhancements: **The recent deterioration in the external financial environment facing these countries makes it more plausible that a case can be made for some form of credit enhancement. We are therefore intensifying our look at the structures that have been proposed thus far in order to see if they can be adequately changed to reflect our outstanding concerns and effectively address the financing needs of these countries.** A number of different proposals have been circulating in recent months concerning ways the IFIs, the United States, Japan or other developed countries would provide some credit enhancement or guarantee in order to improve the terms on which these countries could borrow on international markets, although each raises a number of problems for us.

A number of key principles are guiding our analysis of possible credit enhancement programs:

- U.S. government funds should not be used to provide guarantees.

- Credit enhancement should help to mobilize additional funds or lengthen maturities of private sector financing which would otherwise not be available. The MDBs or other public entities should not take more than 50-60% of the net present value exposure under a partial credit guarantee in order to leverage official resources and ensure continued risk-bearing on the part of the private sector.

- These structures should be used to assist countries regain private market access, although it will be critical to limit as much as possible a continuing reliance on official support for future private financing.

- Financing supported by guarantees should support policy conditionality and should not be used for purposes such as directed credit which conflict with other U.S. policy objectives.

- Private sector risk-bearing and involvement in the selection of fund recipients is essential to limit moral hazard and minimize the extent to which financing goes to non-viable entities.

DI to RER (READING) 8/28/98
DI to LS

cc: MF
SS
NC/DI/PA/AK

Please log In

1998-SE-012816

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

ACTION

ASSISTANT SECRETARY

MEMORANDUM FOR SECRETARY ROBERT E. RUBIN

FROM: Timothy Geithner *EZ for*
Assistant Secretary, International Affairs

SUBJECT: Memorandum to the President On His Upcoming Trip to Asia

ACTION-FORCING EVENT:

President Clinton will attend the APEC leaders' meeting in Kuala Lumpur on November 17-18, and then will visit Japan (November 18-20) and Korea (November 21-22). The trip will provide an important opportunity to highlight the progress that has been made in attempting to overcome the current financial crisis, while also underscoring that difficult challenges remain to be overcome and overcoming them will require both time and considerable political will on the part of governments in the region.

RECOMMENDATION:

That you sign the attached memo to the President (see Tab A).

✓ Agree _____ Disagree _____ Let's Discuss

BACKGROUND:

The President's stops in Japan and Korea, the broader APEC meetings, and bilaterals or pull-asides with the leaders of China, Thailand, Malaysia, and Russia, will provide an opportunity for President Clinton to deliver a strong message to his counterparts about the necessity of implementing policies designed to bolster economic growth and to accelerate essential structural reforms. In order to encourage this effort, we have been working with Japan, the World Bank and the ADB on a multilateral initiative designed to help accelerate the pace of corporate and bank restructuring and restore growth in the region. While this initiative will help countries mobilize the financial resources they need to overcome the crisis, the ultimate success of these efforts will depend in large measure on the willingness of governments in the region to undertake politically difficult policy measures (you attach a draft explanation of this initiative to your memo).

The U.S.-Japan security relationship and our economic agenda will play a prominent role in the President's visit to Japan. On the economic agenda, more policy action will be needed to jumpstart an economic recovery in Japan and to effectively resolve financial system problems. Deregulation remains an important, but subsidiary point (in the note, you promise to send an update on Japan after next week's fiscal stimulus announcement).

Attachment: Tab 1: Memorandum to the President

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

November 13, 1998

MEMORANDUM FOR THE PRESIDENT

FROM: Robert E. Rubin RER

SUBJECT: Your Trip to Asia

Your trip to Asia comes at a critical juncture for the region and the global economy as a whole. The key objectives I see for your trip are:

APEC: Highlight the progress that countries in Asia have made responding to the crisis, but emphasize that extraordinary challenges remain. Our growth agenda for Asia includes these priorities:

- Growth oriented macro policies, including the acceleration of structural reforms.
- Support for social safety net in the crisis countries.
- A broad initiative to promote financial and corporate sector restructuring – we hope to make a joint announcement with PM Obuchi prior to APEC.
- Endorsement of use of MDB instruments to catalyze private sector flows.
- Renewed commitment to achieving free and open trade and investment in APEC.
- Strengthen the international financial architecture.

Malaysia: Recognize their concerns about globalization but convey that capital controls do not solve any of the underlying causes of the crisis and could exacerbate problems if used to avoid the adoption of sound policies and necessary restructuring.

China: Commend President Jiang on China's continued economic growth and on maintaining a stable exchange rate, but caution him that continued reforms of China's financial system and state-owned enterprises are critical to its long-term prosperity.

Thailand: Praise PM Chuan for his implementation of an economic reform program that has led to renewed market confidence, reenforcing the importance of staying the course and moving forward with corporate and financial restructuring.

Russia: Emphasize that Russia needs a credible economic strategy to win support from the IMF and external creditors. Reaffirm that the U.S. is still prepared to engage with Russia in many areas, including bank restructuring and humanitarian assistance.

Japan: Welcome efforts to make substantial public funds available for the banking system and to stimulate domestic demand -- including PM Obuchi's commitment to achieve a 2% growth rate. What is crucial, however, is to urge quick, aggressive fiscal stimulus and that bank restructuring funds be used quickly and effectively, with appropriate conditions.

Korea: Underscore our support for President Kim and his reform agenda, while stressing that financial and corporate restructuring is necessary for a sustainable recovery.

Asia: Since the APEC meetings in Vancouver last year, the regional financial crisis has deepened dramatically and spread to other parts of the world. Economic growth in the crisis countries is expected to range from -5% to -15% – much worse than originally anticipated. In recent months, however, there have been some encouraging developments: Greater stability in exchange rates and the crisis countries' external financial situation has allowed for a lowering of interest rates, an easing of fiscal policies to support demand and employment, and a replenishment of reserves.

Many challenges remain, including fending off proposals for radical solutions to the crisis, such as Malaysia's capital controls, that tend to have a siren-like effect. Our challenge is to continue to emphasize the importance and benefits of sound macroeconomic policies, structural reforms, and liberalized trade and investment environments, while simultaneously helping to provide international financial support to alleviate the burden on those most afflicted by the crisis, catalyze growth-enhancing stable capital flows, and revitalize the private sector. It is in this last area that we hope that you and Prime Minister Obuchi will be able to make a joint announcement of an initiative prior to the start of APEC.

Revitalizing the Private Sector in Asia: The systemic insolvency of banks and corporations in Asia represents an important obstacle to the restoration of growth in the region. In response to your Council of Foreign Relations speech on September 14th, Treasury has been exploring ways to accelerate the pace of corporate and bank restructuring.

Working with Japan, the World Bank and the Asian Development Bank, we are developing a multilateral initiative that would help governments in the region finance the cost of bank recapitalization, while also helping companies gain access to trade finance and new equity investments needed to maintain production and restructure their finances and operations. (I have attached a draft description of the initiative and of a facility to provide temporary financial support).

This initiative alone cannot solve all of the problems that are impeding progress in restructuring. Most governments in the region remain unwilling to recognize the full cost of the crisis and to take on the vested political interests that would be adversely affected by the restructuring of insolvent banks and corporations.

In your discussions with other leaders, you should emphasize that while the international community is attempting to help ease the financial burden of the crisis, restructuring will require governments in the region to implement politically difficult measures if growth is to be restored. It also will be important to dispel speculation that the United States or any other country will create a grand plan to solve the debt problem in Asia, otherwise this could counter-productively encourage debtors and creditors to avoid serious negotiations in the hope of a large bail-out.

Malaysia: As host of the leaders' meeting, Prime Minister Mahathir of Malaysia may attempt to use APEC as a stage for espousing his view that strict regulation of currency trading and far-reaching capital controls are necessary to stabilize the global economy and prevent the recurrence of crises. While we should not ignore or underplay the challenges and difficulties that can accompany

globalization, it is critical that the current crisis not be used as an excuse to return to the failed isolationist economic and financial policies of the past. The measures supported by Dr. Mahathir may be successful in the short-run in reducing Malaysia's vulnerability to external developments, allowing for an easier monetary policy, and possibly stimulating growth. The jury is still out. We believe that controls and an intensification of government interference in the economy will have an adverse medium- and long-term impact on the growth and competitiveness of the Malaysian economy.

China: As the Chinese struggle to reach their 8% growth target, they have slowed and even reversed progress on a number of key reforms related to the financial system, state-owned enterprises and trade liberalization. While these steps could be painful in the short-run, they are essential to China's long-run development. The recent closure of a large financial institution (GITIC) with substantial foreign borrowings and potentially serious spillover effects, and a crack-down on foreign-exchange licenses for imports, primarily through bureaucratic delay, have underscored the need for China to adopt more transparent and rule-based policies.

Thailand: Prime Minister Chuan's government moved quickly to implement its IMF program that helped stabilize financial markets, and despite a projected GDP decline of 8% this year, has managed to weather the political storms well. Renewed confidence in Thailand has allowed an easing of interest rates to below pre-crisis levels and a relaxation of fiscal policy. Markets are becoming increasingly optimistic that the recession may soon bottom out. Insolvent corporations and weak financial institutions, however, pose a barrier to strong growth. The government is putting in place a comprehensive program to address this problem, but it requires parliamentary approval of amendments to foreclosure laws to encourage corporations to negotiate workout deals. The government hoped for passage by October, but now hopes for approval by the end of the year.

Russia: Russian economic policy remains largely adrift, with no immediate prospect of support from the IFIs. Russia has unveiled an economic strategy that is short on details, but appears to represent a step backward toward more administrative control over the economy. Russia has yet to lay out its budget plans for the remainder of the year, and the draft 1999 budget is unlikely to be approved before March. High-level Russian officials have publicly admitted that Russia will not be able to pay its external debt obligations ($20 billion due by end of 1999) and instead will seek to reschedule those debts. Though Russia's economic progress will depend on choices that only Russia can make, the U.S. will remain engaged through a variety of channels. Our efforts include providing food and humanitarian aid; bolstering policies that will attract foreign direct investment; supporting technical assistance for bank restructuring, tax reform, and fighting crime and corruption; and intensifying programs to promote regional development, the rule of law, and civil society.

Japan: Japan faces its most severe post-war recession and very weak domestic demand. Private forecasters expect a 2½% contraction this year. As the world's second largest economy, and by far the largest economy in Asia, Japan must address its economic problems quickly and effectively if it is to contribute to, rather than impede, resolution of the current financial crisis. Much more aggressive stimulus is needed to jumpstart a recovery next year, let alone achieve Prime Minister Obuchi's recently stated 2% growth target. On fiscal policy, we have suggested an additional stimulus of ¥10 trillion (2% of GDP) beyond the plans announced in August, a doubling of effective stimulus. Financial system reform is also needed. While a substantial amount of public funds have been made

available to recapitalize the banking system, appropriate conditions are needed to make this effective in resolving the financial system's problems -- including full and accurate financial disclosure and disposal of bad assets. The premium Japanese banks must pay to attract funding has increased substantially in recent weeks, indicating the early emergence of year-end financial pressures as well as great skepticism that Japan has resolved its banking problems. In addition, continued deregulation and market opening are critical to Japan's longer-term economic health and to defray external political pressures building in connection with Japan's bilateral trade surplus. (I will provide you another note next week after Japan makes an announcement of its fiscal package).

Korea: Korea has made important progress in implementing necessary economic reforms and stabilizing its external financial situation in the last year, but the government still faces extraordinarily difficult challenges. While a few hopeful signs of economic recovery have emerged, we remain concerned that insufficient progress in corporate restructuring will jeopardize Korea's efforts to restore growth. The five largest *chaebol* appear to be strongly resisting President Kim's calls for them to restructure, thus impeding the bank restructuring process and hindering efforts to deal with issues of over-capacity and over-leverage. Given the disproportionate importance of the *chaebol* in output and exports, it will be difficult for Korea to mount a sustainable recovery in the absence of real restructuring.

Attachment: Multilateral Initiative to Revitalize Private Sector Growth in Asia
Asian Growth and Recovery Facility

draft: 11/12/98; 9:00 am

Multilateral Initiative to Revitalize Private Sector Growth in Asia

As the financial situation of countries in Asia has stabilized somewhat in recent months, the focus of the international community and governments in the region has shifted toward the critical task of speeding the restoration of growth. Essential to this effort is the need to revitalize the private sector in these economies by helping to facilitate work-outs of corporations' heavy debt burdens and restore their access to financing. In conjunction with the World Bank and Asian Development Bank (ADB), we therefore are proposing a multilateral initiative that will help to accelerate the pace of corporate and bank restructuring in the region, mobilize new private sector financing and promote the speedy restoration of growth. This initiative has four ~~five~~ key components:

Accelerating Bank and Corporate Restructuring: Rapid progress in restructuring is critical to the restoration of growth in Asia. Success in this effort requires an integrated and comprehensive approach to bank and corporate restructuring, supported by adequate financing for bank recapitalization and incentives for creditors and debtors to play a constructive role in debt work-outs. While countries in the region have made progress in putting in place frameworks to guide this process, there nonetheless remain significant impediments to necessary restructuring.

- A key element of the strategy to accelerate the pace of bank and corporate restructuring is the establishment of the Asian Growth and Recovery Facility (AGRF), which would be financed in part by the World Bank, the ADB and bilateral support in a variety of forms. The AGRF would utilize innovative financing vehicles to mobilize significant private capital in an effort to assist governments in the region finance bank recapitalization. Support from the AGRF would be provided to countries that need assistance and are implementing integrated and comprehensive frameworks for corporate and bank restructuring.

- *[Japan, the World Bank and ADB together are willing to provide an initial commitment of $5 billion to this facility, which would be expected to mobilize substantial additional amounts of private capital.]*

We are also working together to explore ways in which both debtors and creditors can be encouraged to participate constructively in voluntary debt work-outs. We therefore support the following measures:

- The World Bank and ADB, ~~[and IMF]~~ should work closely with countries in the region in an effort to remove remaining impediments to bank and corporate restructuring. While the necessary changes will differ depending on the specific situation of each country, these measures may include, among others, legal or administrative changes to remove obstacles to restructuring, strengthened arbitration or dispute settlement procedures, accelerated implementation of disclosure and transparency requirements, and strengthened asset disposition strategies. Access to the AGRF would be tied to implementation of this strengthened framework for restructuring.

- We also pledge to review, and where necessary remove, tax, regulatory or legal obstacles that prevent creditor banks in our countries from engaging actively in debt restructuring in Asia.

Trade and Working Capital Finance: While recapitalization of banks is critical to restore functioning financial systems in Asia, companies in the region also face a more immediate lack of working capital and trade finance necessary to maintain production and employment.

- In order to help alleviate this problem, the Export-Import Bank of the United States (US ExIm) and the Japan Export-Import Bank (JEXIM) will substantially increase the size of their trade finance programs for the region.

- We are also asking US Exim, JEXIM and other export credit agencies to work with the multilateral development banks to explore ways to facilitate the provision of badly needed working capital and trade finance to companies in the region.

Mobilizing the Return of Private Sector Capital : Successful restructuring of companies and banks in Asia will also require significant infusions of new private capital to help them rebuild their balance sheets and undertake necessary restructuring of their finances and operations. Institutions such as the International Finance Corporation (IFC) and the United States' Overseas Private Investment Corporation (OPIC) are uniquely positioned to aid this process by providing political risk insurance and establishing investment funds that mobilize substantial additional private sector resources.

[details on IFC/OPIC to be determined].

Technical Assistance: The massive task of restructuring so many insolvent banks and corporations has overwhelmed the institutional capacity of countries in the region. Japan and the United States will expand their existing technical assistance programs in cooperation with the ongoing efforts of the IMF, World Bank and ADB. These programs will help provide countries with the essential financial, legal, and accounting expertise necessary to tackle bank and corporate restructuring and necessary market-based reforms.

Draft 11/12/98; 9:30 am

Asian Growth and Recovery Facility

Objective:
Accelerating the pace of corporate and bank restructuring is critical to restoring growth and revitalizing the private sector in Asia. While governments have made progress in putting in place frameworks to guide this process, there remain significant impediments to necessary restructuring, including the lack of sufficient financing to recapitalize insolvent banks and weak incentives for debtors and creditors. Unless banks are able to recognize the extent of their loan losses and are prepared to participate in workouts, companies will be unable to emerge from their burden of bad debts and new financing will not flow, thus postponing the restoration of economic growth. A strategy to accelerate the pace of restructuring will therefore require the combination of a determined effort to overcome policy and institutional constraints and additional financial resources to underwrite the costs of accelerated implementation.

The proposed Asian Growth and Restructuring Facility (AGRF) would be designed to assist governments in the region finance the cost of bank recapitalization. The resources mobilized by the AGRF will be provided to those countries which implement comprehensive and integrated restructuring frameworks linking bank recapitalization and corporate restructuring. Such assistance would help to limit the extent to which governments are forced to choose between funding budgetary programs designed to alleviate the impact of the crisis on the poor and unemployed and supporting the restructuring of financial institutions and corporations that is necessary to jump start growth, job creation and economic recovery.

2. Participants: The World Bank, the Asian Development Bank, Japan, the United States, and other countries interested in participating in the facility.

3. Purpose of the use of resources mobilized by the AGRF: The AGRF temporarily will assist countries in financing bank recapitalization. It will be considered on country by country basis whether the facility could be used to help mobilize private sector funds to finance the provision of super-priority working capital to companies in restructuring.

4. Menu of Financing Modalities: Financial support for the facility from bilateral and multilateral sources could take a variety of forms (guarantees, loans, purchases of bonds, etc) and would use innovative financing structures to mobilize additional private capital.

- *[Japan, the World Bank and ADB together are willing to provide an initial commitment of $5 billion [$3 billion from Japan and $1 billion each from the World Bank and ADB] to this facility, which would be expected to mobilize substantial additional amounts of private capital.]*

5. Beneficiaries: The AGRF will cover Asian countries that need assistance in financing bank recapitalization and are tackling the restructuring of corporate debt and the operational restructuring and recapitalization of the banking system in an integrated manner in conjunction with World Bank or ADB programs.

6. Policy Framework: The facility could be used to support programs with the following elements:

- Credible strategies for the timely disposition of non-performing assets and any equity that public sector entities acquire as part of the restructuring process.
- Reliable mechanisms for binding resolution and settlement of disputes between creditors and debtors, and the removal of inappropriate legal, regulatory and tax impediments to restructuring.
- Accelerated implementation of strengthened corporate and bank disclosure and transparency requirements, measures to strengthen corporate governance, and improved supervisory and regulatory standards.
- Appropriate burden sharing for equity holders.
- Effective incentives for the timely completion of each step of the financial and operational restructuring process.
- Strengthened social safety net programs to complement accelerated restructuring and mitigate the negative social effects of the crisis, particularly on the poor and unemployed.

TREASURY CLEARANCE SHEET

No. _____
Date _____

MEMORANDUM FOR: ■ SECRETARY ☐ DEPUTY SECRETARY ☐ EXECUTIVE SECRETARY
☐ ACTION ☐ BRIEFING ☐ INFORMATION ☐ LEGISLATION
☐ PRESS RELEASE ☐ PUBLICATION ☐ REGULATION ☐ SPEECH
☐ TESTIMONY ☐ OTHER _____

FROM: Assistant Secretary Timothy Geithner
THROUGH: _____
SUBJECT: Pre-APEC Memo to President Clinton (November 17-22)

REVIEW OFFICES (Check when office clears)

☐ Under Secretary for Finance
☐ Domestic Finance
☐ Economic Policy
☐ Fiscal
☐ FMS
☐ Public Debt

☐ Under Secretary for International Affairs
☐ International Affairs

☐ Enforcement
☐ ATF
☐ Customs
☐ FLETC
☐ Secret Service
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☐ Inspector General
☐ IRS
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☐ Management
☐ OCC

☐ Policy Management
☐ Scheduling
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☐ Treasurer
☐ E & P
☐ Mint
☐ Savings Bonds
☐ Other _____

NAME (Please Type)	INITIAL	DATE	OFFICE	TEL. NO.
INITIATOR(s)				
S. Saeger	SS	11/9/98	INA	622-1041
Carol J. Carnes	CJC	11/3/98	IMI	622-1235
REVIEWERS				
Joseph E. Gagnon	SS for	11/5/97	IMI	622-0138
Dan Zelikow	EZ for	11//97	IN	622-7222
Caroline Atkinson	SS for	~~11/97~~ 11/10	IM	622-0489
Russ Munk/ Ed Knight			GC	
~~*Timothy F. Geithner*~~		11//97	I	622-0656
Ted Truman	EZ for		I	622-1270

SPECIAL INSTRUCTIONS

☐ Review Officer Date ☐ Executive Secretary Date

DO F 80-02.1 (04/89)

- NCC cc to LS (ACTION)
- LS cleared per Sheryl Sandberg (NCC)
- NCC to RER (signature)
- ~~NCC~~ RER signed
- AK original to WH
- NCC cc to RER
  LS
  MF
  SS
  Clay L.
  Karen K.

11/13/98

- Please log and file

1999-SE-000478

DEPARTMENT OF THE TREASURY
Washington

January 14, 1999

TO: SECRETARY RUBIN
DEPUTY SECRETARY SUMMERS

FROM: Timothy Geithner TFG

SUBJECT: IMF Review of Asia Programs

The IMF prepared last year a review of its programs in Asia. They plan to release this study and a summary of the Board discussion on Friday, embargoed for Tuesday.

A reasonable person could conclude from this study that the Fund has acknowledged mistakes of three types:

- that it underestimated the extent of contagion and, therefore, the extent of contraction in GDP;
- that fiscal policy, in the Thai program in particular, was too tight;
- and third, that actions to close banks, particularly Indonesian, may have induced a generalized run on the banking system that conceivable could have been avoided.

Mike Froman and Dan Israel have already talked to you about our proposed public response.

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DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
003. memo	Barry S. Newman (IMF) to Tim Geithner re: Staff Report (1 page)	01/12/99	P1/b(1) Unclass.

This marker identifies the original location of the withdrawn item listed above. For a complete list of items withdrawn from this folder, see the Withdrawal/Redaction Sheet at the front of the folder.

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[History of the Department of the Treasury - Supplementary Documents] [22]

jp2

RESTRICTION CODES

Presidential Records Act - [44 U.S.C. 2204(a)]

P1 National Security Classified Information [(a)(1) of the PRA]
P2 Relating to the appointment to Federal office [(a)(2) of the PRA]
P3 Release would violate a Federal statute [(a)(3) of the PRA]
P4 Release would disclose trade secrets or confidential commercial or financial information [(a)(4) of the PRA]
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RR. Document will be reviewed upon request.

Freedom of Information Act - [5 U.S.C. 552(b)]

b(1) National security classified information [(b)(1) of the FOIA]
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b(7) Release would disclose information compiled for law enforcement purposes [(b)(7) of the FOIA]
b(8) Release would disclose information concerning the regulation of financial institutions [(b)(8) of the FOIA]
b(9) Release would disclose geological or geophysical information concerning wells [(b)(9) of the FOIA]

Withdrawal/Redaction Marker
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DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
004. report	re: Summing Up by the Chairman Fund-Supported Programs in the Asian Crisis Executive Board Meeting, 12/21/98 (IMF document) (6 pages)	12/29/98	P1/b(1) Unclass.

This marker identifies the original location of the withdrawn item listed above. For a complete list of items withdrawn from this folder, see the Withdrawal/Redaction Sheet at the front of the folder.

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1999-SE-002072

THE DEPUTY SECRETARY OF THE TREASURY
WASHINGTON
February 19, 1999

MEMORANDUM FOR SECRETARY RUBIN

FROM: **DEPUTY SECRETARY SUMMERS**

SUBJECT: **PLANS FOR ASIA TRIP**

This is a summary of what I expect to be the main issues I'll be addressing in Asia next week.

Singapore. This brief stop is intended to tap the wisdom of Senior Minister Lee Kwan Yew, Prime Minister Goh, and Finance Minister Hu on regional developments, particularly with respect to Indonesia and Malaysia. I will also be seeking support from Singapore for the President's joint initiative with Prime Minister Obuchi on corporate and financial restructuring.

Indonesia. Here the June parliamentary elections will set the context of my visit, and I will have the chance to speak to the two main opposition candidates, as well as President Habibie, who is likely to be replaced by one of them if the elections are relatively fair. I will be gauging the reform commitments of all of these leaders. The Indonesian economy may be bottoming out right now, but the structural reform effort has stalled during this political season, and it will be important to build confidence for the candidates to commit now to reform. There are also some worrying signs of corruption, nepotism, and ethnicity in economic dealings that need to be raised with the authorities.

China. In the run-up to Premier Zhu's visit to the United States, there is renewed energy on China's part to reach an agreement with us on WTO accession. Our chief USTR negotiator will join me on this leg of the trip. In addition to this, the correct stance for China's macroeconomic policy is an open question for us, so I hope to come to some better understanding of the trade-offs. Heightened capital flight has led the authorities to step up enforcement of exchange controls. This, coupled with the uncertainties associated with the failure of several "Itics", once regarded by some as equivalent to a sovereign obligation, has cast a pall over China in recent months in the eyes of foreign investors and lenders. The local Am-Cham will likely try to draw me in to this problem, which, from our perspective, would not be wise at this point.

Korea. Financial stabilization, credit upgrades, and improving sentiment are now creating a capital inflow problem. This is a high-class problem but one that poses challenges to macroeconomic policy nonetheless. My initial sense is that a slight monetary easing, combined with prepayments to the IMF that would be funded by exchange market intervention, would probably be the right short-term response. You will soon need to take another "certification" decision under the new IMF legislation, so I hope to come up with some judgement about this.

The focus of this judgement will probably be on the quality of financial sector reforms and, in particular, bringing the state banks such as the KDB in to the same regulatory and policy structure as the private commercial banks. I will be giving a speech in Korea, which will highlight President Kim's (and other Asian reformers') impressive accomplishments to date but caution against inertia now if a return to the "old Korea" is to be avoided.

