Mr. Camdessus considers the lessons from Southeast Asia Remarks by the Managing Director of the International Monetary Fund, M. Michel Camdessus, at a press briefing in Singapore, on 13/11/97.

How could events in Southeast Asia unfold as they did, after so many years of outstanding performance? We have a fairly clear analysis of what happened in Thailand. The more difficult question is how the crisis spread so quickly to other economies in the region. I'm not sure we have the full picture yet, but let me give you my perspective on the causes of the crisis and where we go from here.

I. How could it happen?

Certainly, the Thai crisis did not strike out of the clear blue sky. On the contrary, there were numerous signs of a gathering storm. Macroeconomic indicators pointed to substantial imbalances: substantial real exchange rate appreciation; a marked slowdown in export growth; a persistently large current account deficit financed increasingly by portfolio inflows, including a substantial amount of short-term capital; and rising external debt.

These problems, in turn, exposed other weaknesses in the Thai economy, including substantial, unhedged foreign currency-denominated borrowing by the private sector, an inflated domestic property market, and a weak and over-exposed banking system. Markets issued their own warnings in the form of declining equity prices and mounting exchange rate pressure, as doubts about the sustainability of policies grew. And as you know, the Fund also stressed these problems and pressed for urgent measures in a continuous dialogue with the Thai authorities.

It was, of course, difficult for the authorities in Thailand and elsewhere in the region to recognize, after so many years of outstanding macroeconomic performance, that serious underlying deficiencies could seriously jeopardize their track record. This certainly contributed to the delay in taking the necessary corrective action. And at last, in the absence of convincing policy action, the storm broke.

We all have been troubled by developments in the Thai economy, both because they have been so costly for Thailand and its neighbors and because they were so preventable. But at least their origins are by and large clear. What is less evident, and therefore more unsettling to all who are trying to make sense of broader regional developments, is how the crisis spread as it did to economies such as Indonesia, Malaysia and the Philippines, where current account deficits were generally smaller and foreign direct investment more substantial. Although it may be some time yet before we have the complete answer to this question, some elements of the explanation are becoming clear.

Part of the explanation lies in the extent to which developments in Thailand have affected conditions in neighboring countries. For example, in expectation that the depreciation of the baht would erode the competitiveness of Thailand's trade competitors, their currencies also weakened. And as these currency slides acquired an almost self-perpetuating character, the debt service costs of the domestic private sector increased. Uncertainty about how far these currencies would slide and how much debt service costs would increase encouraged a rush to hedge external liabilities that only intensified exchange rate and interest rate pressures.

Another factor is that problems in the Thai economy prompted markets to take a closer look at the risks in other countries. And what they saw -- to different degrees in different places -- were many of the same problems affecting Thailand: among them, overvalued real estate markets, weak and over-extended banking sectors, poor prudential supervision, and substantial private short-term borrowing in foreign currency. Moreover, after Thailand, markets began to look more critically at weaknesses they had previously considered minor, or at least manageable in an orderly way, given time.

I see two other factors that hastened the stampede: one, the lack of transparency, and hence the increased uncertainty, about government and central bank operations, about the true state of financial sectors, about the links between banks, industry, and government and the impact these links might have on economic policy; and two, the controls -- and threat of controls -- on market activity. Given the tendency of financial markets participants to run with the herd, this was a sure-fire way to send the herd scrambling for safer pastures and set back efforts to restore confidence.

II. What lessons should we draw from all of this?

The first lesson is the most obvious one: the necessity of taking early action to correct macroeconomic imbalances before they precipitate a crisis. This did not happen in Thailand, despite timely and vigorous warnings. On the contrary, policymakers attacked the symptom of the crisis, the pressure on the baht, accumulating large reserve losses and forward foreign exchange liabilities in the process. This, together with delays in addressing Thailand's severe financial sector problems and lingering political uncertainties, clearly contributed to a deepening of the crisis and its spread to other economies in the region.

The second lesson is that other countries can find that their vulnerability to crises in other markets is greater than economic fundamentals would suggest. Consequently, they need to take pre-emptive actions to strengthen their policies. Where might such action be needed? Several suggestions come to mind:

- one, maintaining an appropriate exchange rate and exchange rate regime. Clearly, there is no single "right" choice, but more flexible exchange rates can help provide early and visible signals of the need for policy adjustments and are less likely to invite reckless behavior on the part of borrowers and lenders. But regardless of the exchange rate arrangement chosen, appropriate macroeconomic policies are essential to ensure its success;

- two, maintaining a proper policy mix -- among other reasons -- so that high domestic interest rates do not damage the domestic economy, attract excessive amounts of short-term capital, or preclude further monetary tightening if market conditions require; indeed, it is important to keep the option of using the interest rate instrument open, so that the authorities have some room for manoeuvre in times of international instability;

- three, strengthening structural policies -- especially the policies and institutions such as better prudential supervision, needed to underpin a sound financial system;

- and four, carrying out other supporting reforms -- what we call "second generation" reforms -- to promote domestic competition, increase transparency and accountability, improve governance, help ensure that the benefits of future growth are widely shared, and otherwise strengthen the foundations for future growth.