Japan. I finish off the trip in Japan, where I'll be emphasizing the messages you sent in your press conference last week, both in a public speech and in my meetings. The Japanese will also host a short meeting of the "Six Markets", where we expect to discuss current financial and economic conditions in the region (and, I imagine, elsewhere), architecture issues, and progress in implementing the President's and PM Obuchi's Asian Growth and Recovery Initiative mentioned earlier. On architecture, you should know that there has been a move by foreign ministries, especially China's, Malaysia's, and Japan's, to create an ASEAN+3 group on financial issues, which would exclude us. Although a meeting is likely to happen, we detect a lack of enthusiasm on the part of finance ministries, so that I'm not inclined to raise a big fuss about it, at least on this trip.

cc: Geithner and Truman

1999-SE-002192

THE DEPUTY SECRETARY OF THE TREASURY
WASHINGTON

March 2, 1999

MEMORANDUM FOR THE PRESIDENT

FROM: Lawrence H. Summers LHS

THROUGH: Robert E. Rubin R.E.R.

SUBJECT: Report on my trip to Asia, February 20-27, 1999

Following the rather gloomy G-7 meeting in Bonn, I spent last week in Asia, accompanied by Ken Lieberthal of the NSC, discussing financial and economic issues in Singapore, Indonesia, China, Korea and Japan. Here are my main impressions.

General Observations:

- anxiety in the region is still highly focused on the risk of another spiral of competitive devaluations emanating from Japan and China. Another generalized concern relates to the slowing of the United States and European locomotives and a rise in protectionism.

- it is now impossible to generalize across the crisis economies and there are growing differences in performance, with Korea and Thailand doing well and problems of a profound -- and varying -- sort in Indonesia, China and Japan.

- there is enormous interest in being involved in discussions of the international financial architecture and concern about the management of capital flows -- tempered by the recognition that the current problem is to attract capital, not to repel excessive inflows.

- our social safety net ideas need clarification in the context of a crisis in which the middle class, rather than the poorest, have been the main losers. As ever, macroeconomic stability -- the absence of inflation -- will have the broadest social impact. Where a more targeted approach is favored, we and the World Bank need to address the risk of politicization.

Singapore/Indonesia

The Singaporeans (Prime Minister Goh and Senior Minister Lee Kuan Yew) are very nervous because they are: (i) very pessimistic about Indonesia's political evolution, (ii) expect major problems in China including a devaluation, and (iii) are worried about the global economy. They are eager for more G-22 activity.

The Indonesian economy has roughly stabilized, with output about 15% below 1997 levels and major banking problems. While the technical side of economic policy has been well run in recent months, everyone agrees that real economic progress is not possible without political

stability that reassures business in general and Chinese businessmen in particular. Indonesian politics appear very bleak ahead of the June Parliamentary election and the selection of president by an expanded parliament in the fall. All of the potential leaders have serious shortcomings: either weak (Habibie), inexperienced (Megawati) or misinformed (Amien Rais). And none of the likely scenarios are expected to involve much national cohesion or reassurance to the Chinese large and small businessmen who are now rightly paranoid. For their part the Singaporeans wanted the West to hold back assistance until the political situation clarifies, in the belief that anything else would waste money and leave less available for influencing things later.

Assuring adequate international election inspection is an obvious priority. Managing international financial support for safety nets will involve a careful balance between assuring that minimum needs are met, and not providing too much walking around money for President Habibie to manipulate electoral results.

China

There was a sense of apprehension everywhere; one Western financier referred to a "Last Days of Rome" feeling. Part of the concern seemed to be political -- with China approaching the Tenth Anniversary of Tiananmen, among other sensitive dates -- but much seemed to be financial. Chinese officials, notably Premier Zhu, were far more subdued and less confident than on my visit a year ago.

Zhu and other officials affirmed an unchanged exchange rate policy but were far from Churchillian in their rhetoric. In this context explicit reference was made to the importance of the yen for China and the potential impact of further yen decline. Prices appear now to actually be falling in China, suggesting considerable deflationary pressure.

There are signs of financial strain elsewhere. State banks are probably underwater by a total of 25% of GDP and going deeper as state-owned enterprise problems fester. (The United States' S & L crisis was closer to 2% of GDP.) Foreign banks, especially Japanese, are cutting credit lines to China in the wake of the municipal government's failure, in spite of comfort assurances, to guarantee that creditors of the financially-troubled Guangdong International Trust and Investment Corporation (GITIC) get repaid. Capital flight appears to be significant and increasing.

The government will continue to need the 7-8% of GDP in social expenditure that is now funded, in effect, by the banks via their lending to the debts of the state-owned enterprises. China probably needs to double its current very low -- 12 percent of GDP -- tax revenue base to put state finances on sound footing. How they achieve this is a major long-term concern.

It is not clear what will happen. The problems are enormous but Chinese officials have technical skill, considerable national unity and $145 billion in reserves at their disposal.

Zhu did make reasonably positive noises on WTO suggesting he was motivated and understood the case for speed but it is not clear how far the Chinese can go.

Korea

Korea is predominantly a story of happy recovery. It has returned to investment grade and has $51 billion in reserves compared to $4 billion a year ago and $30 billion before the crisis. Interest rates are at 6%. The currency is strong. Industrial production is hovering at pre-crisis levels. And growth in calendar 1999 is predicted to be in the 4% range. Foreign investment is flooding into the country.

We encountered considerable gratitude towards the United States for its support -- and even towards the IMF for encouraging what many, including the President, Kim Dae Jung, have seen as necessary structural reforms.

But having made a great recovery from an economic heart attack, the challenge now will be developing an economic lifestyle that will prevent recurrence. There has been some progress but there is a danger that the rapid restoration of confidence will induce complacency, and undermine Kim's authority pressing trade unionists and the *chaebol* for deeper reform. The influence of the IFIs could also wane with Korea's reduced need for official support.

With recovery, commercial issues will again come to the fore. The IMF appears to have had considerable success in reducing subsidies, directed lending and excess capacity. The President has made strong commitment to reduce debt ratios in major chaebols from well above 300% to below 200% next year.

Japan

"The more things don't change -- the more they stay the same." The general expectation is that the economy will shrink this year, with no clear growth story for the year after that. In fact, some Japanese experts now estimate Japan's potential annual growth rate at close to zero, with the labor force very soon due to start shrinking by nearly ½% or more per year.

The good news is that, thanks in part to your pressure, banking reform has been carried out somewhat more energetically than most observers expected. The "Japan premium" reflecting concern about Japanese banks' solvency in the inter-bank market has fallen sharply. And the risk of bank runs is way down.

With the budget deficit, by some measures, close to 10% of GDP, the room for fiscal stimulus is limited. There is much discussion of reflating the economy by expanding the money stock.. But with short term interest rates already at or below one tenth of a percent, it is not clear how much difference this will make.

There is still amazingly little sense of crisis in Japan -- despite unemployment rates that are likely to rise considerably going forward.

The difficult issue for us will be insisting that Japanese growth be led by domestic demand, and not by more competitive exports.

Conclusions

Since your speech to the Council on Foreign Relations last fall and the G-7 declaration on the need to emphasize growth, forecasts of growth have been marked down almost everywhere except for the United States. (Korea and Thailand are other exceptions.) While financial strains are easing, it will continue to be crucial to find ways of pushing for more growth-oriented policies in Japan and Europe, and to keep supporting the re-emergence of emerging markets. The world economy cannot fly on a single American engine.

We will keep in close touch with you as we move towards the IMF/World Bank meetings in the Spring and the G-7 Summit in Cologne.

D. Fisher to PA/NCC 3/2/99

MF ok to autopen

PA autopenned

PA original to WH

PA cc MF
SS
NC/DL/PA/AK
D. Fisher

Please log in.

1999-SE-004353

not in Asia

DEPARTMENT OF THE TREASURY
WASHINGTON

UNDER SECRETARY

April 29, 1999

TO: **DEPUTY SECRETARY SUMMERS**

FROM: Timothy Geithner ABG/
Under Secretary for International Affairs

SUBJECT: Malaysia/Asian Comparisons

Attached is an interesting set of data describing Malaysia's economic performance relative to other Asian countries. Note, in particular, that:

- Since the imposition of capital controls in September, Malaysia's real exchange rate has slipped slightly while other Asian currencies have strengthened. This has helped Malaysia's relative competitiveness.

- Since the imposition of capital controls, Malaysia's interbank interest rates have fallen, but not significantly more than rates have fallen in other Asian countries, except Indonesia. Thus, it does not appear that capital controls have allowed Malaysia to ease monetary policy more rapidly.

Department
of the Treasury
Office of the
Assistant Secretary
for International Affairs
Office of East Asian Nations

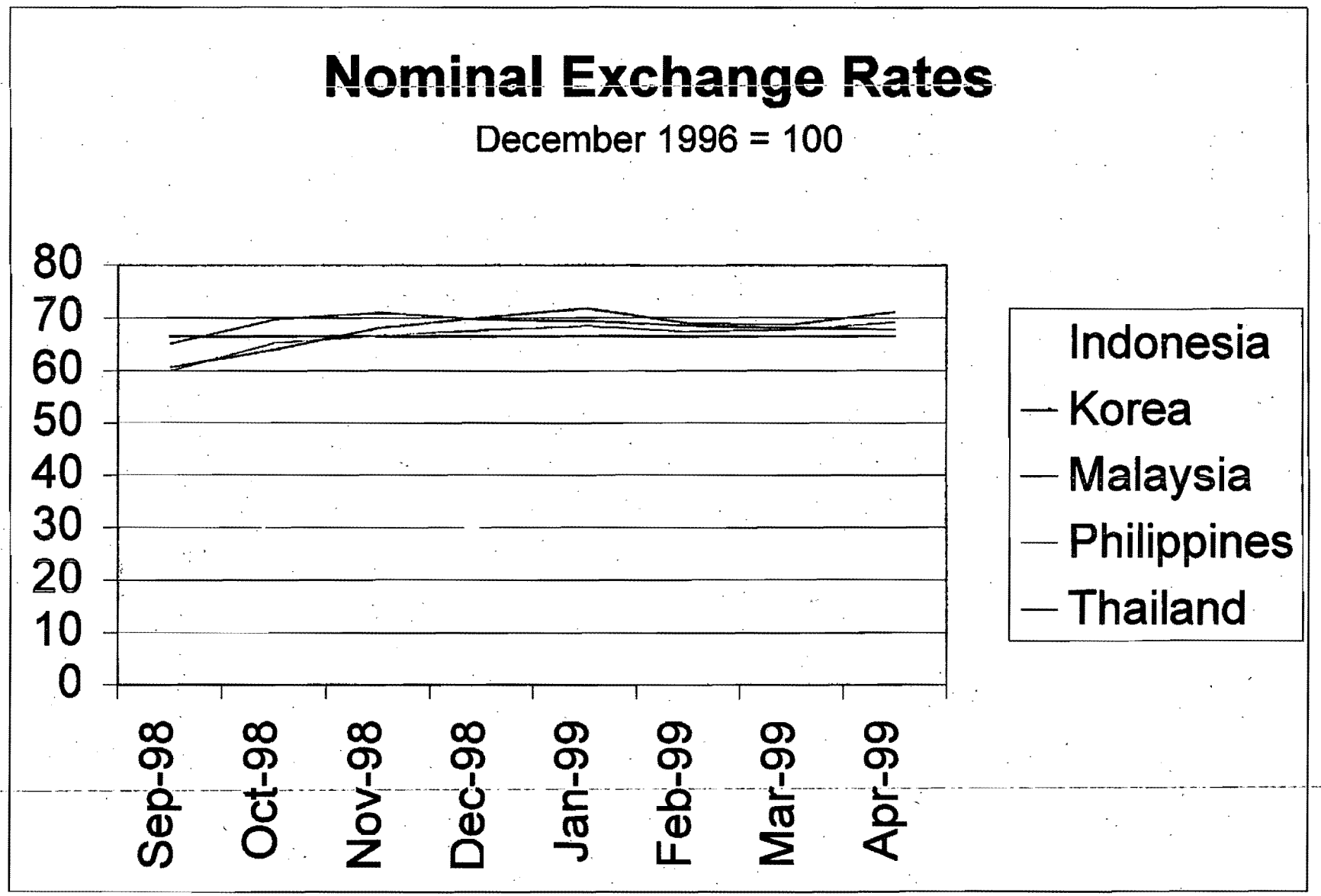
To: Tim Geithner

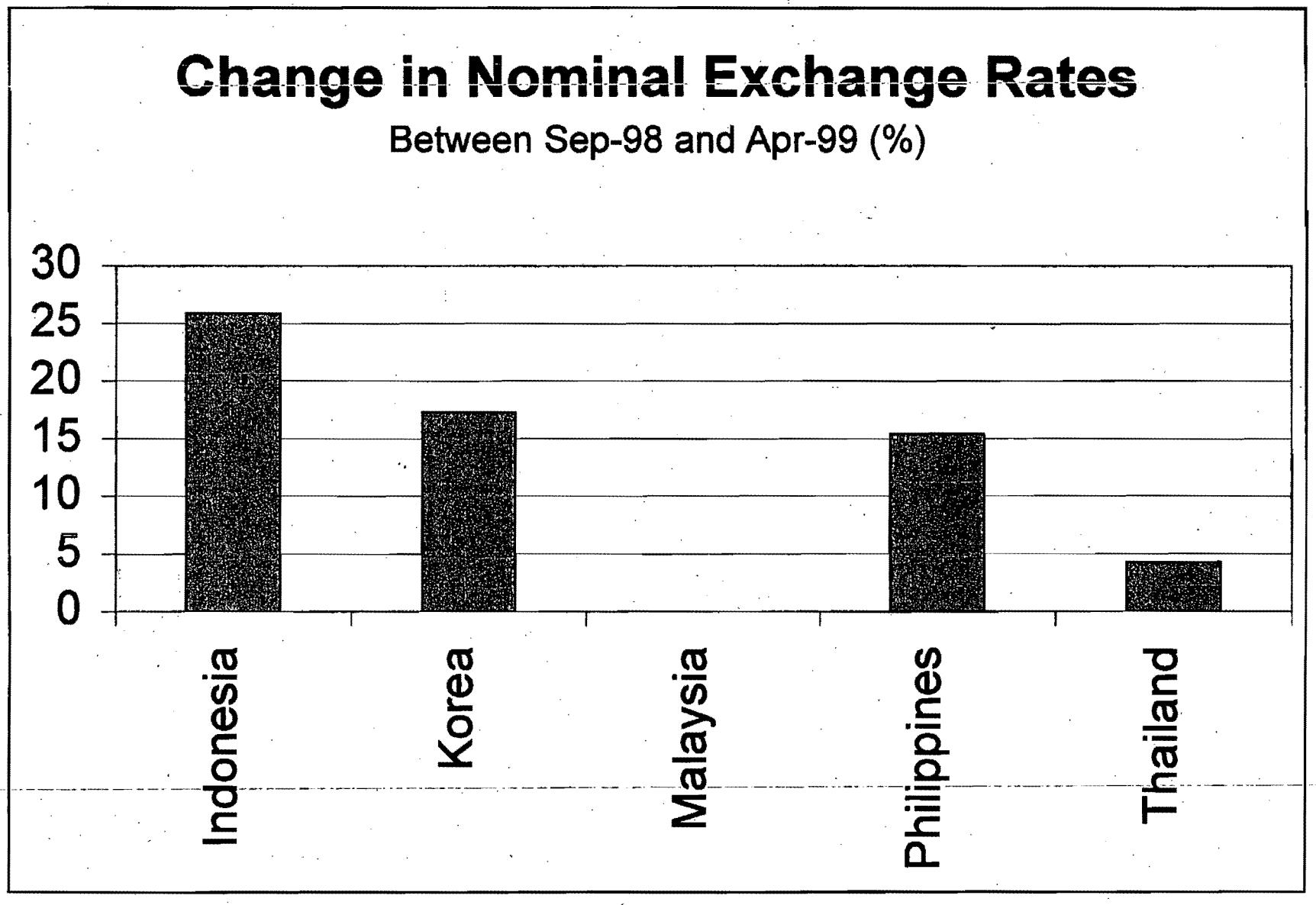
Room:_____ **Date:** 4/29/99

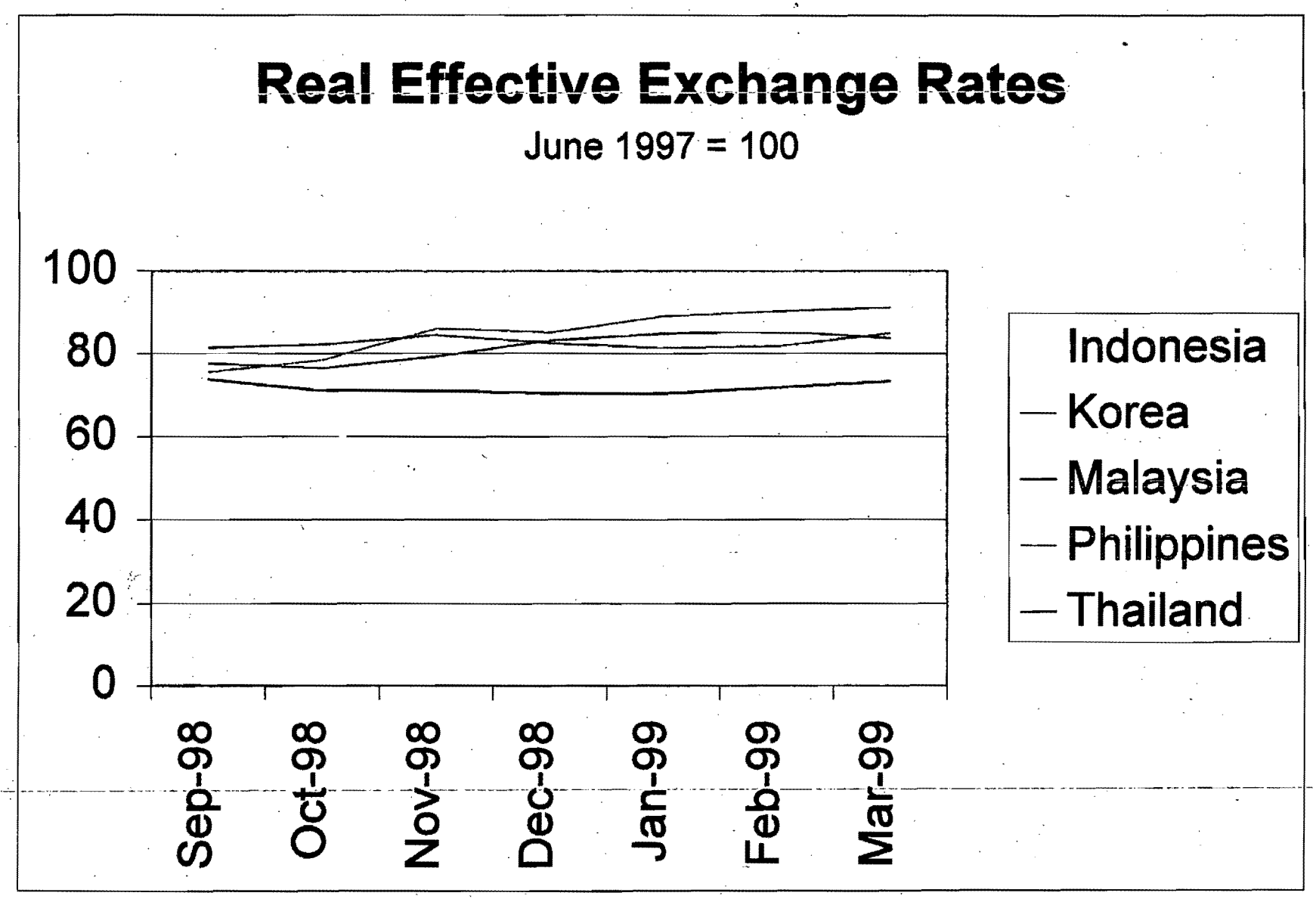
Subject: Asia financial data

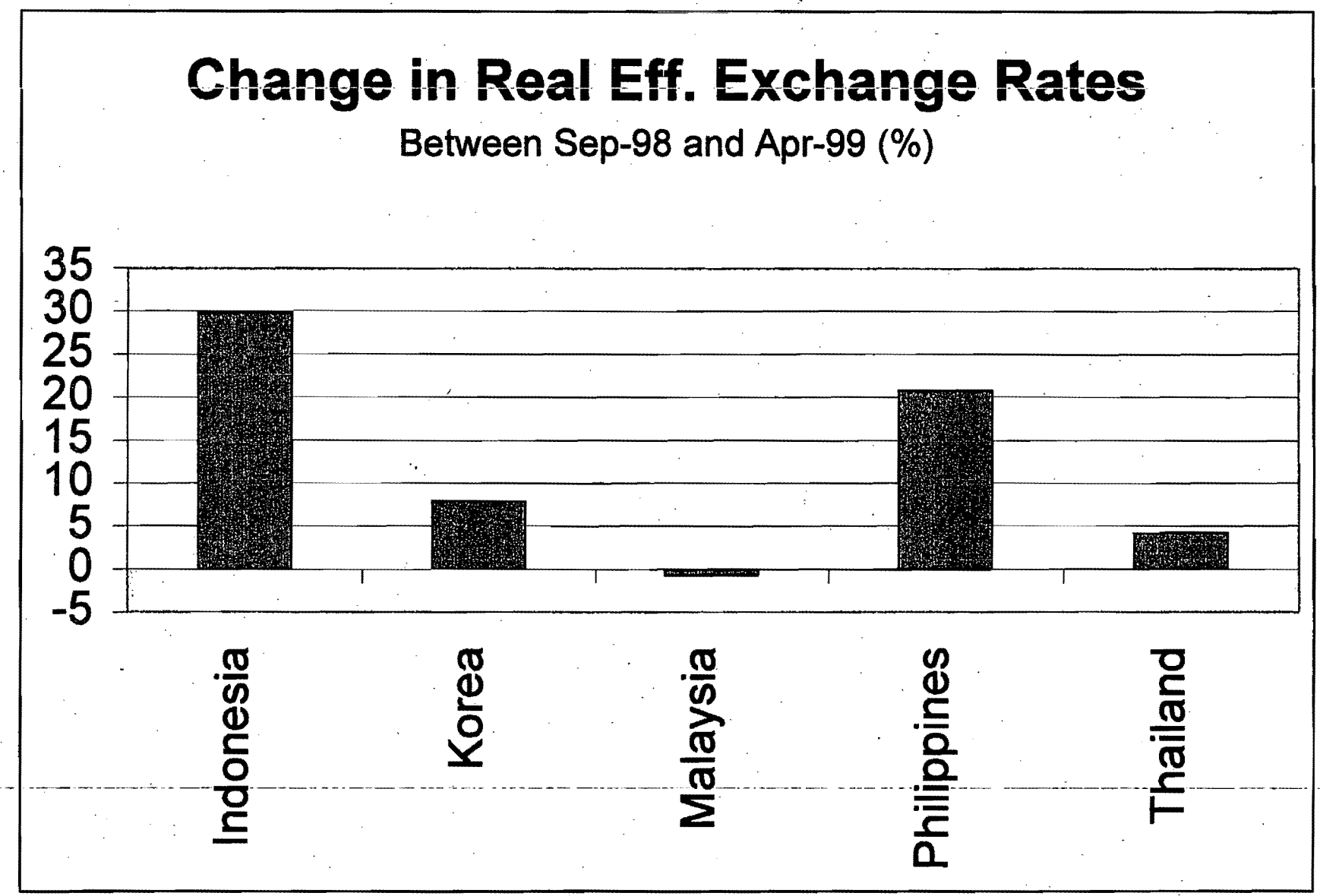
Per your request.

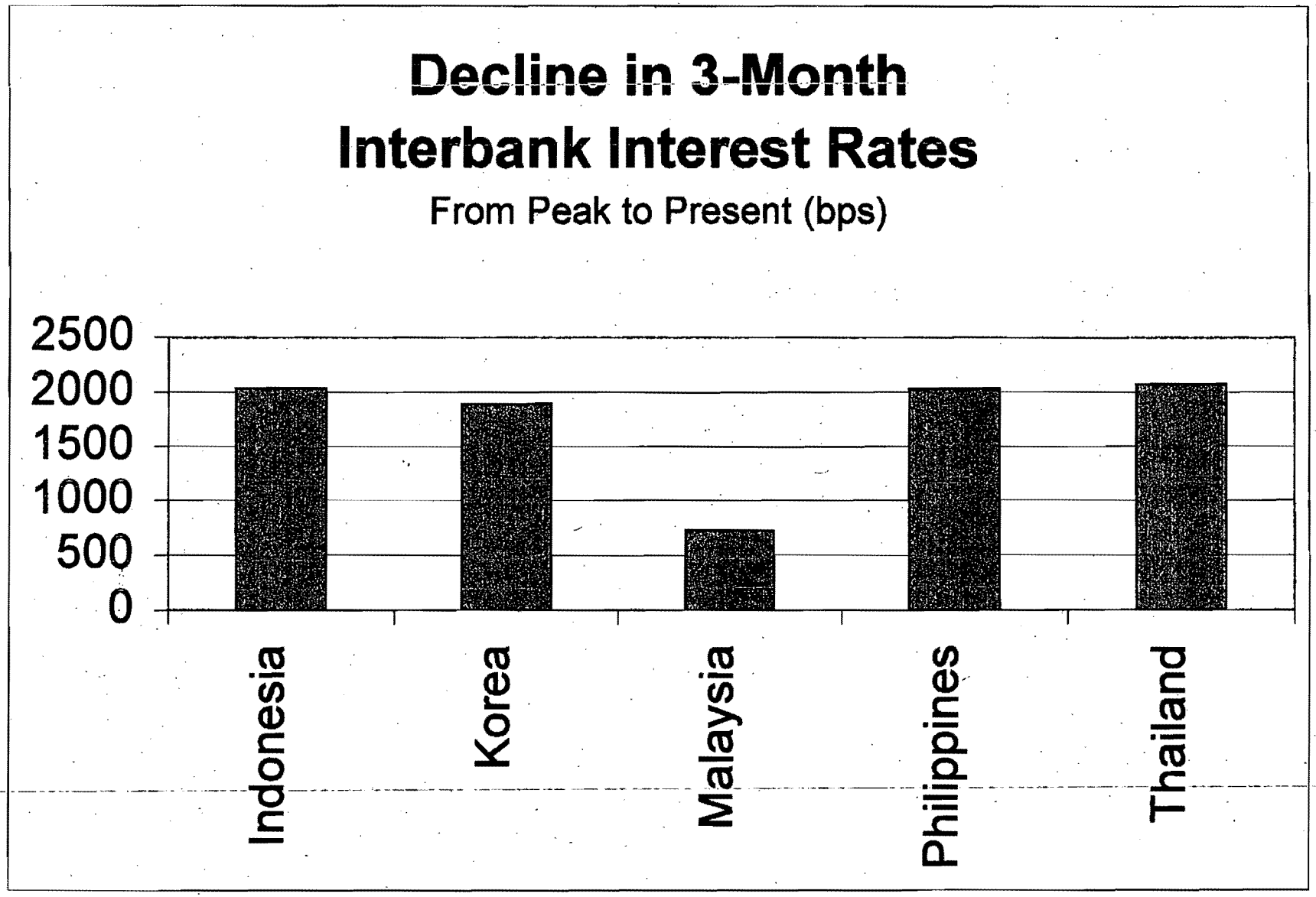
Chi Yin
Room 1440 NY - 4414
Tel: 622-0603
Fax: 622-0349


Nominal Exchange Rates
December 1996 = 100
80
70
60
50
40
30
20
10
0
Sep-98
Oct-98
Nov-98
Dec-98
Jan-99
Feb-99
Mar-99
Apr-99
Indonesia
Korea
Malaysia
Philippines
Thailand

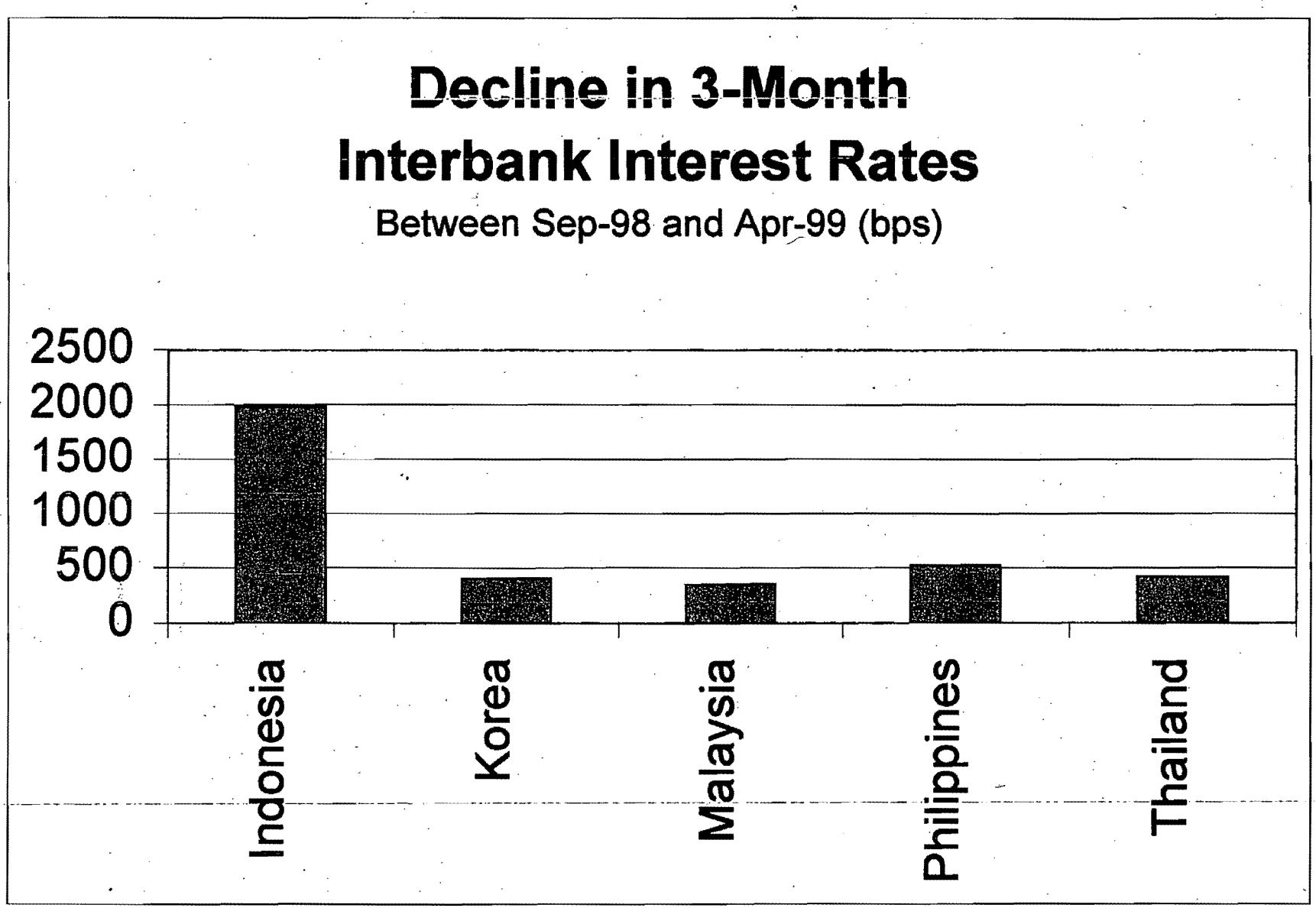

Change in Nominal Exchange Rates
Between Sep-98 and Apr-99 (%)
30
25
20
15
10
5
0
Indonesia
Korea
Malaysia
Philippines
Thailand


Real Effective Exchange Rates
June 1997 = 100
100
80
60
40
20
0
Sep-98
Oct-98
Nov-98
Dec-98
Jan-99
Feb-99
Mar-99
Indonesia
Korea
Malaysia
Philippines
Thailand


Change in Real Eff. Exchange Rates
Between Sep-98 and Apr-99 (%)
35
30
25
20
15
10
5
0
-5
Indonesia
Korea
Malaysia
Philippines
Thailand



Peak: Indonesia (8/98), Korea (12/97), Malaysia (6/98), Philippines (12/97), Thailand (12/97)


Decline in 3-Month
Interbank Interest Rates
Between Sep-98 and Apr-99 (bps)
2500
2000
1500
1000
500
0
Indonesia
Korea
Malaysia
Philippines
Thailand

1999-SE-006448

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

June 14, 1999

ASSISTANT SECRETARY

INFORMATION

MEMORANDUM FOR SECRETARY RUBIN

FROM: Edwin M. Truman
Assistant Secretary (International Afffairs)

SUBJECT: Lessons of the Asia Crisis

Attached is a package of materials prepared by OASIA for a briefing for Deputy Secretary Summers on June 7. Discussion at the meeting focused on two questions:

- Given that Asian countries generally had low government debts and a history of fiscal prudence, would it not have been better to use fiscal policy aggressively to minimize the decline in output below potential?

- In the face of the inflationary shock of massive depreciations, would it not have been better for monetary policy to tolerate a large temporary increase in inflation and in the growth rate of nominal GDP rather than to minimize the increase in inflation and allow nominal GDP growth to slow?

There was general agreement that more expansionary fiscal policy would have been appropriate in the Asian crisis, because fiscal sustainability was not an issue for these countries, even taking into consideration the cost of bank restructuring. However, there was some concern over the ability of countries to finance a large fiscal expansion without threatening the credibility of a country's overall macro policy framework. It may be appropriate in the future to consider including additional financing to provide a fiscal stimulus in IMF/World Bank programs from the start–but only for countries with a record of fiscal prudence.

On monetary policy, the group felt that the initial focus of programs on regaining exchange rate stability through tighter monetary policy was justifiable. Indonesia is an example of a country that did not consistently apply tighter policy in the early stages of the crisis, and it paid the price in tremendous inflation and instability. The group agreed that it is difficult to know how tight is tight enough (or too tight) because there is no single measure of monetary policy that is appropriate for all circumstances and the objective of monetary policy once a crisis has broken should not be to fix the exchange rate at a particular value. The best way to enable policy to ease quickly over time is to appoint a central bank governor with market credibility.

Attachment: Briefing for the June 7 meeting

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

ASSISTANT SECRETARY

BRIEFING

MEMORANDUM FOR DEPUTY SECRETARY SUMMERS

FROM: JB for Edwin M. Truman
Assistant Secretary (International Afffairs)

SUBJECT: Meeting on Lessons of the Asia Crisis

Attached are materials for an interagency meeting on lessons of the Asia Crisis scheduled for June 7 at 11:00 am in the large conference room. The purpose of the meeting is to assess the appropriateness of IMF monetary and fiscal policy advice, as well as the effects of the actual monetary and fiscal policies that were adopted by crisis-affected countries, in order to improve our responses to future crises.

cc: Under Secretary Geithner, David Lipton, Karen Johnson, Robert Lawrence, Nouriel Roubini, SDAS Atkinson

Attachments:
- Tab 1 *Questions for Discussion*
- Tab 2 *Key Points on IMF Macroeconomic Policy Prescriptions for Asia*
- Tab 3 *Charts of Crisis-Country Data*
- Tab 4 *Background on Korea*
- Tab 5 *Background on Thailand*
- Tab 6 *Background on Indonesia*
- Tab 7 *Background on Malaysia*

QUESTIONS FOR DISCUSSION

- What are the appropriate objectives of policy in response to a crisis and how should policy levers be matched to objectives? What are the appropriate indicators of policy stance on which to focus?

- Were monetary and fiscal policy recommendations at the beginning of the crisis overly restrictive? Was the IMF too optimistic in its initial forecast of economic activity? What role did the affected governments play in determining the forecasts and what role should they play?

- Did the IMF adapt quickly enough to changing developments? Should programs be designed to be more flexibly implemented? How can fiscal policy, in particular, be used more flexibly in response to changing economic information?

- In what ways were the Asia crisis countries similar to each other (and to Mexico)? In what ways did they differ?

- Why did crisis-led devaluations appear to be contractionary in Asia, whereas they have often been expansionary elsewhere?

KEY POINTS ON IMF MACROECONOMIC POLICY PRESCRIPTIONS FOR ASIA

- **The IMF's monetary advice to raise short-term interest rates was justified in light of the loss of reserves, risk of external default, and fears of inflation that characterized the crisis-affected countries.** The initial magnitude of the interest rate increase was reasonable under the circumstances and compared to other examples of external crises. Despite the existence of notional targets for monetary aggregates, these targets received very little emphasis in almost every case.

  - The initial reticence of some of the crisis countries to follow the IMF's monetary advice appears to have worsened the currency collapse and may have made the subsequent stabilization more difficult than otherwise.

  - Currency stabilization through high interest rates helped to avoid a potentially traumatic default on foreign-currency debt; however, it exacerbated difficulties associated with high levels of private domestic-currency debt in some countries.

  - Inflation rates rose quickly in every country. The experience of Indonesia demonstrates the dangers of not tightening monetary policy aggressively at an early stage. In the other crisis countries the rise in inflation was reversed faster than expected, but this is due in part to declining world commodity prices and faster exchange rate recoveries than initially expected.

- **The IMF's initial advice to tighten fiscal policy was based on an overly optimistic projection of the effects of the crisis on real activity.** A more realistic assessment of the evolution of private domestic demand in the crisis countries would have justified a recommendation of significant fiscal easing rather than tightening. Political pressure from the affected governments was partially responsible for the adoption of overly optimistic forecasts.

  - The example of Mexico in 1995 showed that a similar loss of confidence, exchange rate devaluation, and higher real interest rates led to a sharp drop in private domestic demand of the same magnitude as the final outcome for Thailand and Korea.

  - Most of the Asian crisis countries had low public-sector debts and a history of fiscal rectitude, thereby mitigating concerns about the credibility of future fiscal policy, which may have been more important in the case of Mexico.

  - While easier fiscal policy might have mitigated some of the decline in output, it is not realistic to expect that declines in output could have been avoided entirely given the extent of overinvestment in a number of private sectors.

- **Both monetary and fiscal policy were eased substantially over time, as exchange rates strengthened and the size of the economic contraction became more apparent.**

It is arguable that this easing should have occurred more rapidly (and we have argued that fiscal policy should have been easier from the start) but given the tremendous uncertainties at the time and the lags in obtaining data on real activity, it may be unreasonable to have expected a faster adjustment of the IMF's policy advice than actually occurred.

- In every case, the IMF reversed its advice from fiscal tightening to fiscal easing within the first six to nine months of the program. Moreover it is impossible for governments to reverse course on fiscal policy as quickly as on monetary policy–in some cases it took around six months after the decision to ease fiscal policy before spending measures began to provide an effective stimulus.

- In recent months, the IMF has focused on tax rates as an aspect of fiscal policy that can adapt more quickly to changing economic conditions. Perhaps future programs could build in from the beginning greater fiscal flexibility through the tax system.

- Thailand was the first country affected by the crisis, and the IMF was slowest in revising its policy advice in this case. Thailand's was the case closest to the classic balance of payments crisis with a very large current account deficit and a small, but growing, fiscal deficit prior to the crisis.

- Korea was the most responsive to IMF advice and it has experienced a somewhat more rapid turnaround, although it also suffered from initially tight fiscal policy.

- Indonesia did not follow the IMF's monetary advice initially, and it paid a large price in runaway inflation. Social unrest subsequently contributed to the most extreme decline in real output of the crisis-affected countries.

- Malaysia benefitted from the lowest exposure to short-term foreign-currency debt and relatively healthier financial and corporate sectors. It was probably correct in ignoring the IMF's advice to tighten monetary policy, as exchange rate depreciation imposed lower costs on Malaysia than on the other countries. Capital controls do not appear to have played a significant role in improving Malaysia's macroeconomic outcomes, and they may have a long-term cost in discouraging foreign investment.

- **Perhaps the most important question for further analysis is why exchange rate devaluation after currency crises led to an economic contraction in these countries,** whereas in other circumstances (e.g., the ERM crisis of 1992) devaluation led to economic expansion. **One factor that appears to be especially important in this regard is the burden of foreign-currency debt,** which becomes more onerous with devaluation. Another element may be the inability to quickly take advantage of increased export competitiveness, possibly due to difficulty in obtaining trade finance.

Korea

Table 1: Evolution of IMF Monetary and Fiscal Targets

	1997	1998				1999		
	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep
NDA (Won Billion)								
SBA Request, 12/3/97	10950							
2nd Biweekly Review, 1/7/98	26571	12386						
1st Quarterly Review, 2/13/98		17875	6745					
2nd Quarterly Review, 5/19/98		21630	4080	5180	-5170			
3rd Quarterly Review, 8/14/98				2480	-7770			
4th Quarterly Review, 11/30/98					-7770	-17341		
5th Quarterly Review, 3/18/99							-25787	-28713
Actual	**26432**	**6241**	**-8210**	**-11063**	**-19857**			
NIR ($ Billion)								
SBA Request, 12/3/97	11.2							
2nd Biweekly Review, 1/7/98	-3.0	8.1						
1st Quarterly Review, 2/13/98		3.8	11.9					
2nd Quarterly Review, 5/19/98		1.3	13.9	15.0	23.7			
3rd Quarterly Review, 8/14/98				15.0	23.7			
4th Quarterly Review, 11/30/98					23.7	31.8		
5th Quarterly Review, 3/18/99							40.3	43.7
Actual	**-3.0**	**8.2**	**18.7**	**24.4**	**31.2**			
Reserve Money (Won Billion)								
SBA Request, 12/3/97	23270							
2nd Biweekly Review, 1/7/98		23523						
1st Quarterly Review, 2/13/98		23580	24000					
2nd Quarterly Review, 5/19/98		23580	23540	25430	25640			
3rd Quarterly Review, 8/14/98				25430	25640			
4th Quarterly Review, 11/30/98						23999		
5th Quarterly Review, 3/18/99								
Actual	**22519**	**22035**	**20798**	**22026**	**20700**			
Govt. Balance (Won Billion)								
SBA Request, 12/3/97	-2000							
2nd Biweekly Review, 1/7/98								
1st Quarterly Review, 2/13/98		-3000	-3300					
2nd Quarterly Review, 5/19/98		-3000	-6000	-7000	-7800			
3rd Quarterly Review, 8/14/98				-10000	-17500			
4th Quarterly Review, 11/30/98					-21300	-5000		
5th Quarterly Review, 3/18/99						-7154	-12895	-18625
Actual	**1163**	**2167**	**505**	**-5743**	**-16352**			

Note: Actual outcomes in bold.

Initial targets for NDA and NIR do not take into account adjustors (i.e. degree to which BOK deposits at overseas branches and subsidiaries of domestic financial institutions are above or below baseline projections)

Korea

Table 2: Evolution of IMF and Consensus Forecasts

	For 1998							For 1999	
	12/97	1/98	2/98	5/98	8/98	11/98	Actual	11/98	3/99
Real GDP Growth (%)									
IMF	2.5	1.2	1.0	-1 to -2	-5.0	-7.0	-5.8	-1.0	2.0
Consensus Projections	1.8	-0.1	-0.2	-1.9	-4.7	-6.7		-0.3	2.3
Avg. CPI Inflation (%)									
IMF	5.0	8.5	9.5	10.5	8.5	7.8	7.5	3.8	1.8
Consensus Projections	5.1	8.9	9.8	9.8	8.6	7.8		4.9	2.8
GDP Deflator (%)									
IMF	4.1	5.6	6.3	7.8	6.1	8.3	8.8		
CA Balance ($ Billion)									
IMF	-2.3	3.0	8.0	23.1	35.0	39.5	40.5	22.0	26.1
Consensus Projections	-4.6	1.1	2.7	22.0	31.1	37.5		25.8	25.7
Overall Govt. Balance									
IMF (% of GDP)	0.2	-1.5	-1.5	-1.7	-4.1	-5.0	-3.8	-5.1	-5.1
IMF (Won Trillion)	0.8	n.a.	-7.0	-7.8	-17.5	-21.3	-16.4	-22.1	-22.7

Thailand

Table 1: Evolution of IMF Monetary and Fiscal Targets

	1997		1998				1999		
	Aug	Nov	Feb	May	Aug	Dec	Mar	Jun	Sep
NDA (Baht Billions)									
SBA Request, 8/14/97	-525	-507	-503	-525	-520				
1st Review, 11/24/97*		-133	64	74	110				
2nd Review, 2/18/98		**-166**	34	31	51				
3rd Review, 5/26/98			**-144**	-17	-2	30			
4th Review, 8/25/98				**-96**	2	52			
5th Review, 12/1/98					**-89**	-16	-28		
6th Review, 3/23/99						**-118**	-46	-32	-28
NIR ($ Millions)									
SBA Request, 8/14/97	1,300	500	8,300	11,200	11,300				
1st Review, 11/24/97	**5,761**	3,400	3,900	5,500	7,200				
2nd Review, 2/18/98		**5,761**	3,900	5,500	7,200				
3rd Review, 5/26/98			**8,592**	8,800	10,500	12,500			
4th Review, 8/25/98				**11,432**	10,500	11,500			
5th Review, 12/1/98					**14,122**	14,000	15,500		
6th Review, 3/23/99						**18,489**	15,500	19,500	20,000
Reserve Money (Baht billions)									
SBA Request, 8/14/97	456	489	499	489	502	543			
1st Review, 11/24/97	**422**	489	499	489	502				
2nd Review, 2/18/98		**455**	480	464	469				
3rd Review, 5/26/98			**451**	468	471	505			
4th Review, 8/25/98				**445**	460	495			
5th Review, 12/1/98					**445**	485	490		
6th Review, 3/23/99						**470**	480	477	477
Govt. Balance (Baht billions)									
SBA Request, 8/14/97	-52.8	-34	-30.4	41.3	69.8				
1st Review, 11/24/97	**-31.1**	-37	-33	38	69.8				
2nd Review, 2/18/98		**-26.8**	-61.7	-46.6	-50.4				
3rd Review, 5/26/98			**-27**	-70	-117				
4th Review, 8/25/98				**-20**	-117	-53			
5th Review, 12/1/98					**-115**	-63	-85		
6th Review, 3/23/99						**-31**	-85	-90	-100

Note: Actual outcomes in bold.

*As of the 1st review, the definition of NDA was changed to clarify consistency between monetary and external targets. NDA is thus now defined as the difference between reserve money and net foreign assets valued in baht.

Thailand

Table 2: Evolution of IMF and Consensus Forecasts

IMF/CF Projections	For 1998							For 1999	
	Aug/97	Nov/97	Feb/98	May/98	Aug/98	Dec/98	Actual	Dec/98	Mar/99
Real GDP Growth (%)									
IMF	3.5	0.0	-3.0	-4.0	-7.0	-8.0	-8.0	1.0	1.0
Consensus Projections	2.3	1.2	-3.5	-4.1	-7.9	-8.0		0.1	0.5
Avg. CPI Inflation (%)									
IMF	8.0	10.0	11.6	10.5	9.2	8.0	8.1	2.5	2.5
Consensus Projections	7.8	9.5	11.6	11.7	10.1	8.2		4.0	2.6
CA Balance ($ Billions)									
IMF	-5.3	-2.5	4.4	8.5	11.5	13.5	14.3	11.0	12.0
Consensus Projections	-7.0	-4.8	6.1	8.3	13.8	12.5		11.1	11.1
*Overall Govt. Balance**									
IMF (% of GDP)	1.0	1.0	-2.0	-5.8	-6.2	-5.9	-5.3	-8.2	-8.2
IMF ($ Billions)	1.2	1.2	-2.4	-7.0	-7.4	-7.1	-6.4	-12.7	-12.7

Indonesia
Table 1: Evolution of IMF Monetary and Fiscal Targets

	1997 Dec	1998 Mar	1998 Jun	1998 Sep	1998 Dec	1999 Mar	1999 Jun	1999 Sep
NDA (Rupiah Trillion)								
SBA Request, 11/1/97								
1st Review, 4/10/98		-30.5	-29.4	-27.3	-30.7	-39.5		
2nd Review, 6/24/98		**-70.0**	-67.7	-66.6	-54.7	-44.2		
3rd Review, 7/29/98				-67.5	-50.9	-54.3		
EFF Request, 8/11/98								
1st Review, 9/17/98			**-72.5**					
2nd Review, 10/19/98				**-70.1**	-50.9			
3rd Review, 11/13/98					-50.9	-53.2		
4th Review, 3/16/99					**-67.0**	-32.8	-27.2	-20.3
5th Review, 5/20/99						**-79.2**	-45.0	-32.9
NIR ($ Billion)								
SBA Request, 11/1/97	17.4	16.0	14.0	12.5				
1st Review, 4/10/98	**17.6**		13.1	12.9	13.4	14.6		
2nd Review, 6/24/98		**13.2**	13.6	13.6	12.9	12.2		
3rd Review, 7/29/98				13.7	12.5	13.2		
EFF Request, 8/11/98								
1st Review, 9/17/98			**14.4**					
2nd Review, 10/19/98				**14.0**	12.5			
3rd Review, 11/13/98					12.5	13.0		
4th Review, 3/16/99					**14.2**	14.3	13.8	13.3
5th Review, 5/20/99						**15.7**	16.2	15.0
Base Money (Rupiah Trillion)								
SBA Request, 11/1/97	42.7	42.7	44.2	45.7				
1st Review, 4/10/98	**46.7**		62.2	62.9	63.0	62.6		
2nd Review, 6/24/98		**61.8**	68.6	69.7	74.3	77.6		
3rd Review, 7/29/98				69.7	74.3	77.6		
EFF Request, 8/11/98								
1st Review, 9/17/98			**71.7**					
2nd Review, 10/19/98				**69.9**	74.3			
3rd Review, 11/13/98					74.3	76.5		
4th Review, 3/16/99					**74.6**	74.5	76.3	79.4
5th Review, 5/20/99						**77.5**	76.3	79.4
Govt. Balance (Rupiah Trillion)								
SBA Request, 11/1/97	7.6	3.5	2.1	3.0				
1st Review, 4/10/98	**8.4**	-5.5	-13.0	-25.8	-30.3	-36.5		
2nd Review, 6/24/98		**2.7**	-1.0	-30.0	-51.0	-81.3		
3rd Review, 7/29/98				-30.0	-51.0	-81.3		
EFF Request, 8/11/98								
1st Review, 9/17/98								
2nd Review, 10/19/98					-51.0			
3rd Review, 11/13/98					-51.0	-72.7		
4th Review, 3/16/99				**-1.6**	**-8.0**		-16.7	-35.2
5th Review, 5/20/99						**-21.1**	-16.7	-35.2