III. Restoring confidence

As developments have shown, confidence, once lost, is hard to regain. Restoring confidence takes a strong commitment to economic adjustment and reform demonstrated by the implementation of often painful measures. It also requires a free flow of timely, accurate, and comprehensive information so that markets can assess the extent of underlying problems and the seriousness of efforts to correct them and uncertainty can be reduced. And, of course, restoring confidence takes time.

This process is now under way in Southeast Asia. With the support of the IMF, Japan, and a number of other countries in the region, Thailand has launched a courageous and comprehensive program that addresses the problems of large external deficits and troubled financial institutions.

As a result, the budget is moving back into surplus and a comprehensive restructuring of the financial sector is getting under way. The Philippines, for its part, has taken necessary measures and extended its program with the IMF under which a substantial amount of economic adjustment and reform had already taken place. Malaysia is also adapting to changing conditions by scaling back investment plans, tightening its fiscal stance, and strengthening prudential banking regulations.

Indonesia has strengthened its policy stance in continuous dialogue with us, and has recently reached agreement with the Fund on a major program consisting of: strong monetary and fiscal policies to bring about orderly adjustment in the economy and restore confidence to financial markets; a major restructuring of the financial sector, along with measures to ensure its future soundness; and significant deregulation measures and trade reforms that should improve economic efficiency immediately and over the longer term.

The Fund has agreed to support this program with a loan of $10 billion in a total package of $23 billion, of which $18 billion will consist of multilateral financing. On top of that, a contingency safety net is being established through which an important group of countries have declared their readiness to complement our package in the case of unexpected need.

Naturally, it will take time for these efforts to bear fruit. But developments in recent months have by no means wiped out the achievements of past decades. On the contrary, the region’s longer term fundamentals -- including its high domestic saving rates, strong fiscal positions, dynamic private sectors, and recent gains in competitiveness -- remain favorable. Moreover, all of these countries still have a long way to go to catch up with advanced economies. Thus, with sound policies, they should be able to sustain high rates of growth for another two decades or more.

In the less distant future, growth can be expected to rebound strongly after a relatively short, but sharp, weakening of economic activity, especially in Thailand, and a rapid narrowing of external deficits. In fact, we are already seeing improvements in exports, even though recent exchange rate changes have not had much opportunity yet to generate their effects. And as these adjustments take place, each of these countries will have seized the opportunity to strengthen their economies in fundamental ways. This leads me to agree with those in the region who see this crisis not as a blight on the future, but as a blessing in disguise. Indeed, after this period of adjustment, these economies will emerge stronger than before.

In the meantime, I hope that some perspective about the benefits of global markets will be maintained. First, we must give credit where credit is due: the capital provided by global markets has been a key factor in Southeast Asia's exceptional growth rates and its ability to lift so many out of poverty. Certainly, there are risks in tapping global markets to which no country is immune. At times, markets can be slow to react to changes in economic conditions and then react sharply; and in some instances, herd instinct seems to prevail.

But let us not forget that markets also provide tremendous opportunities to accelerate growth and development, as Southeast Asia itself so vividly shows. Thus, the lesson to be drawn from recent developments is not about the risks of global markets, but rather about the importance of approaching markets in a responsible manner -- with strong macroeconomic fundamentals and sound structural policies that give markets confidence and therefore encourage long-term investment; with respect for the signals that markets provide; and with transparent and market-friendly policies that allow markets to allocate resources efficiently.

IV. Perspectives for stronger regional cooperation

Spillover and contagion effects can be so rapid, so costly, to countries with basically sound policies, that every country has an obligation to keep its own house in order. No country should run the risk of becoming the tinder for a wider conflagration. At the same time, there is also much that can be done on a regional and multilateral basis to bolster the efforts of individual countries seeking to manage their economies well.

At the regional level, countries can make a valuable contribution to regional and global stability by joining voluntarily with their neighbors in mutual surveillance. The objective should be to complement IMF surveillance by developing a "club spirit" through which neighboring countries can encourage one another -- and, at times, exert some peer pressure on one another -- to pursue sound policies. We welcome the efforts being made in this direction in various fora.