Note: Actual outcomes in bold

Indonesia

Table 2: Evolution of IMF and Consensus Forecasts

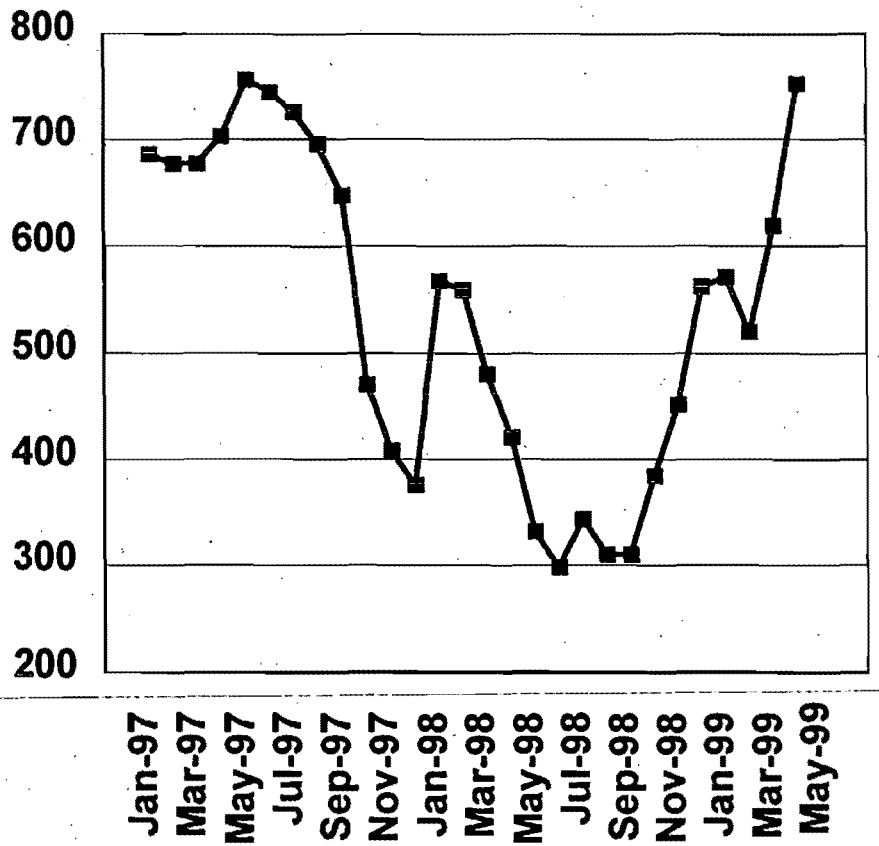
	For 1998								For 1999	
	11/97**	4/98	6/98	8/98	9/98	10/98	11/98	Actual	11/98	3/99
Real GDP Growth (%)										
IMF	3.0	-5.0	-12.1	-13.0	-15.0	-15.0	-15.0	-15.3	-2.0	-2.0
Consensus Projections	3.0	-6.3	-13.4	-16.2	-16.5	-16.5	-16.0		-4.0	-3.3
Avg. CPI Inflation (%)										
IMF	9.0*	44.0	60.0	60.0	60.0	60.0	60.0	66.2	17.0	17.0
Consensus Projections	10.7	45.9	65.4	74.6	74.8	65.1	66.8		34.8	25.1
CA Balance ($ Billion)										
IMF	-4.9	4.3	1.4	1.4	1.4	1.4	4.5	4.0	2.5	3.4
Consensus Projections	-3.6	1.1	2.5	5.3	5.2	6.1	6.1		7.0	4.6
Overall Govt. Balance										
IMF (%)	1.0	-3.8	-8.5	-8.5	-8.5	-8.5	-6.0	-2.0	-6.0	-5.8
IMF (Rupiah Trillion)	7.3	-30.8	-81.3	-81.3	-81.3	-81.3	-58.3		-45.7	-71.0

*end-period

**Consensus Forecast for 12/97

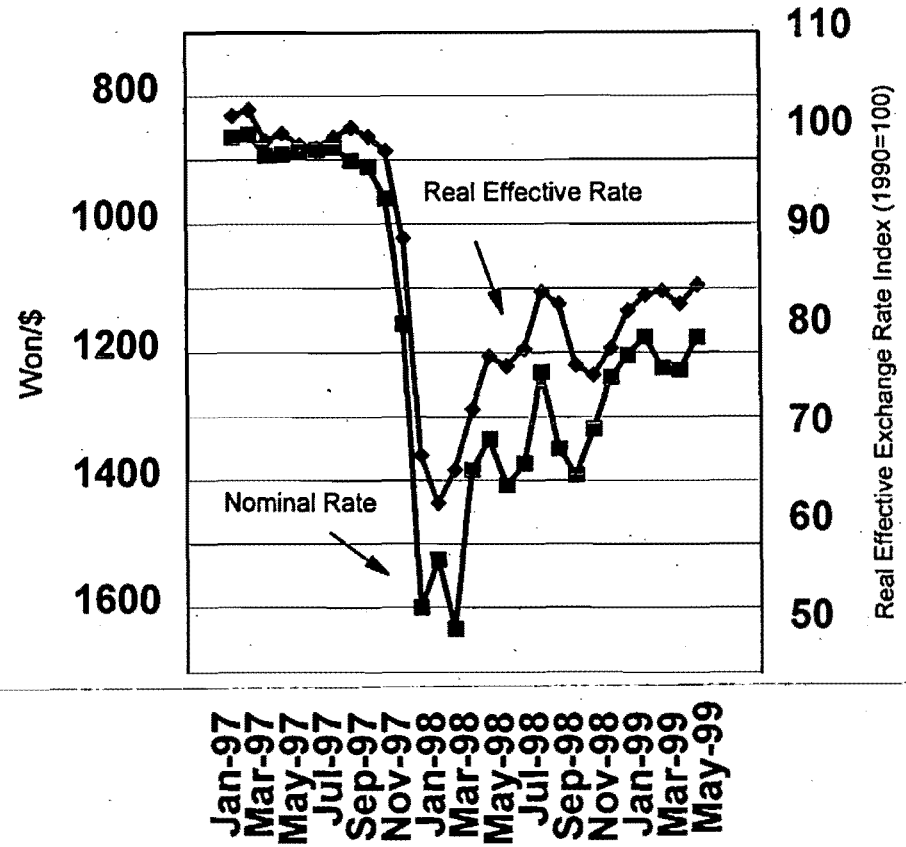
Korea

Equity Index



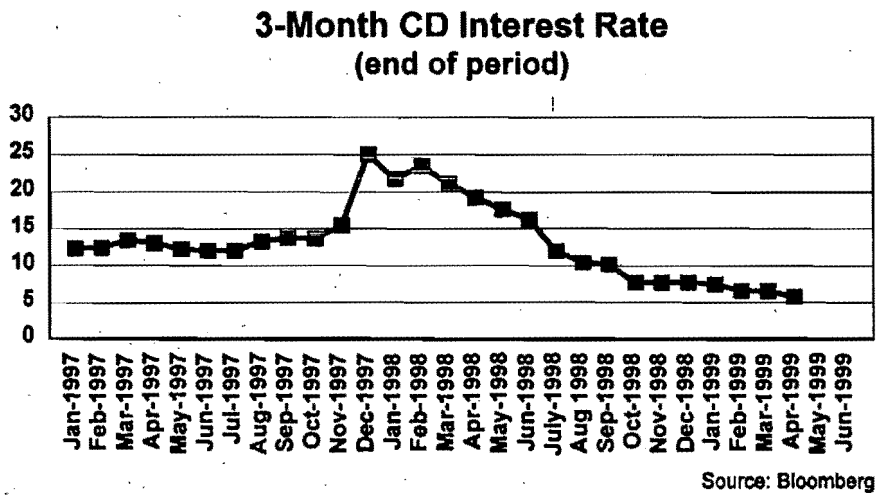
Source: Bloomberg

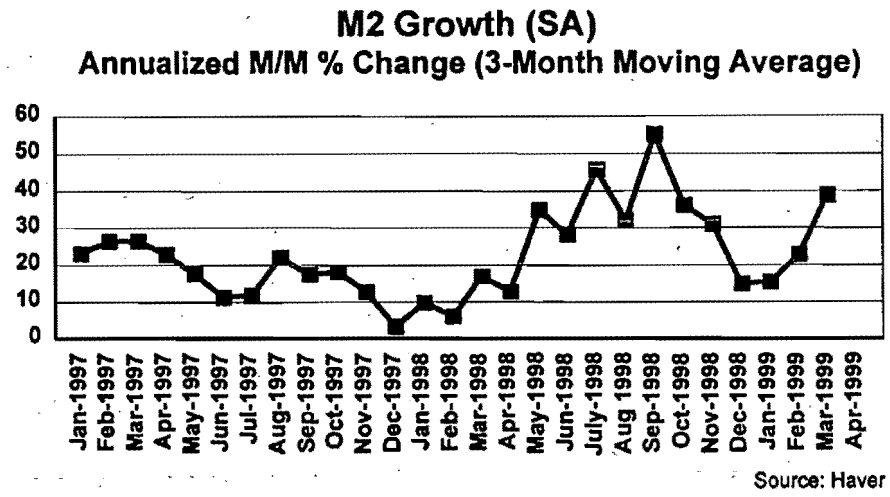
Exchange Rate

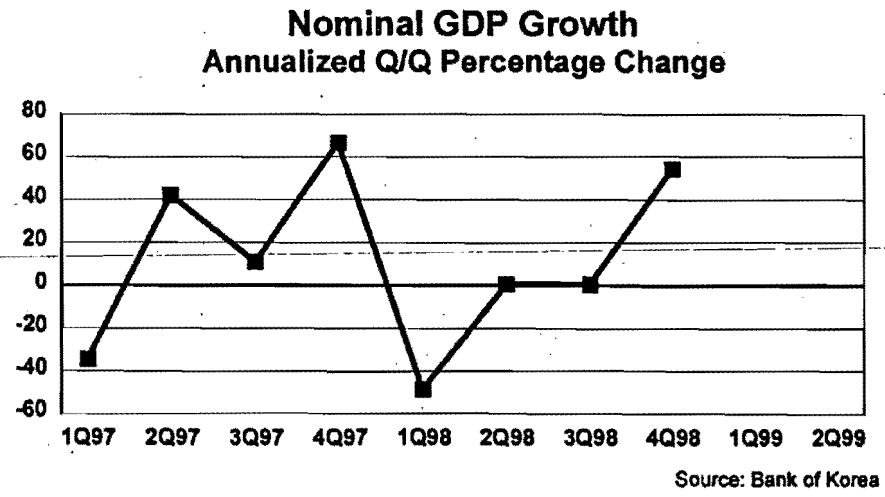


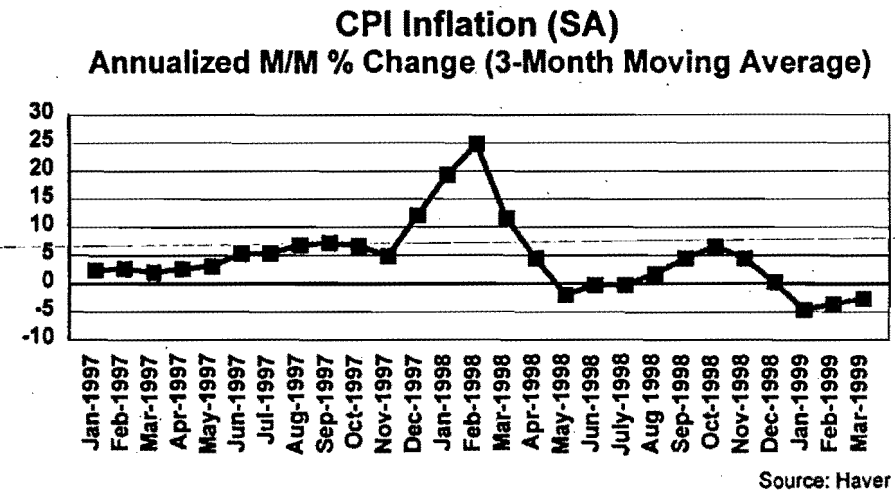
Source: Bloomberg, JP Morgan

Korea


3-Month CD Interest Rate
(end of period)
30
25
20
15
10
5
0
Jan-1997
Feb-1997
Mar-1997
Apr-1997
May-1997
Jun-1997
Jul-1997
Aug-1997
Sep-1997
Oct-1997
Nov-1997
Dec-1997
Jan-1998
Feb-1998
Mar-1998
Apr-1998
May-1998
Jun-1998
July-1998
Aug 1998
Sep-1998
Oct-1998
Nov-1998
Dec-1998
Jan-1999
Feb-1999
Mar-1999
Apr-1999
May-1999
Jun-1999
Source: Bloomberg

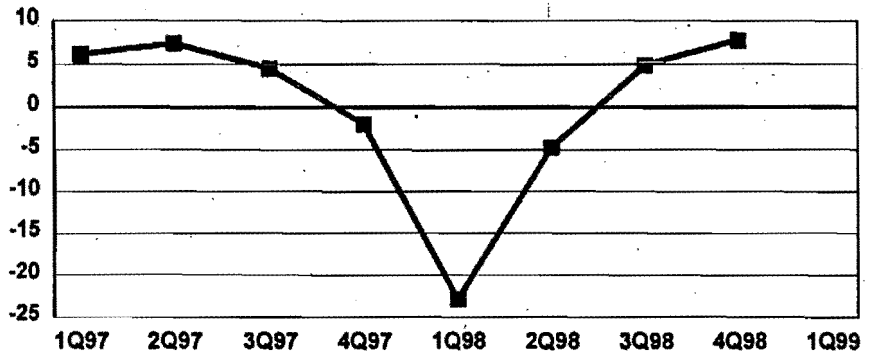

M2 Growth (SA)
Annualized M/M % Change (3-Month Moving Average)
60
50
40
30
20
10
0
Jan-1997
Feb-1997
Mar-1997
Apr-1997
May-1997
Jun-1997
Jul-1997
Aug-1997
Sep-1997
Oct-1997
Nov-1997
Dec-1997
Jan-1998
Feb-1998
Mar-1998
Apr-1998
May-1998
Jun-1998
July-1998
Aug 1998
Sep-1998
Oct-1998
Nov-1998
Dec-1998
Jan-1999
Feb-1999
Mar-1999
Apr-1999
Source: Haver


Nominal GDP Growth
Annualized Q/Q Percentage Change
80
60
40
20
0
-20
-40
-60
1Q97
2Q97
3Q97
4Q97
1Q98
2Q98
3Q98
4Q98
1Q99
2Q99
Source: Bank of Korea


CPI Inflation (SA)
Annualized M/M % Change (3-Month Moving Average)
30
25
20
15
10
5
0
-5
-10
Jan-1997
Feb-1997
Mar-1997
Apr-1997
May-1997
Jun-1997
Jul-1997
Aug-1997
Sep-1997
Oct-1997
Nov-1997
Dec-1997
Jan-1998
Feb-1998
Mar-1998
Apr-1998
May-1998
Jun-1998
July-1998
Aug 1998
Sep-1998
Oct-1998
Nov-1998
Dec-1998
Jan-1999
Feb-1999
Mar-1999
Source: Haver

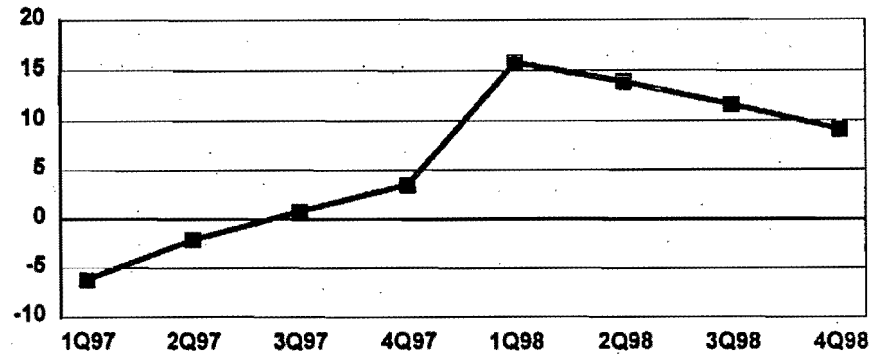
Korea

Real GDP Growth (SA)
Annualized Q/Q Percentage Change



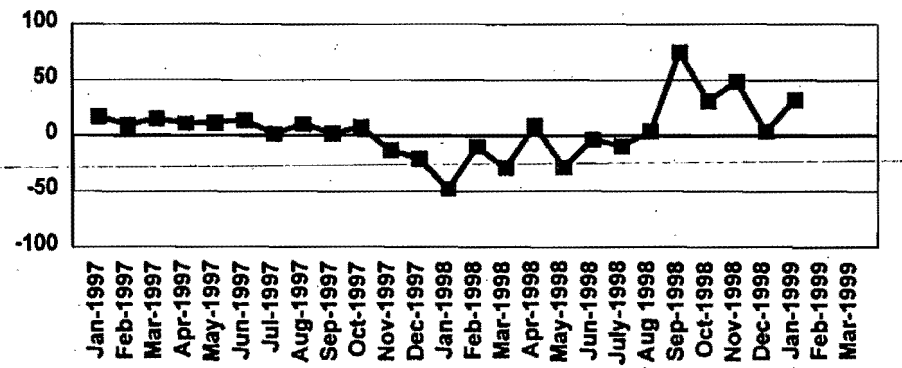
Source: IMF

Current Account Balance
(As % of Quarterly Nominal GDP)



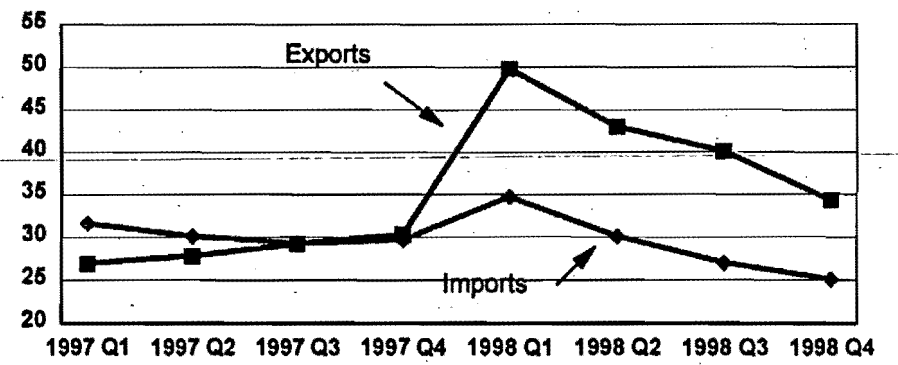
Source: Bank of Korea

Manufacturing Production Growth (SA)
Annualized M/M % Change (3-Month Moving Average)



Source: Haver

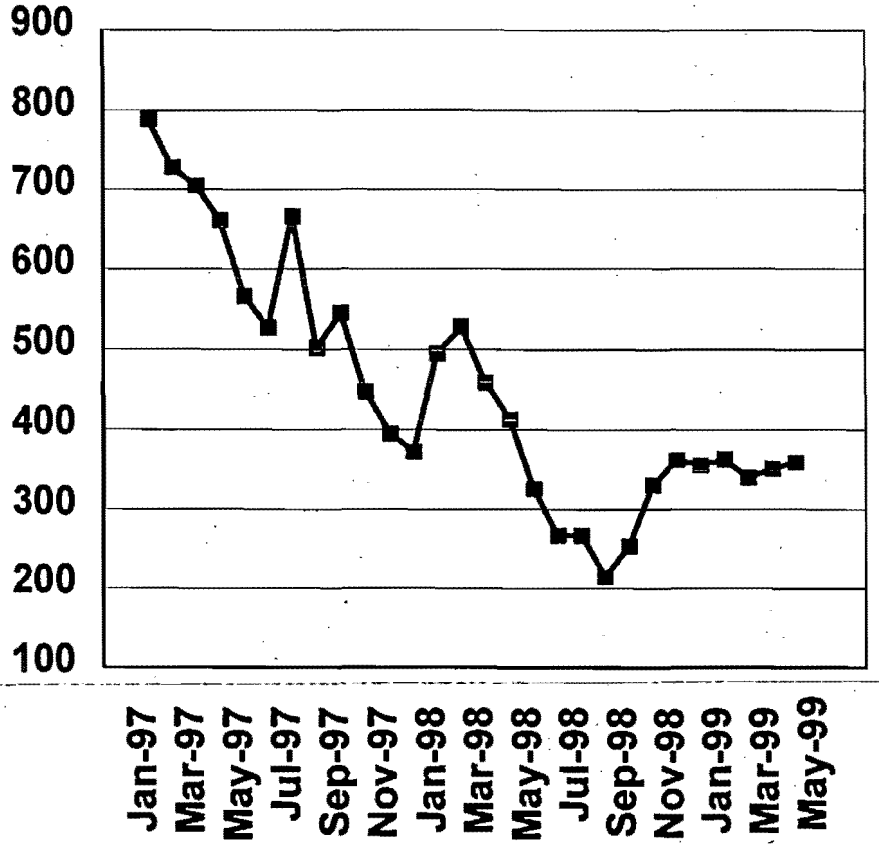
Exports and Imports
(As % of Quarterly Nominal GDP)



Source: Bank of Korea

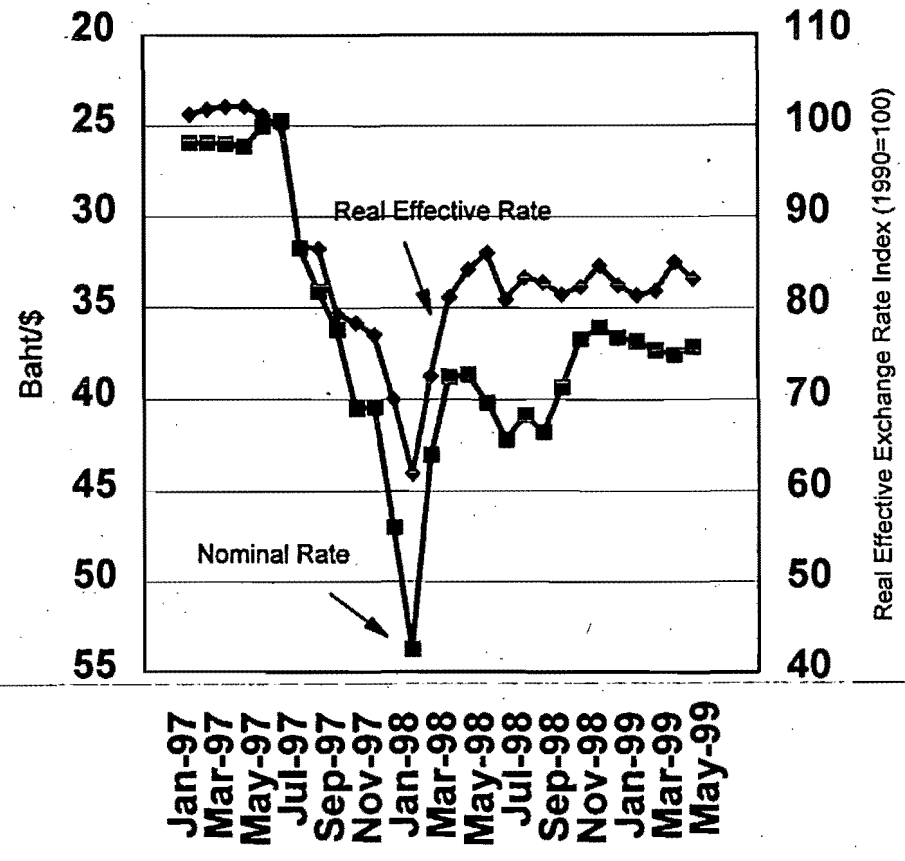
Thailand

Equity Index



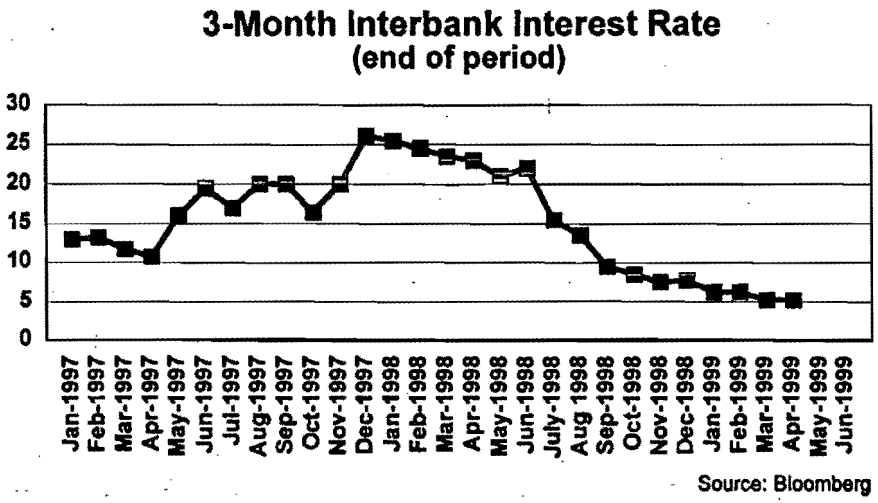
Source: Bloomberg

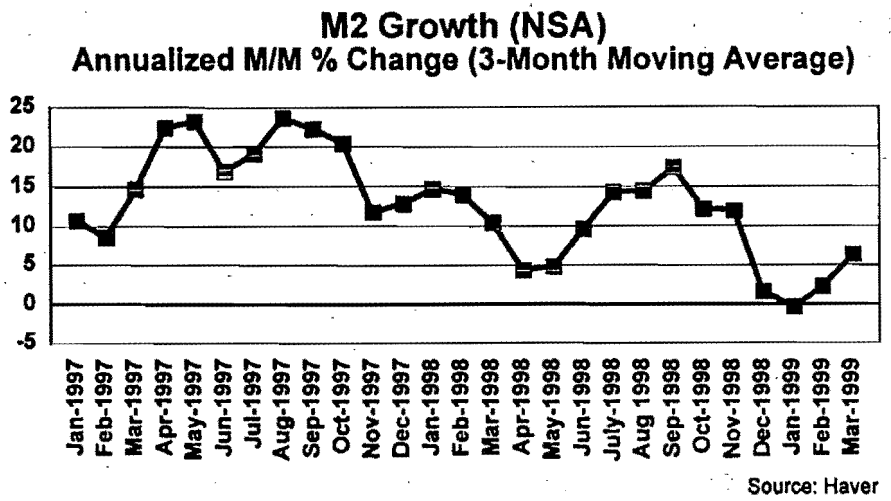
Exchange Rate

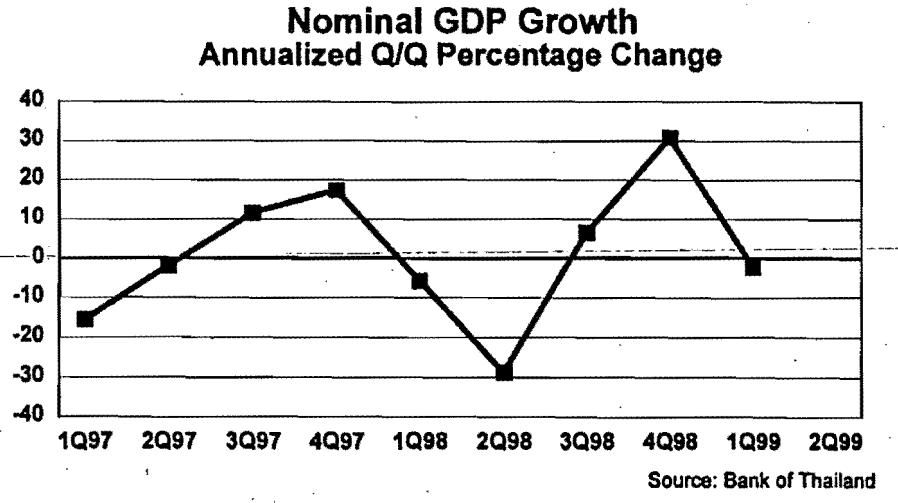


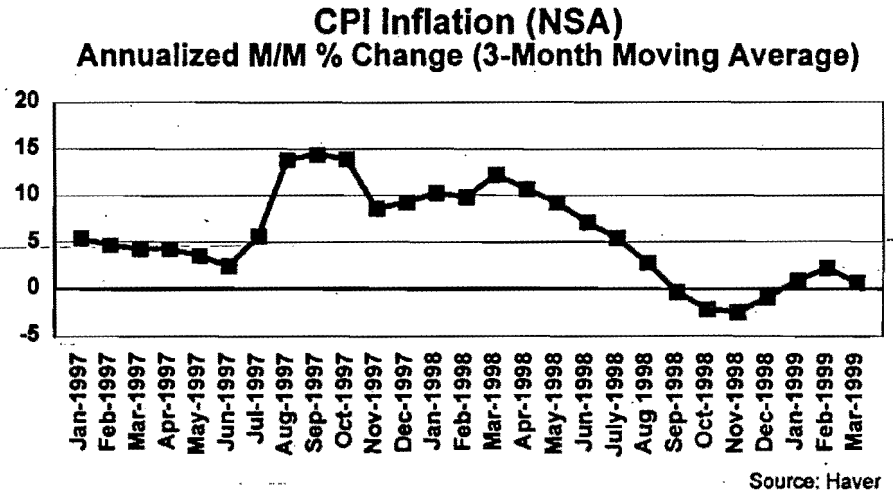
Source: Bloomberg, JP Morgan

Thailand

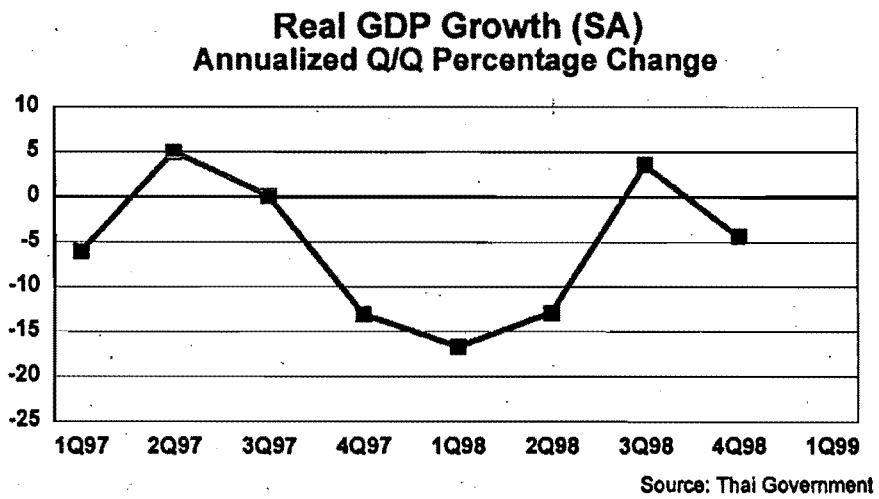

3-Month Interbank Interest Rate
(end of period)
30
25
20
15
10
5
0
Jan-1997
Feb-1997
Mar-1997
Apr-1997
May-1997
Jun-1997
Jul-1997
Aug-1997
Sep-1997
Oct-1997
Nov-1997
Dec-1997
Jan-1998
Feb-1998
Mar-1998
Apr-1998
May-1998
Jun-1998
July-1998
Aug 1998
Sep-1998
Oct-1998
Nov-1998
Dec-1998
Jan-1999
Feb-1999
Mar-1999
Apr-1999
May-1999
Jun-1999
Source: Bloomberg

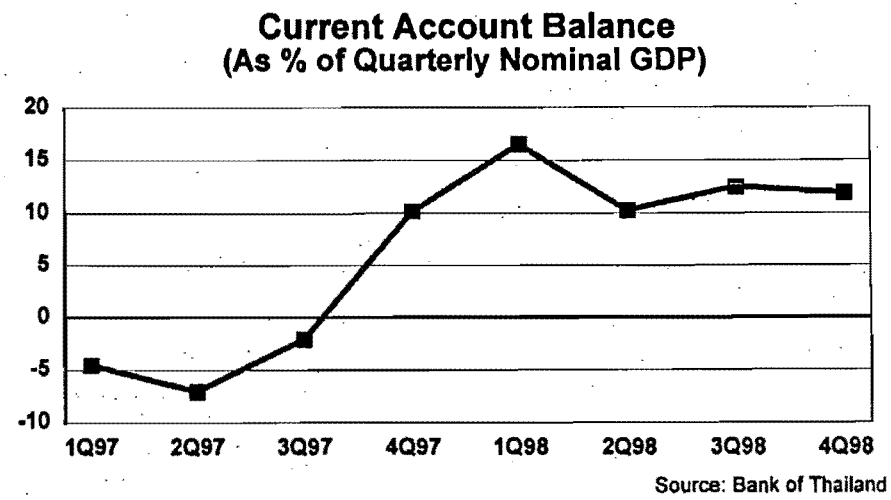

M2 Growth (NSA)
Annualized M/M % Change (3-Month Moving Average)
25
20
15
10
5
0
-5
Jan-1997
Feb-1997
Mar-1997
Apr-1997
May-1997
Jun-1997
Jul-1997
Aug-1997
Sep-1997
Oct-1997
Nov-1997
Dec-1997
Jan-1998
Feb-1998
Mar-1998
Apr-1998
May-1998
Jun-1998
July-1998
Aug 1998
Sep-1998
Oct-1998
Nov-1998
Dec-1998
Jan-1999
Feb-1999
Mar-1999
Source: Haver

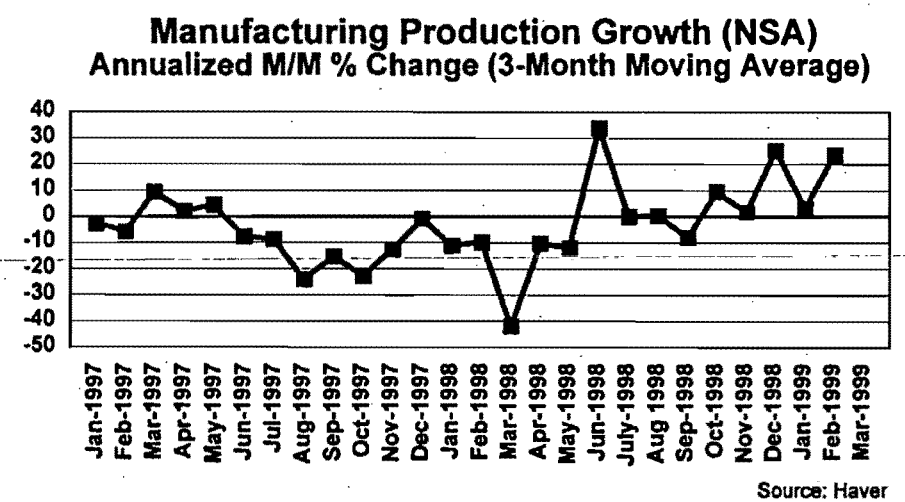

Nominal GDP Growth
Annualized Q/Q Percentage Change
40
30
20
10
0
-10
-20
-30
-40
1Q97
2Q97
3Q97
4Q97
1Q98
2Q98
3Q98
4Q98
1Q99
2Q99
Source: Bank of Thailand

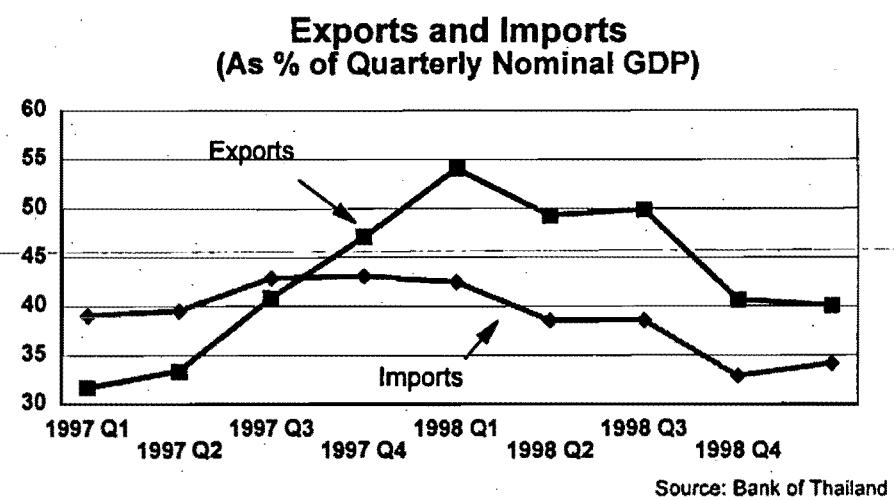

CPI Inflation (NSA)
Annualized M/M % Change (3-Month Moving Average)
20
15
10
5
0
-5
Jan-1997
Feb-1997
Mar-1997
Apr-1997
May-1997
Jun-1997
Jul-1997
Aug-1997
Sep-1997
Oct-1997
Nov-1997
Dec-1997
Jan-1998
Feb-1998
Mar-1998
Apr-1998
May-1998
Jun-1998
July-1998
Aug 1998
Sep-1998
Oct-1998
Nov-1998
Dec-1998
Jan-1999
Feb-1999
Mar-1999
Source: Haver

Thailand


Real GDP Growth (SA)
Annualized Q/Q Percentage Change
10
5
0
-5
-10
-15
-20
-25
1Q97
2Q97
3Q97
4Q97
1Q98
2Q98
3Q98
4Q98
1Q99
Source: Thai Government

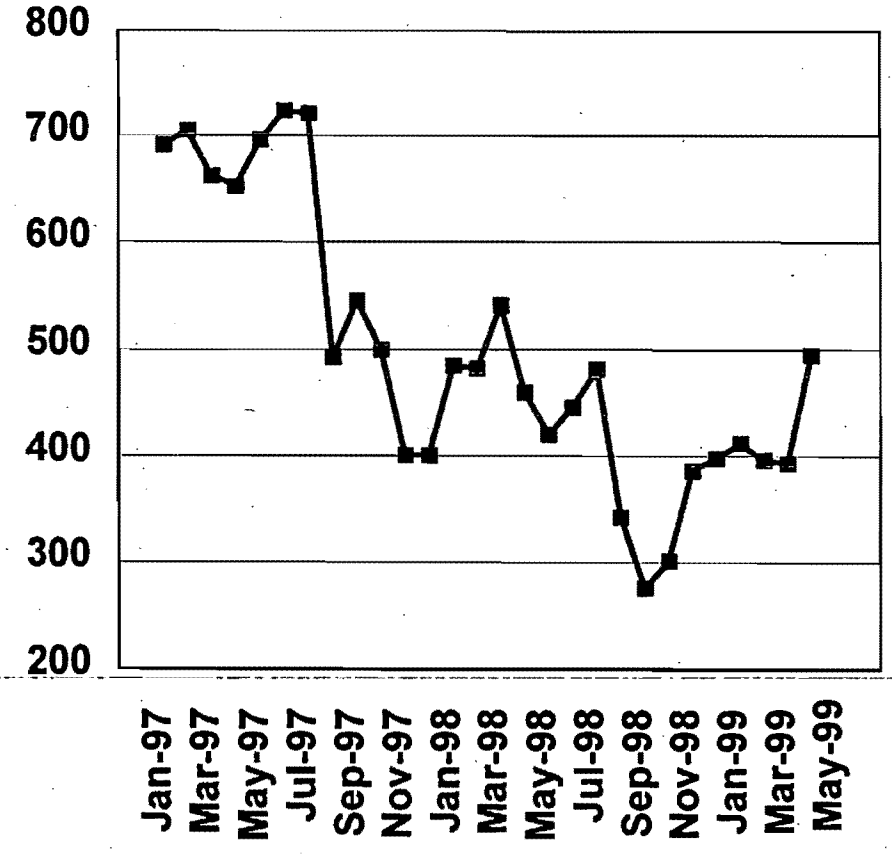

Current Account Balance
(As % of Quarterly Nominal GDP)
20
15
10
5
0
-5
-10
1Q97
2Q97
3Q97
4Q97
1Q98
2Q98
3Q98
4Q98
Source: Bank of Thailand


Manufacturing Production Growth (NSA)
Annualized M/M % Change (3-Month Moving Average)
40
30
20
10
0
-10
-20
-30
-40
-50
Jan-1997
Feb-1997
Mar-1997
Apr-1997
May-1997
Jun-1997
Jul-1997
Aug-1997
Sep-1997
Oct-1997
Nov-1997
Dec-1997
Jan-1998
Feb-1998
Mar-1998
Apr-1998
May-1998
Jun-1998
July-1998
Aug 1998
Sep-1998
Oct-1998
Nov-1998
Dec-1998
Jan-1999
Feb-1999
Mar-1999
Source: Haver


Exports and Imports
(As % of Quarterly Nominal GDP)
60
55
50
45
40
35
30
Exports
Imports
1997 Q1
1997 Q2
1997 Q3
1997 Q4
1998 Q1
1998 Q2
1998 Q3
1998 Q4
Source: Bank of Thailand

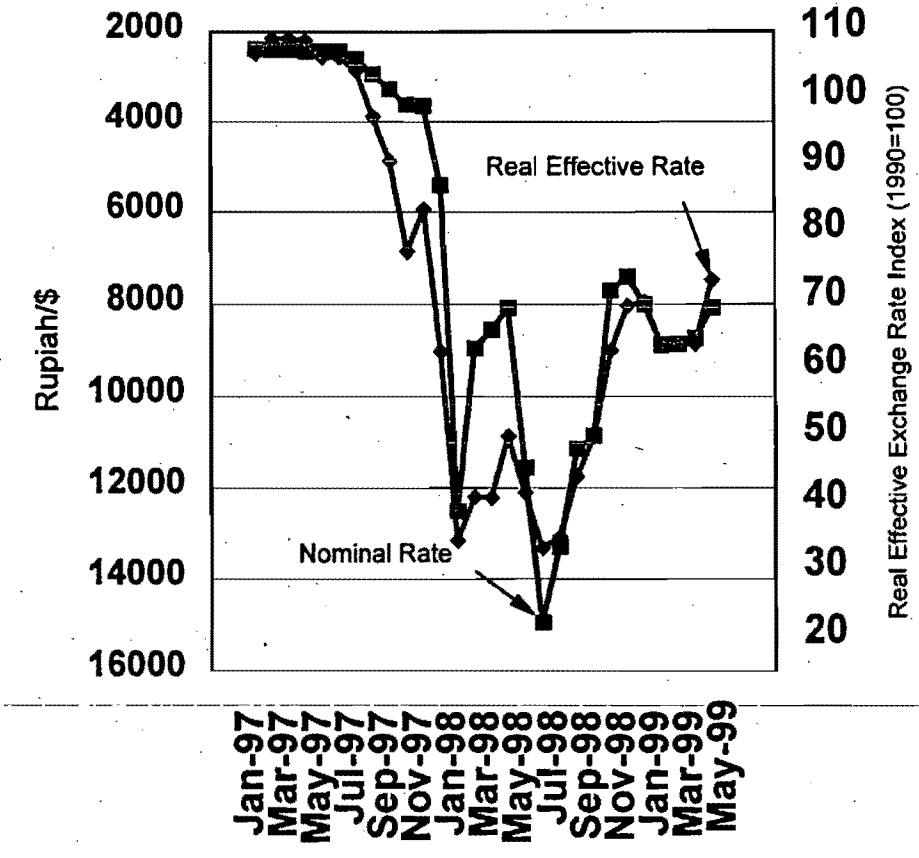
Indonesia

Equity Index



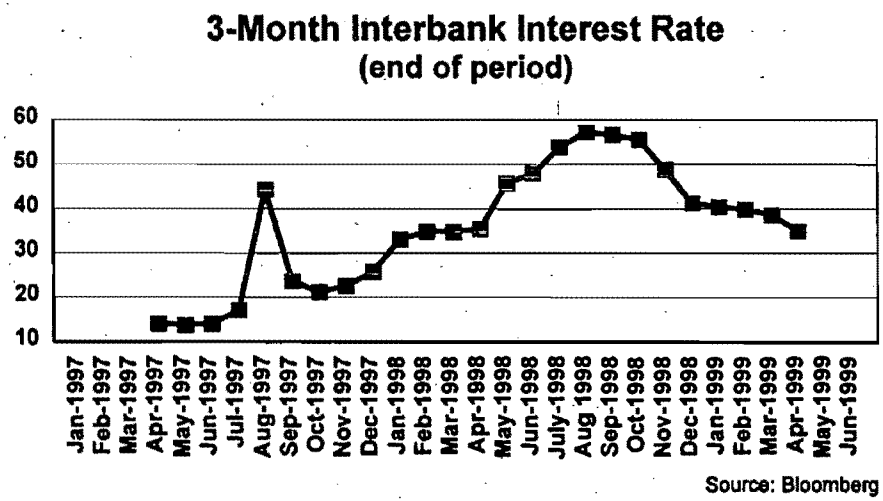
Source: Bloomberg

Exchange Rate



Source: Bloomberg, JP Morgan

Indonesia


3-Month Interbank Interest Rate
(end of period)
60
50
40
30
20
10
Jan-1997
Feb-1997
Mar-1997
Apr-1997
May-1997
Jun-1997
Jul-1997
Aug-1997
Sep-1997
Oct-1997
Nov-1997
Dec-1997
Jan-1998
Feb-1998
Mar-1998
Apr-1998
May-1998
Jun-1998
July-1998
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Nov-1998
Dec-1998
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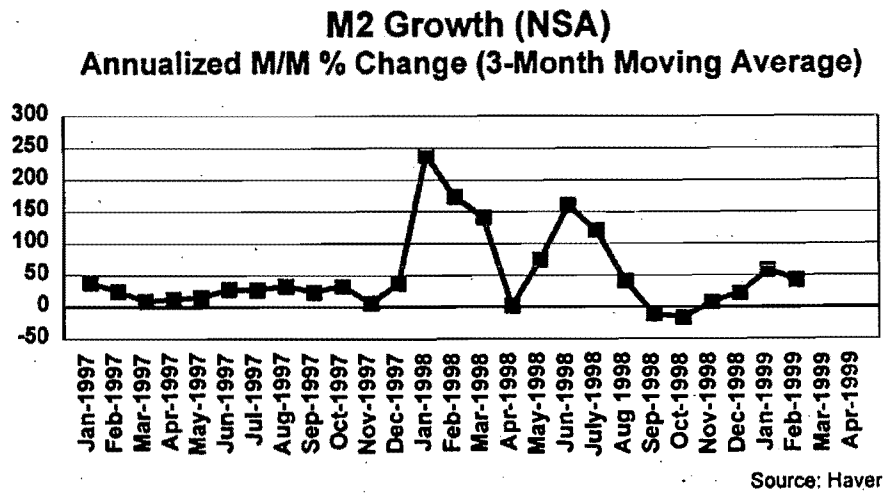
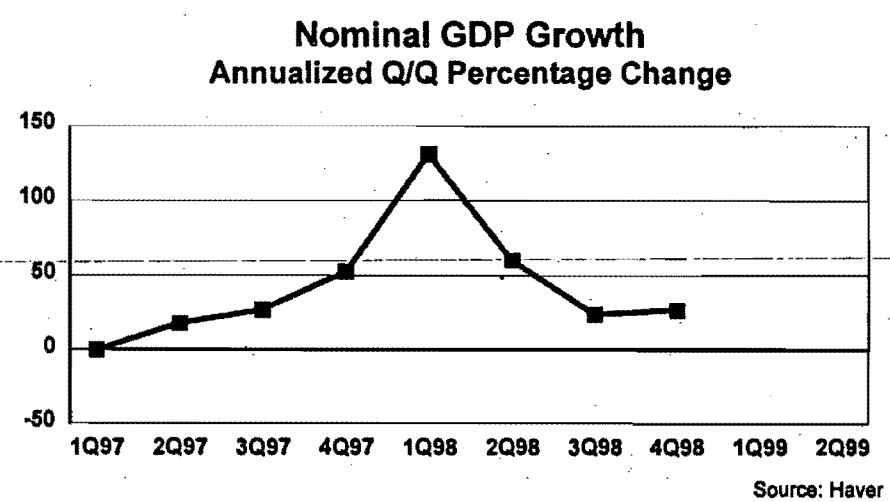
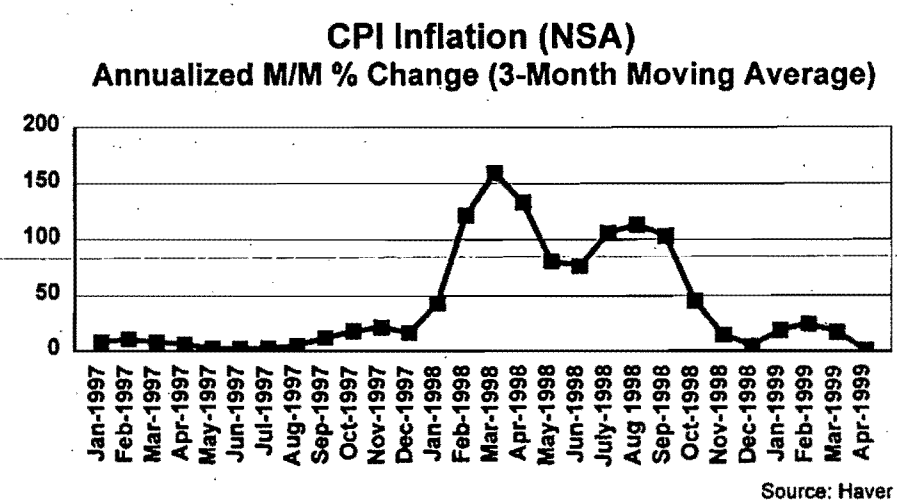
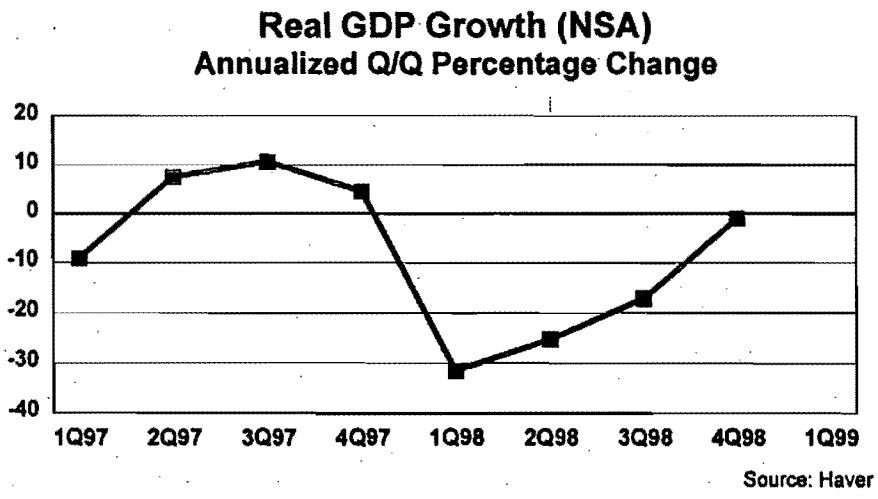
Apr-1999
May-1999
Jun-1999
Source: Bloomberg

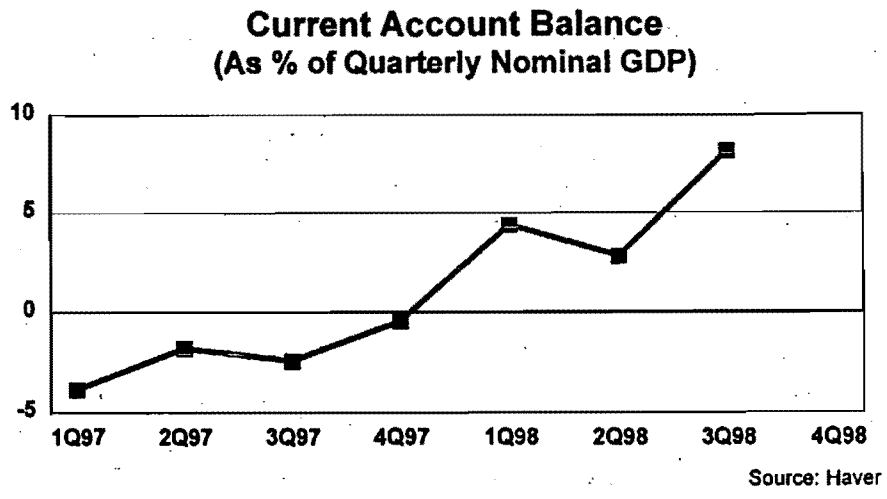

M2 Growth (NSA)
Annualized M/M % Change (3-Month Moving Average)
300
250
200
150
100
50
0
-50
Jan-1997
Feb-1997
Mar-1997
Apr-1997
May-1997
Jun-1997
Jul-1997
Aug-1997
Sep-1997
Oct-1997
Nov-1997
Dec-1997
Jan-1998
Feb-1998
Mar-1998
Apr-1998
May-1998
Jun-1998
July-1998
Aug 1998
Sep-1998
Oct-1998
Nov-1998
Dec-1998
Jan-1999
Feb-1999
Mar-1999
Apr-1999
Source: Haver

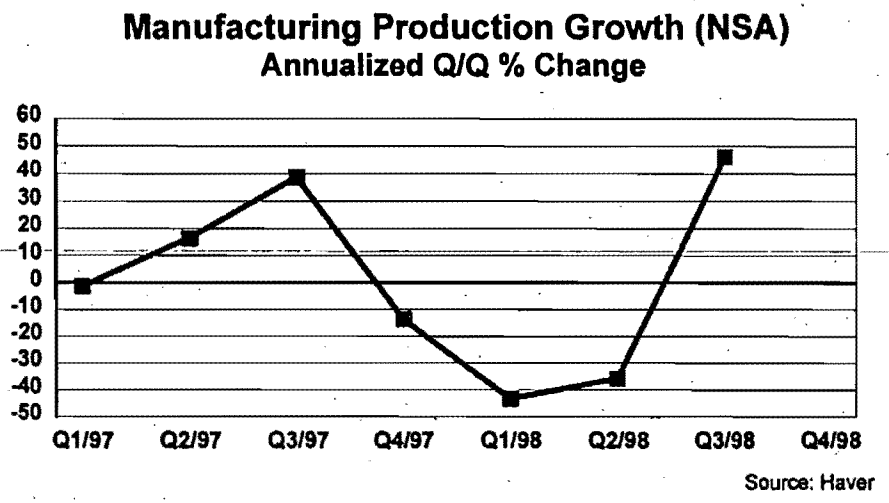

Nominal GDP Growth
Annualized Q/Q Percentage Change
150
100
50
0
-50
1Q97
2Q97
3Q97
4Q97
1Q98
2Q98
3Q98
4Q98
1Q99
2Q99
Source: Haver

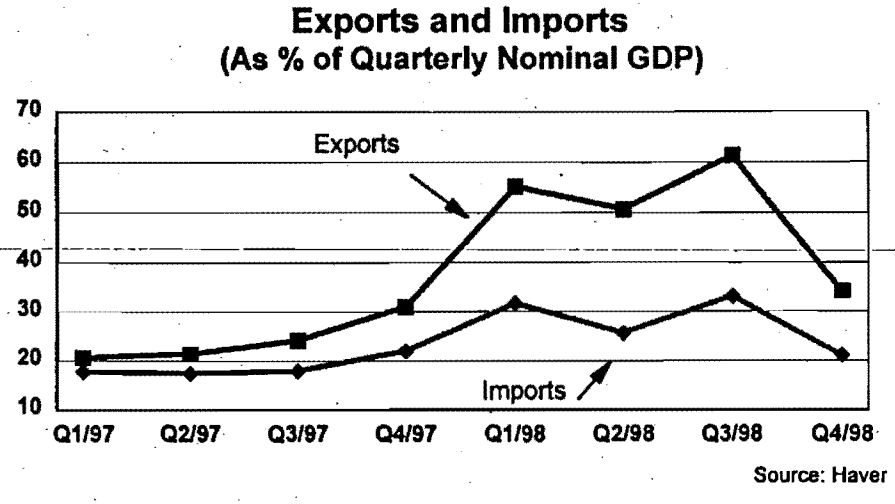

CPI Inflation (NSA)
Annualized M/M % Change (3-Month Moving Average)
200
150
100
50
0
Jan-1997
Feb-1997
Mar-1997
Apr-1997
May-1997
Jun-1997
Jul-1997
Aug-1997
Sep-1997
Oct-1997
Nov-1997
Dec-1997
Jan-1998
Feb-1998
Mar-1998
Apr-1998
May-1998
Jun-1998
July-1998
Aug 1998
Sep-1998
Oct-1998
Nov-1998
Dec-1998
Jan-1999
Feb-1999
Mar-1999
Apr-1999
Source: Haver

Indonesia


Real GDP Growth (NSA)
Annualized Q/Q Percentage Change
20
10
0
-10
-20
-30
-40
1Q97
2Q97
3Q97
4Q97
1Q98
2Q98
3Q98
4Q98
1Q99
Source: Haver

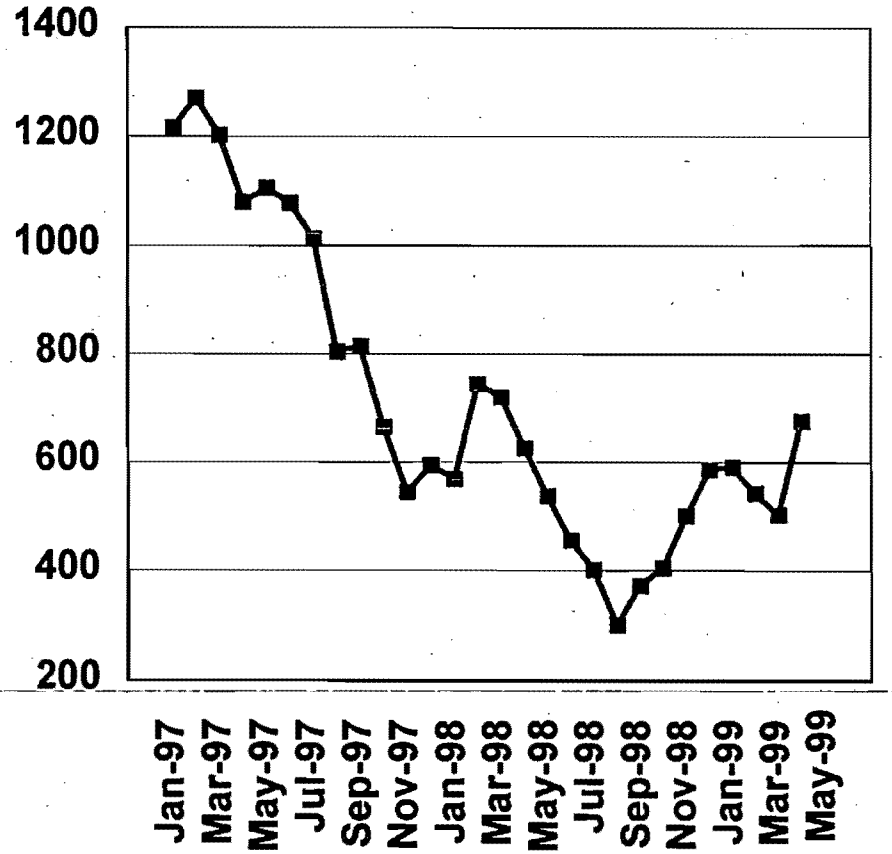

Current Account Balance
(As % of Quarterly Nominal GDP)
10
5
0
-5
1Q97
2Q97
3Q97
4Q97
1Q98
2Q98
3Q98
4Q98
Source: Haver


Manufacturing Production Growth (NSA)
Annualized Q/Q % Change
60
50
40
30
20
10
0
-10
-20
-30
-40
-50
Q1/97
Q2/97
Q3/97
Q4/97
Q1/98
Q2/98
Q3/98
Q4/98
Source: Haver


Exports and Imports
(As % of Quarterly Nominal GDP)
70
60
50
40
30
20
10
Exports
Imports
Q1/97
Q2/97
Q3/97
Q4/97
Q1/98
Q2/98
Q3/98
Q4/98
Source: Haver

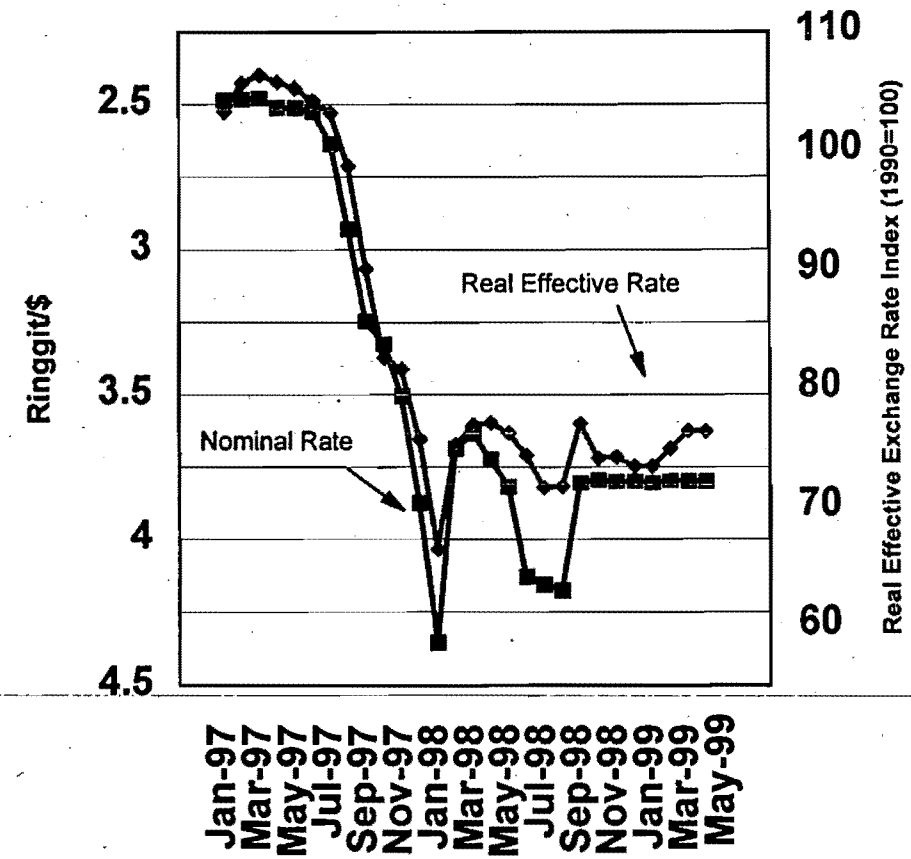
Malaysia

Equity Index



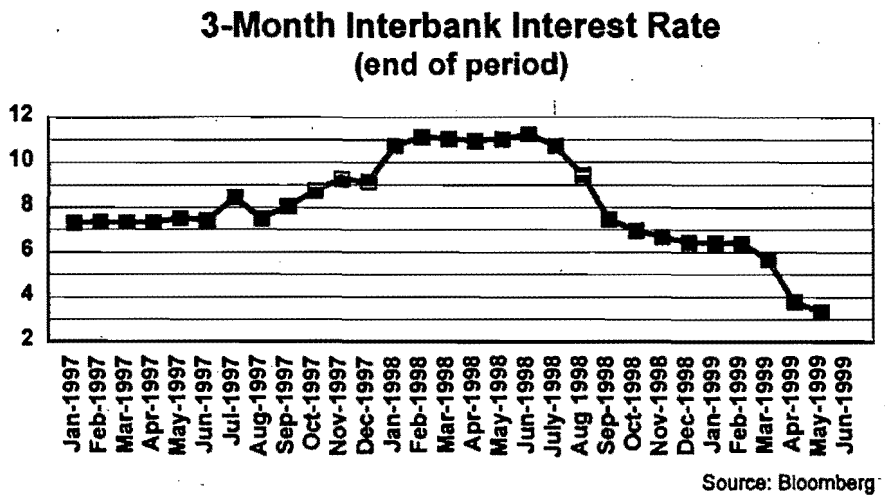
Source: Bloomberg

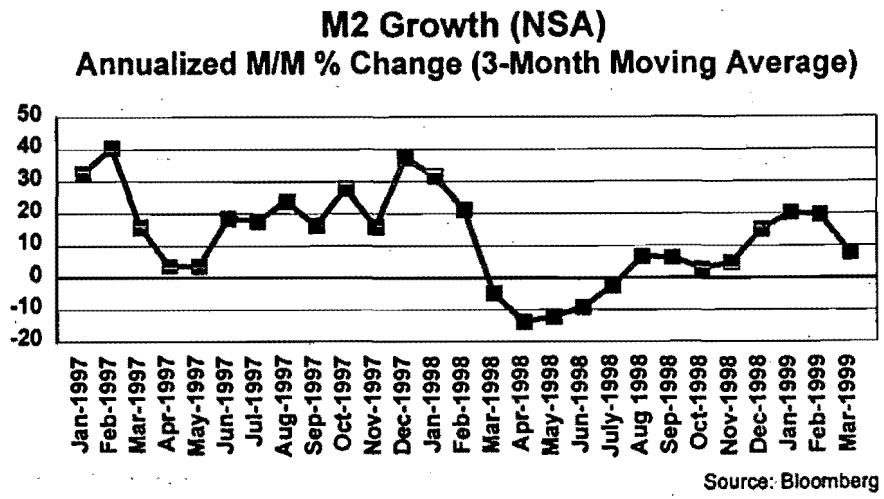
Exchange Rate

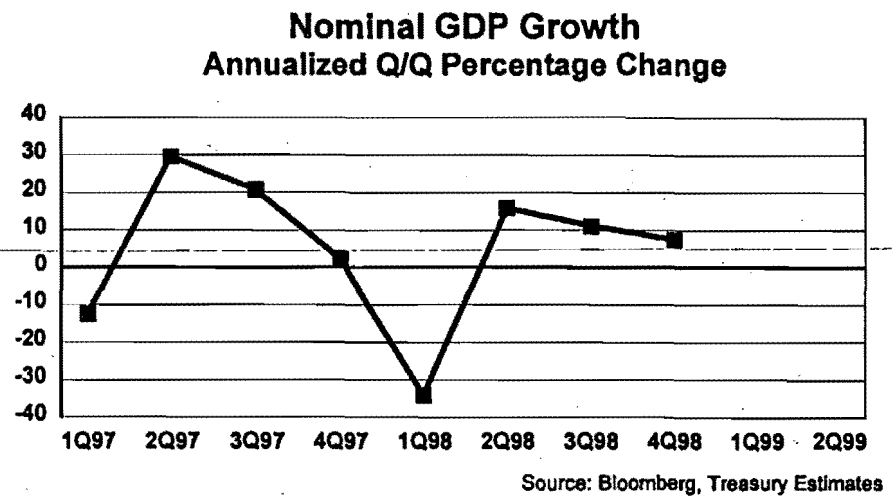


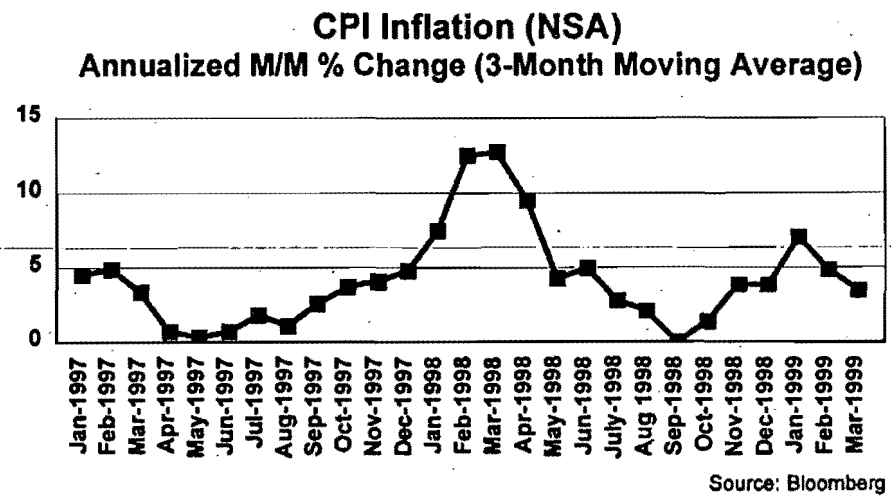
Source: Bloomberg, JP Morgan

Malaysia


3-Month Interbank Interest Rate
(end of period)
12
10
8
6
4
2
Jan-1997
Feb-1997
Mar-1997
Apr-1997
May-1997
Jun-1997
Jul-1997
Aug-1997
Sep-1997
Oct-1997
Nov-1997
Dec-1997
Jan-1998
Feb-1998
Mar-1998
Apr-1998
May-1998
Jun-1998
July-1998
Aug 1998
Sep-1998
Oct-1998
Nov-1998
Dec-1998
Jan-1999
Feb-1999
Mar-1999
Apr-1999
May-1999
Jun-1999
Source: Bloomberg

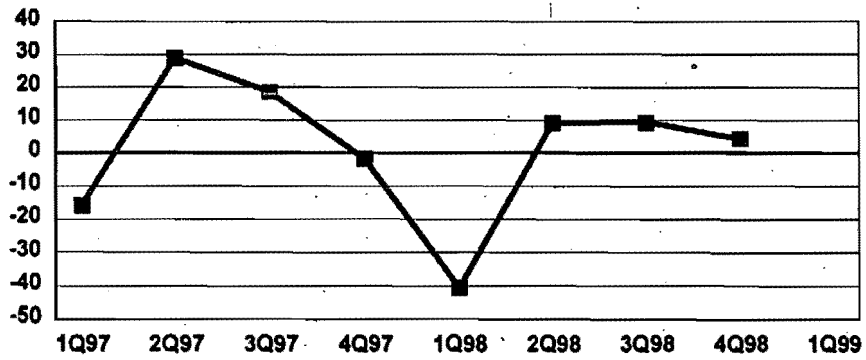

M2 Growth (NSA)
Annualized M/M % Change (3-Month Moving Average)
50
40
30
20
10
0
-10
-20
Jan-1997
Feb-1997
Mar-1997
Apr-1997
May-1997
Jun-1997
Jul-1997
Aug-1997
Sep-1997
Oct-1997
Nov-1997
Dec-1997
Jan-1998
Feb-1998
Mar-1998
Apr-1998
May-1998
Jun-1998
July-1998
Aug 1998
Sep-1998
Oct-1998
Nov-1998
Dec-1998
Jan-1999
Feb-1999
Mar-1999
Source: Bloomberg


Nominal GDP Growth
Annualized Q/Q Percentage Change
40
30
20
10
0
-10
-20
-30
-40
1Q97
2Q97
3Q97
4Q97
1Q98
2Q98
3Q98
4Q98
1Q99
2Q99
Source: Bloomberg, Treasury Estimates


CPI Inflation (NSA)
Annualized M/M % Change (3-Month Moving Average)
15
10
5
0
Jan-1997
Feb-1997
Mar-1997
Apr-1997
May-1997
Jun-1997
Jul-1997
Aug-1997
Sep-1997
Oct-1997
Nov-1997
Dec-1997
Jan-1998
Feb-1998
Mar-1998
Apr-1998
May-1998
Jun-1998
July-1998
Aug 1998
Sep-1998
Oct-1998
Nov-1998
Dec-1998
Jan-1999
Feb-1999
Mar-1999
Source: Bloomberg

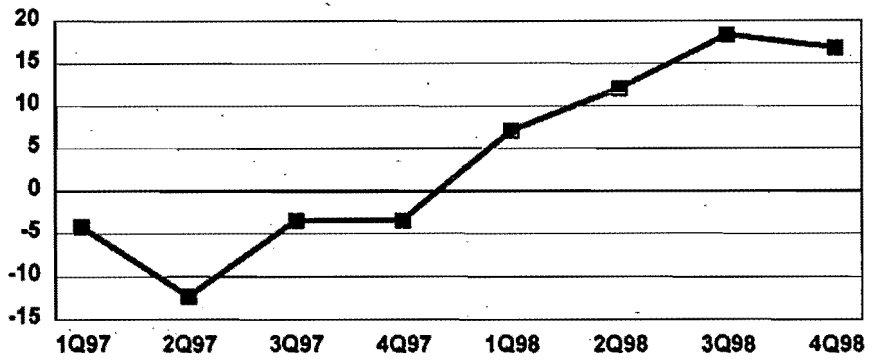
Malaysia

Real GDP Growth (NSA)
Annualized Q/Q Percentage Change



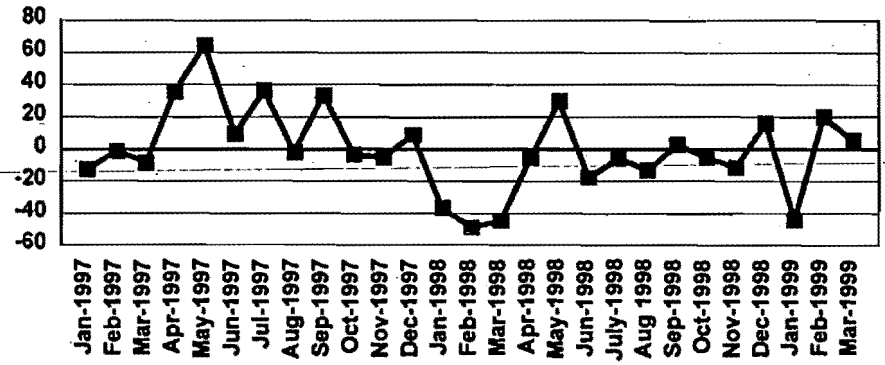
Source: Bloomberg

Current Account Balance
(As % of Quarterly Nominal GDP)



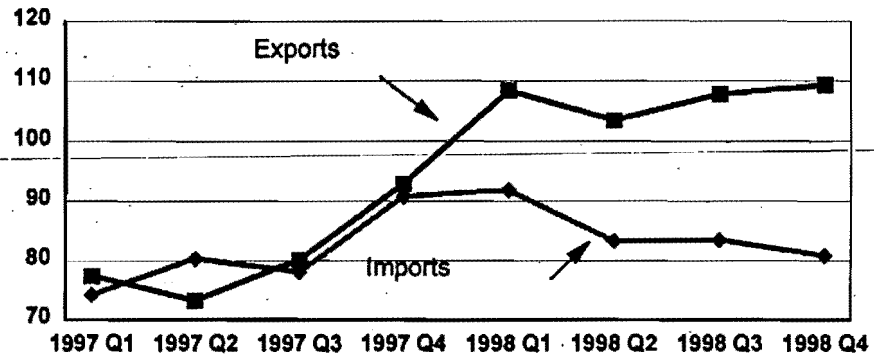
Source: Bloomberg

Manufacturing Production Growth (NSA)
Annualized M/M % Change (3-Month Moving Average)



Source: Bloomberg

Exports and Imports
(As % of Quarterly Nominal GDP)



Source: Bloomberg

IMF Macroeconomic Policy Prescriptions for the Asian Crisis: Background on Korea

Overview:

It is difficult to argue that Korea's tightening of monetary policy at the start of its Fund program was inappropriate given the rapid depletion of its reserves and the associated pressure on the won. The focus on exchange rates and interest rates as the target and instrument of monetary policy thus appears to have been justified and broadly effective. It is nonetheless clear that the IMF's projections for real output during the first half of 1998 were badly off the mark and that the Fund, despite the experiences of Mexico and Thailand, failed to anticipate the sharp reduction in private consumption and investment that occurred. As a result, the overall macroeconomic policy mix, and in particular, the fiscal policy stance, appears to have been overly contractionary at the start of the program. While this was eventually redressed through modifications that allowed for a larger fiscal deficit, these changes did not occur until there was significant downward revision of growth forecasts. Moreover, delays in implementing new social safety net expenditures meant that this fiscal stimulus was relatively ineffective in supporting growth until the first quarter of 1999.

Background:

Exchange Rate Performance: The Korean won started to come under pressure several weeks before Korea approached the IMF in late November 1997, with the won's depreciation gaining momentum following the November 19 announcement that authorities were widening the fluctuation band on the exchange rate from 2.25% to 10% and would no longer intervene to support the won. The won fell 22% against the dollar between late October and the IMF program announcement on December 3rd.

The won plunged an additional than 40% to nearly 2000 won/dollar between December 3rd when the IMF program was first announced and December 24th when a strengthened program including further monetary tightening was announced. While remaining volatile, the won generally traded in a range between 1600 and 1800 won/dollar during the month of January 1998. The won gradually strengthened in value over the next three months, averaging 1618 won/$ in February, 1486 won/$ in March and 1389 won/$ in April. Since that time, it has generally traded in a range between 1150 and 1400 won/$. As of the end of April 1999, the won was trading at 1175 won/$, 25% lower in nominal terms than its value in June 1997 and 14% lower in real effective terms.

Inflation Projections and Performance: The won's depreciation resulted in a sharp acceleration of inflation during December 1997 and January 1998, as a 59% increase in the cost of raw materials drove producer prices up by 28% during those two months. Consumer price inflation also accelerated, although at a slower pace, rising 5% during December and January. Year over year (yoy) CPI inflation peaked at 9.6% in February 1998 and had fallen to 3.9% by December 1998. Actual CPI inflation averaged 7.5% for 1998. Producer price inflation peaked in January 1998 and declined sharply during the course of 1998 as a result of weak global commodity prices and the won's appreciation. PPI inflation averaged 12.2% for 1998, although PPI prices rose only 3.6% yoy in December 1998.

- The December 1997 IMF program projected average consumer price inflation of 5% during 1998. As a result of the greater than expected depreciation of the won, the Fund increased its projections of annual CPI inflation during the course of the first two program reviews, with 1998 CPI inflation projected at 9.5% in February and 10.5% in May. The won's subsequent appreciation led the IMF to decrease projected CPI inflation in the August and November reviews to 8.5% and 7.8%, respectively.

Real Output Projections and Performance:. The Fund program initially projected real GDP growth of 2.5% in 1998, although these projections changed markedly during the course of 1998, with growth forecasts being gradually downgraded to 1% in February, -1 to -2% in May, -5% in August and -7% in November. The most recent estimate of real GDP growth for 1998 is -5.8%.

Nominal Output Projections and Performance: Given the Fund's projections of real output and the nominal GDP deflator, nominal GDP growth was initially projected at 6.6% and was still as high as 5.8-6.8% in May 1998. The deeper than expected contraction in real GDP and slower than expected inflation meant that these projections were marked down significantly to 1.1% in August and 1.3% in November. Estimated nominal GDP growth for 1998 is 3.0%.

Macroeconomic Policy Framework:

Monetary Policy Stance: Korean monetary policy focused exclusively on stabilizing the won exchange rate at the start of the IMF program. Given the uncertainties about money demand behavior as a result of the crisis, the IMF program focused on interest rate and exchange rate developments to gauge the appropriateness of monetary policy. While the IMF program included the standard performance criteria and indicative targets on base money, net international reserves and net domestic assets, these quantities appear to have played relatively little role in actually guiding monetary policy and were generally not a binding constraint. Some attention nonetheless was paid to the need to sterilize Bank of Korea liquidity support to the financial system before it translated into further pressure on the exchange rate.

- In mid-December 1997, the Bank of Korea extended liquidity support of 8 trillion won, equivalent to approximately one-third of reserve money outstanding at the end of November. Failure to sterilize this liquidity injection through open market operations might well have undermined the stabilization effort if it had eventually fed through to further depreciation of the won.

- The government also provided extensive liquidity support to the financial system in the period before it was forced to devalue the won in November 1997. M2A growth accelerated markedly between September and November 1997, rising more than 8% over that three-month period. Year-on year growth in M2A accelerated from 14% in September to nearly 24% in November.

As can be seen in Figure 1, the overnight call rate began trending upward slightly during the second half of November as the won began to come under pressure. Interest rates were then increased sharply at the start of the IMF program in December, with overnight call rates rising from approximately 18% to 25%. Continuing pressure on the won from capital outflows and

political uncertainty prompted the authorities to increase interest rates to 35% at the time the strengthened IMF program was announced. While rates remained at this level for only several days, they generally remained between 28% and 30% during January.

Interest rates began to trend downward in February, falling an average of 275 basis points per month between February and August. By the end of August 1998, the overnight call rate had declined to 8.5%. Rates continued to fall more gradually over the next six months, declining to 4.7% in April 1999 and remaining largely stable since then.

Fiscal Policy Stance: The 1998 budget adopted in November 1997 originally called for a fiscal surplus of 0.2 percent of GDP, though the Fund's baseline projection for 1998 foresaw a deficit of 1.4 percent of GDP due to revenue shortfalls and the added costs of bank recapitalization. The Fund's initial program sought to preserve the originally budgeted surplus of 0.2 percent of GDP, requiring fiscal adjustment of 1.6 percent of GDP. This adjustment was to be equally divided between tax increases and cuts in expenditures and net lending. While the fiscal stance was eventually eased substantially, it was not until August of 1998, after the growth outlook had worsened considerably, that the IMF program allowed for significant fiscal stimulus.

In program reviews between January and May, the fiscal stance was eased somewhat to account for effects of both cyclical and exchange rate developments on the budget, and to allow for greater social safety net spending. Additional spending on the social safety net nevertheless was largely offset by further discretionary measures, including cuts in other areas of the budget and further tax measures.[1]

- In April 1998, Fund staff estimated that the cyclical impact on the central government fiscal balance since the December 1997 program was a decline of 2.1 percent of GDP, with the effect of exchange rate depreciation causing a further increase in the deficit of 1 percent of GDP. Increased discretionary spending of 1.7 percent of GDP was allocated to cover the augmented social safety net and the cost of bank recapitalization.

- These changes in the fiscal balance were offset by expenditure cuts and tax measures totaling 2.9 percent of GDP. Thus the overall decline in the fiscal balance was 1.9 percent of GDP, from 0.2 percent in the December 1997 program, to -1.7 percent of GDP in the April 1998 program as reported in the May staff review.

- Fund staff estimated that the cyclically-neutral deficit based on the revised macroeconomic assessment of April 1998 was 2 percent of GDP. The April fiscal program thus continued to be slightly contractionary in nature.

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[1]The best measure of fiscal stimulus in 1998 would be the change in the structural deficit from 1997. Unfortunately the IMF does not publish historical and projected estimates of structural deficits.

From August through the end of the year, the Fund program shifted its stance on fiscal policy substantially, allowing for a larger budget deficit in the face of significantly lower growth projections. Actual outlays for the year came in well below the budgeted amounts due to bottlenecks in capital spending and delays in starting social safety net programs.

- In August the program allowed for a budget deficit of more than 4 percent of GDP, a projection which was widened to 5 percent in November. The deficits accounted for a further cyclical decline in revenues, increased social safety net spending, and offsetting revenue measures. In November Fund staff estimated that the total fiscal stimulus to the economy to be 1.5 percent of GDP. The actual deficit for 1998 reached 3.8 percent of GDP. About half of the shortfall in the deficit was the result of lower than expected interest costs, with the remainder due to lower spending on current and capital expenditure and net lending.

Assessment:

A number of issues need to be dealt with in assessing the appropriateness of the Fund's macroeconomic policy prescriptions for Korea.

- *Policy Objectives:* How should macroeconomic policies have balanced competing objectives, such as avoiding external default, stabilizing output, and minimizing inflation? Should monetary policy have focused on supporting the won or on maintaining growth from the start of the program, particularly given the weak banking system and highly-leveraged corporations? Was fiscal tightening necessary for external adjustment or for maintaining credibility?

- *Tightness of Initial Program:* Was macroeconomic policy tightened too much at the start of the program, greatly increasing the cost to the real economy?

- *Program Adjustments:* Should monetary policy have been eased sooner and/or more aggressively after the initial stabilization of the exchange rate in Q1/98? Should fiscal stimulus have been used earlier in the program to address the contraction in output?

Policy Objectives: Given the nature of the crisis in Korea and in the region as a whole, focusing monetary policy on stabilizing the value of the won at the start of the crisis appears to have been broadly appropriate, given the need to stem capital outflows, avoid default and control inflation. On the other hand, the dual objectives of fiscal policy -- maintaining credibility and allowing for external adjustment -- while theoretically defensible, seem in this case to be misplaced.

Monetary Policy: With the Bank of Korea's reserves already nearly exhausted at the start of the IMF program and the credibility of the authorities basically shattered, higher interest rates were critical to efforts to stabilize the value of the won and limit further capital outflows. Given the government's de facto guarantee of the banking sector's external liabilities in August 1997, it faced a severely limited set of options if it was to prevent default on these liabilities.

- The success of the bank rollover agreement played a critical role in reducing the drain of foreign exchange reserves and easing the pressure on the won. It is questionable whether this agreement would have been successful in the absence of a tightening of monetary policy, as a failure to stabilize the value of the won could have called into question Korea's ability to service its foreign currency debts.

The focus on exchange rates and interest rates as the gauge of the tightness of monetary policy also appears to have been appropriate, as the behavior of monetary aggregates proved to be very unpredictable. While Korea met all of its quantitative performance criteria, this reflected in large measure much faster than expected reserve accumulation and declining net domestic assets.

- The IMF acknowledges having significantly underestimated the money multiplier, as the public shifted from cash to deposits and from demand deposits to higher-yielding deposits with lower required reserves. Broad money growth was thus broadly in line with initial program projections, even though reserve money growth was weaker than expected.

Fiscal Policy: Maintenance of a tight fiscal policy early in the program appears to have been aimed at achieving moderate growth and supporting moderate external adjustment, while bolstering government credibility. The former objective is a theoretically valid one and probably would have been appropriate had the Fund's initial growth forecast for Korea been accurate. The latter seems unnecessary given Korea's history of fiscal prudence. Korea's budget had been close to balance from 1992 to 1996 and during the same period the level of public debt had averaged 10 percent of GDP.

Thus in hindsight, once negative growth and significant external adjustment appeared likely and since the credibility of fiscal policy was not generally in question, fiscal policy most likely should have been directed more toward supporting output. Fiscal policy was instead in many respects an afterthought of the program and was adjusted so late in the year that it was largely ineffective in boosting growth during 1998.

Tightness of Initial Program: Even if the objectives of the IMF's macroeconomic policy prescriptions for Korea were sound, one can question whether monetary or fiscal policies were tightened too severely at the start of the program, and thus aggravated the decline in real activity.

For monetary policy, the key question is whether a greater amount of inflation should have been tolerated in order to mitigate the decline in real activity. Given the inherent difficulties of setting appropriate interest rates in a crisis environment, however, it is difficult to argue that monetary policy was obviously tighter than necessary to stabilize the situation.

- According to IMF data, expected dollar returns in Korea remained negative during the period between November and January. Both ex ante and ex post real interest rates remained negative during the first quarter of 1998 as inflation surged sharply.

- The tightening of monetary policy undertaken at the start of the program was also unsuccessful in arresting the depreciation of the won. It was only after the second hike in

interest rates, which accompanied a broad strengthening of the program (including rollovers of short-term external bank debt), that the won started to stabilize in late December.

Korea's extraordinarily high level of short-term external liabilities, particularly those of domestic financial institutions ($57.9 billion, 39% of total external debt), meant that exchange rate depreciation carried with it significant costs in terms of its effect on bank solvency and the eventual fiscal cost of bank restructuring.

- It is nonetheless true that in contrast to Indonesia and Thailand, the debt burden of domestic corporations was primarily denominated in domestic currency. The OECD estimates total corporate indebtedness (both foreign and domestic) was approximately $600 billion in 1997. The Korean Ministry of Finance separately estimates that the external debt of non-financial private corporations totaled approximately $43 billion at that time (27% of external debt). The extraordinarily high debt-equity ratios of Korean non-financial corporations also made them more vulnerable to the effects of high interest rates than was the case for most other countries in the region. One could therefore argue that relative to other countries in the region (with the exception of Malaysia), Korea would have benefitted from a real output-inflation trade-off that entailed higher levels of inflation.

It should be noted, however, that given the extent of contagion during the course of the crisis, it is possible that an easier monetary stance in Korea could have had negative repercussions for the currencies of other crisis-affected countries. This was clearly the case with the Indonesian rupiah.

With respect to fiscal policy, the objective of assisting external adjustment was premised on an overestimation of Korea's growth prospects. Had the initial growth projections been accurate, some tightening of fiscal policy may have been useful in aiding the process of external adjustment. Given the unexpectedly sharp decline in real output and massive import compression that occurred, however, there was little need to share the burden of adjustment between the public and private sectors.

The question of the appropriateness of the fiscal policy stance of the IMF's program for Korea thus rests heavily on the faulty, overly optimistic projections at the start of the program. One can legitimately ask whether the Fund should have better anticipated the magnitude of the decline in real output and external adjustment in Korea, particularly given the experience of Mexico in 1995. It is notable that both Korea and Mexico undertook similar amounts of fiscal adjustment at the start of their programs and experienced similar declines in real output and shifts in their external balances. The failure to anticipate the similarity of these output responses has obviously been quite costly for Korea.

Program Adjustments: The Fund encouraged a steady and significant loosening of both monetary and fiscal policies as the severity of the downturn became apparent and the won strengthened. With hindsight it is clear that earlier easing, especially of fiscal policy, would have been helpful. However, it was not obvious in the midst of the crisis that faster adjustment, particularly for monetary policy, was appropriate.

- The extraordinarily turbulent situation in the region and the dangers of a premature easing of policy also provide a strong case for the cautious easing of monetary policy. It should be noted that overnight interest rates remained at their peak level of 35% for only a matter of days and had begun to decline steadily within two months of the start of the IMF program. Within nine months of the start of the crisis, nominal interest rates were below pre-crisis levels and real interest rates had fallen below historical levels.

- At least some portion of Korea's success in bringing inflation rapidly under control can be ascribed to both the appreciation of the won and falling global commodity prices.

  - This can be seen in producer prices, as the prices of raw materials (largely imported) were up 65% yoy in January 1998, but had actually fallen 22% yoy in December 1998. This compares to yoy PPI inflation for finished goods that peaked at 17% in February 1998 before declining to 3.5% in December.

  - The effect of falling global commodity prices can also be seen in import prices denominated in the contracting currency (presumably largely dollar-denominated contracts given the heavy weight of raw materials imports), which fell 12.6% yoy in December 1998.

It is impossible to know in hindsight whether interest rates could have been lowered more rapidly without sacrificing the gains that had been achieved in stabilizing and strengthening the won.

With fiscal policy, the situation is obviously somewhat different, as a significant widening of the fiscal deficit was not allowed until the August 1998 review, when the growth forecast was revised sharply downward to negative 5 percent. While some additional social safety net spending had been budgeted in the first half of the year, it had been mostly offset by additional revenue measures. The projected fiscal deficit increased from only 1.5% of GDP to 1.7% of GDP between January and May, despite the fact that growth forecasts were simultaneously being revised downward from positive 1.2 % to between negative 1% and 2 %. Even once a decision was taken to ease fiscal policy more aggressively, moreover, there were significant delays in delivering this stimulus as a result of slow implementation of new fiscal spending, particularly on social safety net programs. While this was also true of other countries in the region, it helped to magnify the cost of the initial policy error.

Giancola/Saeger; 6/3/99

IMF Macroeconomic Policy Prescriptions for the Asian Crisis: Background on Thailand

Overview:

The tight monetary policy implemented under the IMF program (approved on August 20, 1997) was appropriate given the weak central bank reserve position, growing downward pressure on the baht, and the large amount of Thai corporate debt denominated in foreign currencies. However, initial execution was inconsistent and substantially undermined market confidence during the early stages of the program. Major problems with the IMF program arose from overly optimistic growth projections. This led to excessive fiscal tightening at the onset of the program, further inappropriate tightening during the first and second quarterly reviews, and to insufficient fiscal expansions thereafter. A more expansive fiscal policy during the early stages of the program would have lessen the decline in economic activity (8% decline in GDP in 1998). However, given the degree to which Thai corporations were over-leveraged and the state of Thai financial institutions, a serious economic downturn during 1998 was probably unavoidable. Moreover, the ability of the Thai government to rapidly augment fiscal spending during 1998 was politically constrained.

Background:

Exchange Rate Performance: The baht peg came under downward pressure in 1996 and early 1997 as the current account deficit grew (7.9% of GDP in 1996). Market concerns over the stability of the peg also grew as the vulnerabilities of Thai domestic and external finances became increasingly apparent. Following very substantial intervention in May 1997, the central bank imposed selective capital controls and allowed interest rates to rise. However, shortly thereafter, central bank forward obligations, resulting from continued intervention, rose to unsustainable levels. On July 2, 1997, the authorities introduced a managed float, combined with other adjustment measures, including an increase in interest rates (the o/n repo rate rose ten percentage points to 27% but later declined to 16.5% by end-July) and suspension of operations of 16 finance companies. The baht depreciated by 22% in July (from about 25 to 32 per dollar) as market concerns steadily rose about the adequacy of adjustment measures and continued deterioration of the financial system. The authorities approached the Fund which approved a 3-year stand-by arrangement on August 20, 1997.

Following approval of the program, the baht continued to depreciate as the roll-over rates of short-term liabilities of Thai financial institutions and corporations declined and balance of payments problems spread to other countries in the region. By the time of completion of the first quarterly review on December 8, the baht had declined to 41 per dollar. The currency continued to weaken until its low point of 55.5 per dollar on January 12, representing a 55% depreciation from its pre-devaluation level.

During February 1998, the baht began to recover, closing at 43 per dollar on Feb 27. Market analysts attributed the baht's strengthening to the large turnaround in the current account, high sustained domestic interest rates and growing market confidence in the economic policies of the new government which took office in November. The baht weakened during June and July due

to growing concerns over the health of the banking and corporate sectors. The baht strengthened in August and since October 1998 the baht has fluctuated between 35-40 per dollar with the baht trading at 37 in late May 1999.

Inflation Projections and Performance: Despite a depreciation of more than 50% from the beginning of July through the end of January 1998, consumer prices rose at an annual rate of only 14% during the period due to falling domestic demand, low wage pressures, and the small share of imports of consumer goods in the price index. Consumer prices rose 7.7% in 1997 (Dec/Dec) compared to Fund staff original estimates of 9.5%, and revised estimate of 10% following the first quarterly review in November. At the first review, the Fund projected that consumer prices would rise 6% in 1998 (Dec/Dec). The Fund revised its estimate to 10.6% during the second review in February and raised it to 11% by the third review.

During the balance of 1998, the substantial strengthening of the baht, lower world commodity prices, and lower-than-anticipated domestic demand suppressed inflation. Subsequent IMF reviews included downward revisions in inflation projections. Monthly consumer price inflation was negative from August through December 1998. Consumer prices rose only 4.3% in 1998.

Real Output Projections and Performance: The Fund initially projected real GDP growth of 2.5% for 1997 and 3.5% for 1998. Real GDP declined 1.8% in 1997. By the first review in November 1997, the Fund had revised downward its 1998 growth projection to a negative 0.1%. By the second review, the growth projection was further adjusted to a negative 3-3.5%. Each subsequent review contained revised downward projections. Real GDP is officially estimated to have declined 8% in 1998 (the estimate is expected to be revised to a 9.5% decline).

Nominal Output Projections and Performance: The Fund originally estimated that nominal GDP for FY98 (the fiscal year starts October 1) would increase by 11.3%. The estimate was revised downward at each subsequent review. Nominal GDP for FY98 is estimated to have risen by 0.7% (likely to be revised downward).

Macroeconomic Policy Framework:

Monetary Policy Stance: The Thai IMF program originally focused on stabilizing the exchange rate by raising o/n repo rate to the upper part of the target range (12-17 percent). Given expectations of relatively constrained capital inflows and a weak reserve position, the program envisioned that the central bank would have to allow the baht to depreciate gradually (limit intervention) in the face of strong downward market pressure.

Although of secondary importance to the interest rate/exchange rate objectives, monetary aggregates remained within program targets and assumptions through the balance of 1997.

Faced with stronger-than-anticipated downward market pressure on the baht from continued capital outflows, the central bank, in consultation with the Fund, substantially raised the o/n repo rate to 20-25% during September 1997. However, it allowed the rate to decline below 15% in late October over concerns of a growing credit crunch. Renewed pressure on the baht prompted the

central bank to raise interest rates in November. The o/n repo rate remained in the 20-25% range throughout December.

By the time of the second review in February, monetary policy was almost solely concentrated on stabilizing the baht. The program assumed that despite concerns of the effect of high domestic interest rates on the survivability of the corporate sector, a temporary rise in interest rates was considered less damaging than a steep permanent decline in the baht. The program envisioned that as the baht stabilized at a higher value the central bank would begin to slowly ease interest rates.

By the time of the third review in May 1998, exchange rate stability had been largely achieved along with a substantial improvement in the central bank's reserve position. Concern had now shifted to addressing the deepening recession. The o/n repo rate declined from its range of 20-25% during January through March to around 17% in May. The o/n repo rate began to drop sharply in July. By September the rate was below 9% and was nearly 3% at the end of December 1998. Monetary targets were adjusted to allow M2A to grow by 9% in 1998. Targets were adjusted to allow M2A to grow by 7%, reflecting a lower level of expected economic activity. M2A ended up growing by 6.2% in 1998. Monetary aggregates throughout 1998 were within the program targets.

Fiscal Policy Stance: The Fund program originally included an overall public sector deficit of 1.6% of GDP in 1997 and a surplus of 1.0% in 1998. The bulk of the adjustment (2.8% of GDP during FY98) was to come from an increase in the VAT from 7 to 10 percent and a 1.6% of GDP decline in central government expenditures. The overall fiscal balances excluded the imputed carrying costs associated with the financial sector bail-out.

By the time of the first review the Fund and Thai authorities recognized that in the absence of additional measures, revenues would fall short of original FY98 projections by 2.5% of GDP due to a sharper slowdown in economic activity, the larger-than expected depreciation of the baht and its effect on the VAT tax, and overestimation of revenues. Despite these developments, the Thai authorities felt the public sector contribution to external adjustment needed to be preserved for the credibility of the program. Therefore, the fiscal program called for additional cuts in central government expenditures of 2% of GDP during FY98 and additional excise taxes and import duties.

By the time of the second review the 1998 fiscal balance was projected to be in deficit by 3% of GDP in the absence of additional measures. Revenue increases and spending cuts were undertaken to reduce the projected deficit to 2% of GDP (excluding the cost of support to the financial sector).

At the time of the third review, the fiscal program was adjusted from a projected consolidated deficit of 2% of GDP in 1998 to 3% of GDP. About 0.5% of GDP of the increase represented automatic stabilizers caused by downward revisions in projected economic growth. An additional 0.5% was included to foster domestic demand and was to be concentrated in the social safety net programs.

Although GDP growth estimates were further revised downward at the time of the fourth review in August 1998, the 1998 fiscal deficit targets remained unchanged due in part to concerns about the growing costs of the financial sector restructuring program, which was estimated to total about 4% of GDP during the next two years. The central government, however, had been experiencing some delays in its capital expenditure program. The consolidated fiscal deficit for 1998 totaled an estimated 2.8% of GDP.

Assessment:

Issues to consider in assessing the appropriateness of the Fund program's macroeconomic policy include:

•*Policy Objectives:* How should policies balance competing objectives, such as stabilizing the exchange rate, limiting output decline, limiting the level of corporate sector insolvencies?

•*Initial Implementation of Program:* Was monetary policy too lax and fiscal policy too tight contributing to a weaker baht but still unnecessarily reducing domestic demand as private sector activity declined sharply?

•*Program Adjustments:* Once the baht had stabilized, should monetary policy have been eased sooner, were fiscal adjustments to the program insufficient or in the wrong direction?

Policy Objectives: Focusing monetary policy on stabilizing the baht seems to have been the correct policy given that the exchange rate was tending to substantially overshoot what was warranted on trade competitive terms, and the negative implications of a permanently weaker baht on the solvency of many Thai corporations. Fiscal policy, based upon initial growth projections, may have been justifiable to promote an adjustment in the external current account. The question is why were the projections so overly optimistic? At the time of the program, Thai companies were, in general, highly leveraged and experiencing serious debt servicing problems. Many Thai financial institutions were facing insolvency. These factors, along with a necessarily tight monetary policy, were likely to cause a sharp decline in private sector demand. Nevertheless, the program assumed that real GDP would grow by 3.5% in 1998. This compares to a 6.1% decline in Mexico's GDP during the first year of its IMF program. The austere fiscal policy (an adjustment of 2.8% of GDP in 1998, followed by an additional 2.5% after the first review) was not appropriate and aggravated the economic decline.

<u>Monetary Policy</u>: Given that the baht was under severe downward pressure, the central bank had exhausted its ability to intervene in the exchange market, and concerns existed regarding the adequacy of the emergency official financing package, the choice was between a steeply depreciating currency or a tight monetary policy. The decision to opt for a temporary tighter monetary policy until the baht stabilized at a higher value seems appropriate given the large portion of Thai corporate debt denominated in foreign currency (total corporate of nearly $200 billion, of which 25% in foreign currency). Moreover, the temporary increase in local currency debt service costs for Thai corporations was significantly attenuated given that prime lending rates rose only a small fraction in relation to the increase in the o/n repo rate.

The decision to focus on interest rates as opposed to monetary aggregates also flowed from the decision to directly focus on stabilizing the baht. In hindsight, monetary targeting would have been substantially complicated due to severe difficulties in the financial sector.

One can question whether a Korean-like rescheduling of short-term external liabilities of Thai corporations and financial institutions would have substantially eased capital outflows, reducing the level of monetary austerity needed to stabilize the baht. However, the Thai government would have been extremely reluctant to extend a guarantee on private external obligations.

Fiscal Policy: The IMF argues that the fiscal program was designed to reduce the current account deficit and lower expectations of the need to monetize future deficits, thus lowering expectations of inflation and currency depreciation. The former argument seems valid based upon initial IMF growth projections. The latter argument, however, seems to carry less weight given that the fiscal balance had been in surplus for many years prior to 1997 and the level of public sector debt was relatively low (public domestic and external debt, including guarantees, totaled 12.7% of GDP in FY97).

Initial Implementation of Program: Monetary policy in the initial months was erratic, as authorities alternated between high interest rates to defend the baht and low rates to support the economy. IMF data also indicate that the expected monthly dollar return in Thailand during July 1997 through February 1998 was negative, suggesting that interest rates were inadequate to offer sufficient incentive to hold baht. The loss of market confidence in the Thai program during its early stages may have made subsequent interest rate tightening more severe than would otherwise have been required.

In considering the poor initial execution of monetary policy one should recognize the lack of will on the part of the outgoing government in undertaking decisive measures. Its unwillingness to deal with other pressing issues, including the need to take strong corrective measures in the financial sector, contributed to a general undermining of market confidence.

Program Adjustments: The Thai program was significantly modified during the early stages. Both monetary and fiscal policies were first tightened and then substantially relaxed during the second half of 1998.

Monetary Policy: The tightening of monetary policy undertaken during the first review to stabilize the weakening baht was clearly justified, although the tightening may not have been adequate. The baht did not stabilize until late February 1998. One might question whether the decision to maintain high short-term interest rates through the summer of 1998 was correct given the larger-than-expect improvement in the current account and strengthening reserve position. However, given the premature easing of interest rates in November 1997, the risk of a repeat mistake would have been costly. Moreover, the weakening of the baht during June and July of 1998 would have been more pronounced had a loser monetary policy have been in place during those months. Finally, a substantially easier monetary policy during these months would not likely have significantly eased the liquidity situation of Thai corporate sector since banks were reluctant to extend new loans even though the largest banks were highly liquid.

By the fourth quarter of 1998, monetary policy was substantially eased, since then short-term interest rates have been below pre-crisis levels.

Fiscal Policy: At the time of the first quarterly review, the IMF was aware the economy was moving into recession. The decision to fully offset the natural fiscal stabilizers through additional expenditure and revenue measures totaling 2.5% of GDP were, in hindsight, clearly inappropriate and contributed to an acceleration in the decline of economic activity. However, at the time, the new government was extremely concerned with re-establishing program credibility.

The decision during the second review to partially offset the automatic fiscal stabilizers through additional spending cuts and revenue measures totaling 1% of GDP again seems to have been inappropriate, especially given that by then there were clear signs that the current account and external reserve positions were improving substantially faster than had been envisioned, and that the economy was moving into a steep recession.

By the third review in May 1998 the Fund and the authorities recognized the need to substantially alter fiscal policy to counter the decline in economic activity. However, ability of the government to rachet up spending became the constraining factor.

CMcCoy/JNeil, 6-3-99

IMF Macroeconomic Policy Prescriptions for the Asian Crisis: Background on Indonesia

Overview:

Indonesia provides a cautionary counterexample of what can happen if countries fail to maintain monetary control. While one can argue that the IMF's monetary policy rule at the start of the program was part of the problem, the lack of political will to adhere to the policy package is a more important cause of the failure of macroeconomic policy to stabilize the economy. The eventual success of the monetary policy regime targeting net domestic assets (NDA) in Indonesia points to the need for a clear, transparent rule to guide policy when credibility has been lost. This monetary policy rule served as a helpful anchor for policy at a time of extreme political uncertainty. As in other countries in the region, the initial fiscal stance was overly contractionary, although the IMF understandably was constrained by the government's policy not to finance budget deficits domestically. The IMF adjusted the fiscal stance over time to respond to the deteriorating situation in later program reviews.

Background:

Exchange Rate Performance: Following the devaluation of the baht, the Indonesian authorities moved quickly toward greater exchange rate flexibility by widening the exchange intervention band from 8% to 12% on July 11, and later by allowing the rupiah to float freely on August 14. This policy response initially had a calming effect on the exchange rate. However, by the end of September, the rupiah was again under pressure, and the rupiah had depreciated more than 30% before Indonesia approached the IMF in November 1997. The exchange rate quickly strengthened in response to the policy package announced in early November 1997, rising about 10% during the first week of the program to Rp. 3,300/$, in part as a result of concerted intervention on Indonesia's behalf by Singapore and Japan.

This initial success in stabilizing the rupiah was short-lived as the government's failure to follow through quickly on policy measures, coupled with political uncertainty, contributed to souring market sentiment. In December 1997, the rupiah plummeted to around Rp. 5,500/$, losing over 30% of its external value within two weeks. It then continued its plunge in January, falling to Rp. 8,100/$ on January 7. Capital flight and continuing doubts about the Suharto government's willingness to implement necessary reforms weighed severely on the rupiah during the next three months.

The rupiah finally began to recover in April 1998 as a result of a sharp tightening of monetary policy and the resumption of cooperation between the IMF and the Indonesian government. However, the exchange rate depreciated sharply when the social unrest and political turmoil boiled over in May, falling to as low as Rp. 16,000/$ in early June. After recovering to around Rp. 7,500/$ during the second half of 1998, the rupiah depreciated below Rp. 9,500/$ following Brazil's devaluation. The currency was also weighed on by concerns about delays in the government's bank recapitalization program and continuing political uncertainty, but has strengthened steadily since then to its recent level of around Rp. 8,000/$.

Inflation Projections and Performance: Inflation started to increase in 1997 as a result of drought. The alarming depreciation of the rupiah led to an acceleration of inflation in late 1997 and early 1998. Consumer prices increased by 21% during the first two months of 1998, then settled to a rate of about 5% per month during March-June, only to pick up again during July-August. Cumulative inflation for the first eight months of 1998 was 69%. Inflation then began to moderate as consumer prices rose only 3.8% in September 1998, followed by near-zero inflation in October and November. While inflation increased slightly between December and February, prices have actually fallen in the last three months.

Year-over-year CPI inflation has fallen from its peak of 82.3% in September 1998 to 30.8% in May 1999.

- CPI inflation averaged 66% in 1998/99 and the IMF projects CPI inflation to be 15-17% in 1999/2000.

Real Output Projections and Performance: The program initially projected real GDP growth of 3.0% in 1998/99. These projections were revised downwards during the course of 1998. Growth forecasts were revised to –5.0% in April 1998, to –12.1% in June 1998, to –13 to –14% in August 1998, and to –15% in November 1998. Estimated real GDP growth for the fiscal year was –15.3%. Real GDP growth is projected to be 0-2% in FY 1999/2000.

Nominal Output Projections and Performance: Given the Fund's projections of real output and end-period CPI inflation, nominal GDP growth was initially projected at 12% for 1998/99. By April 1998, the 1998/99 projection was revised to 40% nominal GDP growth using period average CPI inflation estimates. Nominal GDP growth estimates were again revised to 48% in June 1998 and 66% by August 1998. Actual nominal GDP growth for 1998/99 equaled 51%.

Monetary Policy Stance: In examining the success of the Fund's monetary policy prescriptions in Indonesia, one needs to differentiate between two policy regimes: 1) the initial stand-by program, which attempted to use a mix of some tightening of monetary policy and partially sterilized intervention to support the rupiah, and 2) the targeting of net domestic assets (NDA) starting in March 1998.

Initial IMF Approach: The Fund's original monetary policy prescription for Indonesia combined a tight monetary stance with partially sterilized exchange rate intervention. The program targeted both a notional exchange rate zone and base money, which served as a performance criterion. Interest rates, however, were the primary means by which the tightness of monetary policy was gauged.

- While the concerted intervention by Bank Indonesia, Japan and Singapore was initially successful in supporting the appreciation of the rupiah and tightening liquidity conditions, the government lowered interest rates toward pre-crisis levels within a week of the start of the program.

- The decision to lower interest rates, which supposedly came on the orders of President Suharto, quickly undermined monetary policy by limiting Bank Indonesia's ability to soak up the liquidity support (totaling 8% of GDP between November 1997 and March 1998) that was injected in the banking system in response to bank runs. The resulting surge in NDA helped spur capital flight and put the rupiah under sharp downward pressure. While the authorities subsequently raised interest rates, these efforts were unsuccessful in re-establishing monetary control or stabilizing the rupiah. Interest rates on overnight BI certificates increased from 14% to 30% in late January and to 40% in March, but one month rates remained at 22% through mid-March.

- From end-July 1997 to March 1998, cumulative Bank Indonesia intervention in the foreign exchange market equaled $7.94 billion.

NDA Targeting: The Indonesians adopted a revised monetary policy regime in the second half of March 1998 by targeting NDA, which were to remain flat. The new policy also did not allow for exchange market intervention.

- The revised program met with some initial success in regaining monetary control. One month interest rates were raised to 36% in mid March and then to 46% by early April. As a result, monetary aggregates were kept within the program targets and the exchange rate appreciated to around Rp. 8,000/$ in the second half of April.

- The program was temporarily driven off course again by the riots in mid-May 1998. This led to runs on banks with ties to the former President and the provision of large-scale liquidity support by BI.

BI subsequently took strong action to reestablish monetary control, as most of the liquidity support injected in late May and early June was mopped up through open market operations to bring NDA back within the program targets.

- The introduction of the SBI auction system in late July was extremely successful in helping BI mop up excess liquidity while also establishing a market-based interest rate that was somewhat more immune to political pressures to ease monetary policy. BI has generally been successful in meeting its monetary targets over the last 10 months.

- Interest rates steadily declined from a peak of 71% at the beginning of September until December 1998. After rising briefly to 38% in March to enable BI to mop up liquidity support that was necessary following the delay in the bank recapitalization program, rates have subsequently declined dramatically to 26% at the May 26 auction.

Fiscal Policy Stance: Indonesia historically maintained a sound fiscal position during the 1990s based on a balanced budget principle that precluded domestic borrowing by the government[1]. Prior to the crisis, the government projected a budget surplus of ¾% of GDP for the 1997/98 fiscal year. The initial IMF stand-by arrangement in November 1997 called for the government to maintain a surplus of 1%. The objectives of this tightening of fiscal policy were to reassure markets that a sound macroeconomic stance would be maintained, to facilitate an orderly adjustment of the current account, which was necessitated by the sharp reduction in inflows of foreign savings, and to finance the cost of bank restructuring (estimated at ½% of GDP in the initial program). This required the government to reduce infrastructure and development spending, yielding a budgetary saving of around 1% of GDP, and to compress other expenditures, yielding a further adjustment of ¼ % of GDP. The remaining budgetary gap was projected to be filled by increasing non-oil revenue. The baseline overall balance after bank restructuring without measures for FY 1997/98 was –0.8% of GDP. The program called for a overall balance after bank restructuring of 0.3% of GDP, thus tightening fiscal policy by approximately 1.1%.

[1] The balanced budget rule, which is contained in the Guidelines for State Policy, was adopted initially in 1968. It requires that every year total budgetary expenditure should be equal to budgeted revenue, defined to include all foreign grants and loans. The rule also requires that domestic revenue be sufficient to cover current expenditure, including the amortization of government debt, and a portion of development expenditure, which in Indonesia includes both investment and some "current" expenditures, including a significant portion of the public sector wage bill. This principle by and large prevents domestic private bank and nonbank financing of the central government. To the extent that development expenditure exceeds public saving, the gap can normally be filled only by external borrowing.

The deterioration in Indonesia's economic and financial situation during the course of 1998 led to a series of revisions to the fiscal policy stance that allowed for progressively larger fiscal deficits, all of which were to be financed externally.

- In *April 1998*, the fiscal strategy was revised in order to increase support for the poor and accommodate the costs of bank restructuring (the total interest costs of bonds to finance bank restructuring were estimated at 1.5% of GDP), while keeping the programmed deficit to a level that could be largely covered by foreign financing. The 1998/99 budget deficit was revised to 3.8% of GDP as higher subsidies on some food and other essential items were programmed into the framework in order to cushion the impact of the depreciation on the poor (total subsidies were projected at 2.3% of GDP in 1998/99). Total revenues and grants were projected to be less than in the enacted budget, though some steps were taken to raise tax revenues and non-tax revenues.

- In *June 1998*, the 1998/99 budget deficit was revised to 8.5% of GDP in order to allow for a substantially increased subsidy bill for basic foodstuffs, petroleum products, and electricity; increased expenditures for health and education; and the expansion of employment-creating projects. The expanded subsidy program was estimated to cost over 6% of GDP and the budgetary cost of servicing the bank recapitalization bonds was relatively unchanged at its estimate of 1.6% of GDP.

- By *November 1998*, the budget position was much stronger than programmed, reflecting underperformance on spending due to delays in implementing new social spending initiatives and elimination of some subsidies. The 1998/99 budget deficit target was revised downward to 6% of GDP. The actual deficit for the fiscal year is estimated to have come in at 2%, significantly lower than the 6% target. This was mainly due to non-oil and gas revenues coming in higher than projected while current expenditures, particularly subsidies, were lower than projected.

The budget deficit target for 1999/2000 was projected at 6% of GDP in November 1998 and has been maintained at that level in subsequent reviews. The costs of bank restructuring are currently estimated at approximately 45% of GDP. Preliminary 1998/99 figures estimated the interest costs of bank restructuring at 0.8% of GDP and project these costs to increase to 2.8% of GDP in 1999/00.

<u>Assessment</u>:

A number of issues need to be dealt with in assessing the appropriateness of the Fund's monetary policy prescriptions for Indonesia.

- *Policy Objective:* Were the initial policy objectives appropriate?

- *Tightness of Policy During Stabilization Period:* Was policy tightened too much at the start of the program, greatly increasing the cost to the real economy?

- *Gradual Easing of Policy:* Were program adjustments appropriate?

Policy Objective: Given the nature of the crisis in Indonesia and the region, the initial focus of monetary policy on stabilizing the rupiah and containing inflation appears to have been appropriate.

- The failure of the initial IMF policy framework is due at least in part to Suharto's interference which prevented the authorities from letting interest rates rise.

- This failure to tighten monetary policy early proved extremely costly. The IMF's concerns about inflation were not groundless and this example illustrates that the failure to mop up liquidity can have dire consequences on the health of the economy.

- The experience of Indonesia's intervention in the foreign exchange market illustrates that such intervention is only effective when coupled with strong macroeconomic policy.

- Maintenance of a tight fiscal policy early in the program appears to have been aimed at achieving moderate growth and supporting moderate external adjustment, while bolstering government credibility. The former objective is a theoretically valid one and probably would have been appropriate had the Fund's initial growth forecast for Indonesia been accurate.

- The inability to fund the budget deficit domestically hampers the use of fiscal policy for macroeconomic stabilization and may be undesirable.

Tightness of Policy During Stabilization Period: The initial fiscal stance was probably overly contractionary, although the Fund was limited by the government's desire to avoid domestic financing of the deficit. Furthermore, the easing of monetary policy in the initial stages was not appropriate, although this was not the Fund's fault and did not follow along the initial program's framework.

Gradual Easing of Policy: As the deterioration in Indonesia deepened, the Fund was responsive in adjusting the program quickly. A large amount of external financing was mobilized to support the budget deficit. However, spending was constrained by a number of factors:

- The inability of the government to implement social safety net spending caused the actual deficit to come in much less than programmed. The delays in the implementation of social safety net programs were due to a lack of infrastructure, concerns about corruption, and a cultural bias against deficit spending. These delays meant that the fiscal stimulus was much less than intended and did not support growth until the last quarter of FY 1998/99. However, given concerns about corruption and the lack of proper targeting of social safety net funds, there was limited scope for pushing the government to spend at an accelerated pace.

- There are also concerns about fiscal sustainability in Indonesia given the increasing bank recapitalization costs and the medium-term outlook. This further limited the ability of the Fund to increase the fiscal deficit.

- Monetary easing could only begin late in the program due to the costly mistakes made early on. Given the failure to tighten monetary policy early in the program and ongoing political uncertainty, the eventual loosening of monetary policy was probably at the right speed.

L.Kuriyan/ INA/ June 3, 1999

IMF Macroeconomic Policy Prescriptions for the Asian Crisis: Background on Malaysia

Overview:

While Malaysia did not have a formal IMF program, there were regular consultations with the Fund in the form of an enhanced Article IV consultation process. The Fund's advice to Malaysia appears to have been quite similar to what was advocated in the rest of Asia, as it called for a substantial tightening of monetary and fiscal policy early in the crisis. The IMF then appears to have shifted to advocating somewhat looser fiscal policy, although it still supported higher interest rates. While we obviously do not support all the Malaysian government's policy actions, there does appear to be considerable justification for the Malaysian's decision not to tighten monetary policy as much as desired by the Fund. A more rapid easing of fiscal policy also probably would have been appropriate given the collapse in domestic demand.

Background:

High Credit/Money Growth: The Malaysian economy started to experience over-heating pressures three years prior to the Thai baht devaluation. The government began to take steps to rein in the high growth of credit and money in March of 1997 by curtailing lending to the property sector and for the purchase of stocks, and instituting credit growth targets. Despite these measures, however, it was not until Bank Negara raised interest rates by 200 bps (from 9% to 11%) in January of 1998 that credit and money growth started a steep downward trend. Both credit and money growth fell continuously throughout 1998 and into 1999, even after the government had reversed its position in the fall of 1998 and set an 8% yoy credit growth target for all banks.

Debt: As a result of the rapid credit growth since 1995, Malaysia's private domestic debt at 150% of GDP was the highest among all Asian countries at the beginning of the crisis. Domestic debt of the non-bank private sector was at 140% of GDP, with the rest belonging to the banking sector.[1] Unlike other regional crisis countries, however, Malaysia had very little foreign debt due to relatively strong prudential supervision and regulation on foreign borrowing. Total foreign debt was about $40 billion at the end of 1997, 35% of which was owed by the private sector. Total short-term foreign debt was only $10 billion (compared to reserves of over $20 billion), of which $2.5 billion was owed by the non-bank private sector and $7.5 billion was owed by the banking sector. The relatively small amount of short-term foreign debt helped Malaysia avoid a balance of payments crisis and the need for IMF support. It also made stabilizing the exchange rate a lower priority for Malaysia than for the other crisis countries.

Exchange Rate Performance: Bank Negara initially attempted to defend the value of the ringgit after the Thai baht was devalued. The overnight interbank rate shot up to 40% on July 10, 1997, compared to 7.5% in the previous day. Bank Negara abandoned its interest rate defense of the ringgit after one day, however, and the overnight rate fell back to the single digit level on July 11th. The central bank allowed the ringgit to float, but still attempted to support it by intervening in the FX market, spending $4.5 billion of reserves during July alone. Some further intervention,

[1] Bank deposits not included.

totaling about $1 billion, took place in early August to prevent the ringgit from falling too quickly. The ringgit then fell unabated during the rest of the year, declining 35% in value. The ringgit finally stabilized following Bank Negara's decision to raise interest rates in January of 1998 and traded in a range between RM3.5/$1 and RM3.9/$1 until June. During the summer, the ringgit faced renewed downward pressure as the global financial situation deteriorated. The ringgit was trading around RM4.2/$1 in late August before it was pegged by the government at RM3.8/$1 on September 2nd as part of the capital controls. The peg is still in effect today.

Inflation Projections and Performance: Inflation remained below 3% yoy during 1997 but began to trend upward in December of 1997. There was only limited pass-through of the exchange rate depreciation to inflation, however, as inflation remained below 6% in 1998.

- Some analysts have cited Malaysia's price controls (which cover 11 major products, or about 10% of the CPI basket) as having dampened the effects of the devaluation. If this had been the case, however, one would most likely have seen the development of a black market for these goods, which has not occurred. The limited inflation pass-through is also consistent with the experience of other countries in the region, suggesting that Malaysia's price controls had only a marginal effect.

- The IMF projected that inflation would average 7-8% for 1998 as a whole at the time of its Article IV Review in March.

- As in other crisis-affected countries, inflation turned out lower than projected due to falling world commodity prices and a larger than expected drop in domestic activity.

Capital Controls: Malaysia imposed capital controls on September 1, 1998 intended to "regain monetary policy independence" and deal effectively with global financial instability. One of the main restrictions was that foreign portfolio capital would be locked up for one year before it could be repatriated. Malaysia subsequently relaxed the capital controls on February 4, 1999 by replacing the one year lock-up rule on foreign portfolio flows with a tax-based rule.

Real Output Projections and Performance: The IMF projected that Malaysia's real GDP would grow 8.2% in 1997 at the time of its Article IV Review in July. Actual GDP growth in 1997 turned out to be 7.7%. The Fund forecasted real GDP growth of 2.5% in 1998 at the time of its Article IV Review in March, significantly higher than the actual growth of -6.7%.

Nominal Output Projections and Performance: The Fund's projection for Malaysia's inflation rate can be used to derive the Fund's forecasts for nominal GDP growth, which were 11.5% and 10% in 1997 and 1998, respectively. Actual nominal GDP growth turned out to be 10.6% and -1.5% in 1997 and 1998, respectively.

Macroeconomic Policy Framework:

Given its relatively strong fundamentals at the start of the crisis, Malaysia never ran into a balance of payments crisis, thus removing the need to seek an IMF program. This allowed the

government to maintain its policy independence, which was particularly important given the political situation and Prime Minister Mahathir's rhetoric. Nevertheless, with the deteriorating domestic and regional economic conditions, Deputy Prime Minister Anwar decided to adopt a "shadow" IMF program in late 1997/early 1998. The shadow program included a 200 bp hike in interest rates in January of 1998 and the cancellation of various pet projects of the government (and the PM). The IMF's policy advice was then largely ignored after the ouster of DPM Anwar and the imposition of capital controls.

Monetary Policy Stance: The Fund consistently recommended that Malaysia tighten its monetary policy stance during the first year of the crisis. In its July 1997 Article IV Review, Fund staff recommended the Malaysian government should slow credit and money growth to prevent the economy from further overheating, although they did not specify which instrument to use to achieve a soft-landing. (Several Executive Directors did urge the government to raise interest rates during the September 1997 Board discussion.) Bank Negara eventually followed this advice in January of 1998, rasing interest rates by 200 bps. Fund staff called for a further increase in interest rates in the March 1998 Review. The Malaysians declined to follow this advice.

The Malaysians began to ease monetary policy in late summer 1998, the first evidence of the government's efforts to aggressively stimulate growth. The first round of interest rate cuts began in August, and led to a 400 bp fall in the three month interbank rate (cut from 11% to 7%) by November. Further rate cuts were undertaken in April of 1999 with the government lowering rates by another 100 bps (from 7% to 6%). Analysts expect more rate cuts to come if inflation falls further.

- The imposition of capital controls in September of 1998 was designed to allow Malaysia to quickly lower interest rates without affecting the value of the ringgit, despite domestic political uncertainties and turbulence in the global financial markets. However, it is unclear that the benefits brought by capital controls were significant since other regional countries also were able to lower their interest rates at the same time as Malaysia while their currencies strengthened progressively.

Fiscal Policy Stance: Malaysia's fiscal response to the crisis was similar to that of other countries, as it initially cut back on spending in an effort to avoid a budget deficit. It eventually shifted to a more stimulative policy stance, although there have been delays in implementing the stimulus.

The 1998 budget, announced in October of 1997, initially aimed for a surplus of 2.5% GDP.[2] This largely continued the efforts of the previous budget to bring the overheating economy under control. By December, when the government introduced a supplemental budget, deteriorating domestic and regional economic conditions led to a downward revision of the budget surplus to

[2] The 1997 budget surplus was targeted at 2.25% of GDP. Actual surplus was 2.6% of GDP.

about 1.5% of GDP. This surplus was to be achieved by sharply cutting the government's operating and development expenditure by 2.5% of GDP. In addition, the government postponed indefinitely some RM66 billion (22% of GDP) of infrastructure developments, including the government's pet projects like the Multimedia Super Corridor and Putrajaya.

The government started to shift toward a more stimulative fiscal policy stance in March of 1998 when it restored some of the previously announced cuts in social expenditure. The goal was to strengthen the social safety net to mitigate the effects of economic adjustment on the most vulnerable sectors of the economy. This marked a relatively small adjustment, however, as the projected budget surplus was only reduced by 1% of GDP. While the Fund apparently supported this fiscal adjustment, staff also cautioned the Malaysian government to keep a vigil on fiscal sustainability.

The government announced more aggressive fiscal stimulus in July of 1998. An Infrastructure Development Fund was set up with RM5 billion (2% of GDP) designed to assist the financing of infrastructure projects and large public facilities so that their implementation could proceed. In addition, another RM7 billion (2.5% of GDP) was allocated to further strengthen the social safety net. Including all of these expenditures, 1998's budget reached a deficit of 3.7% of GDP.

- The 1999 budget is even more expansionary, with a projected deficit of 6.1% of GDP.

Assessment:

A number of issues need to be dealt with in assessing the appropriateness of the Fund's policy recommendations to Malaysia.

- *1997 Article IV Review (July 31, 1997)*: Was the Fund correct to recommend a tightening of monetary policy to curtail the growth of credit and money? Did the Fund overemphasize the need to tighten fiscal policy in order to run a budget surplus?

- *1998 Article IV Review (March 27, 1998)*: Was the Fund right to have recommended a further hike in interest rates after the government had already done so (by 200 bps) in January of 1998? Should the Fund have encouraged the government to further relax fiscal policy in order to stimulate domestic demand?

<u>1997 Article IV Review</u>: The main concern of the Malaysian government and the Fund at this time was to achieve a soft-landing for an economy that was growing past potential for the previous three years. There was also an added sense of urgency to rein in the Malaysian economy following the devaluation of the Thai baht, which made the regional economic situation much more risky. Malaysia had been running current account deficits of over 5% of GDP since 1994, and it was questionable that this was sustainable even for a country like Malaysia which had a strong external position.

- The Fund's recommendations for macroeconomic policy in July of 1997 appear to have been appropriate, particularly given existing concerns of overheating and the lack of

information about the nature of the developing regional crisis.

- The monetary tightening adopted in early 1998 at the IMF's behest was relatively modest and does appear to have helped stabilized the ringgit.

1998 Article IV Review: The Malaysians appear to have been justified in resisting the IMF's recommendation in March of 1998 to raise interest rates further. The depth of the crisis in the rest of the region was becoming apparent and the Malaysian economy was showing increasing weakness. Credit growth was already slowing rapidly. Manufacturing production growth was deeply in the negative for the first three months of the year. Import growth also entered negative territory starting in January, reflecting the collapse in domestic demand. Quarterly GDP contracted 2.8% yoy in 1Q98, the first decline in real GDP during the 1990s. The dramatic fall in the prices of stocks and property also provided evidence that the credit bubble had burst. Increasing interest rates further in March of 1998 would only have exacerbated the economic downturn that was only beginning.

In addition, it is unclear what benefits higher interest rates would have brought to the Malaysian economy at that time. Unlike other regional crisis countries, Malaysia had very little short-term foreign-currency debt, so there was less need to support the currency in order to prevent the foreign debt from exploding in domestic currency terms. Inflation pass-through was never a problem, despite the Fund's warning of a possible devaluation/inflation cycle. The Fund staff may have been right to be concerned about the distortionary effects of relying on administrative restraints to control credit growth. But they ignored the Malaysians' warning that credit growth was already firmly on a downward path by the time of the 1998 Article IV Review.

Malaysia's fiscal policy was clearly too tight under the "shadow" Fund program. The December 1997 supplementary budget was quite contractionary. It is unclear why the supplementary budget was not kept neutral given the emergence of debt-deflation forces in the region. The March 1998 supplementary budget certainly should have been much more expansionary since the extent of the economic contraction was becoming more evident by then and the current account had switched to a deep surplus. There might have been concerns that some of the government's pet projects were white elephants. But nevertheless, the continuation of these projects would have given the economy a much needed demand boost. The IMF, therefore, probably should have encouraged the Malaysian government to adopt a more stimulative fiscal stance in the March 1998 Review.

CYIN/INA, 6/1/99

TREASURY CLEARANCE SHEET

No._____

Date: June 3, 1999

MEMORANDUM FOR: ☐ SECRETARY ☐ DEPUTY SECRETARY ☐ EXECUTIVE SECRETARY
☐ ACTION ☐ BRIEFING ☐ INFORMATION ☐ LEGISLATION
☐ PRESS RELEASE ☐ PUBLICATION ☐ REGULATION ☐ SPEECH
☐ TESTIMONY ☐ OTHER _____

FROM: Assistant Secretary Truman

SUBJECT: Meeting on Lessons of Asia Crisis

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  - ☐ Domestic Finance
  - ☐ Economic Policy
  - ☐ Fiscal
    - ☐ FMS
    - ☐ Public Debt
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- ☐ Enforcement
  - ☐ ATF
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  - ☐ FLETC
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- ☐ General Counsel
- ☐ Inspector General
- ☐ IRS
- ☐ Legislative Affairs
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- ☐ OCC
- ☐ Policy Management
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  - ☐ E & P
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