To be effective, such regional surveillance will, of course, have to be based on sound economic analysis. In this connection, the management and staff of the IMF are ready to contribute to regional surveillance in Asia, as they already do in Europe, the G-7, and other fora. Indeed, one of the tasks of our new regional office in Tokyo could be to help promote more intensive regional surveillance.

V. The response of the Fund

At the multilateral level, the international community sees it as indispensable to work and cooperate through a central institution, the IMF, in order to help countries deal with the opportunities and risks of globalization. And given the challenges of the global financial markets, the international community has encouraged the Fund to strengthen its capacity in this respect. The Fund's response centers on four broad areas.

First, we have strengthened Fund surveillance, which, as you know, lies at the heart of the IMF's efforts to maintain an orderly international monetary system. In order to detect financial tensions as early as possible, we have sought to make our dialogue with member countries more continuous and probing and put more emphasis on the continuous and timely provision of accurate data. We are also concentrating more on policies decided at a regional level, on the regional implications of national economic policies, on banking and financial sector soundness, and on the policies and institutions that sound financial systems require.

Second, we are doing what we can to help markets function more smoothly. Considerable progress has been made in liberalising current account transactions worldwide so that countries can take advantage of the opportunities offered by the expansion of world trade. Now, we must turn our attention to fostering an orderly liberalization of capital account transactions, so that countries can also reap the benefits of global capital markets, while minimizing their risks.

To this end, IMF members have agreed that the Fund's charter should be amended to make the liberalization of capital movements one of the purposes of the Fund and to extend the Fund's jurisdiction to capital movements, with appropriate safeguards, including transitional arrangements, to ensure that liberalization is neither premature nor unduly delayed.

At the same time, the IMF is actively encouraging all countries to be transparent about their economic performance by improving the dissemination of economic and financial data to the public. Greater transparency will help strengthen market discipline and avoid market surprises that can lead to disruptive market reactions.

To this end, the Fund has developed a set of standards regarding the quality, coverage, frequency, and timeliness of data made available to the public and has established a Dissemination Standards Bulletin Board on the Internet to which 43 economies have now subscribed, including Hong Kong, Indonesia, Korea, Malaysia, the Philippines, Singapore, and Thailand. Procedures have also been put in place through which countries can make known to the markets, and to the public in general, the Fund's views on their economic policies and situation.

Recognizing the importance for growth of creating an environment that encourages private sector activity, the Fund has also become more active -- in close collaboration with the World Bank, regional development banks, and others -- in promoting the "second generation" reforms that I referred to earlier. These include developing an institutional framework that will, among other things, provide an efficient, professional justice system, help limit arbitrary and corrupt government practices, and set clear regulatory and supervisory standards for markets, including financial markets.

They also include policies to improve the quality of public expenditure, making adequate allocations for education and health to help ensure that individuals are able to realize their potential to participate actively in a market economy, and providing social protection to those who bear the brunt of the changes of a dynamic economy.

Third, the Fund has taken action on several fronts to strengthen its resource base and adapt its procedures and financing facilities. As you may know, the membership has just agreed to an increase of 45 percent, equivalent to about $90 billion, in IMF quotas. This will raise the capital base of the institution to some $290 billion. In addition, the Fund has taken steps to augment its financial resources through the agreement on the New Arrangements to Borrow.

Under these arrangements, participants would be prepared to lend up to the equivalent of some $47 billion when additional resources are needed to forestall or cope with an impairment of the international monetary system, or deal with an exceptional situation that poses a threat to the stability of the system. We hope that participants who have not yet done so will complete the necessary legislative action so that these arrangements can enter into force soon.

Furthermore, in order to allow all members to participate on an equitable basis in the SDR system, agreement has been reached on a proposal to amend the Fund's Articles of Agreement to authorize a special one-time allocation of SDRs of about $30 billion that would equalize all members' ratios of SDR allocations to quotas and would double the amount of SDRs allocated to date. These resources will supplement members' reserves, giving them more flexibility in economic policies and a cushion against adverse developments.

Last but not least, recent experience has demonstrated once again that early warnings cannot always prevent crisis from blowing up. This makes it indispensable for the international community to strengthen the financial capacity of its central monetary institution to assist countries in a crisis situation. This is also why the Fund has established an emergency financing mechanism to allow financial assistance to be provided more speedily, when countries facing external crises are willing to take strong corrective action.

This mechanism was used effectively to expedite the recent programs for the Philippines, Thailand, and Indonesia. Even if it would be naive to believe that such programs could produce an immediate return to the status quo ante, we are confident that once these programs have produced their full effects in the next months, these economies will be in a much better position to start growing again at a strong, but more sustainable, rate.

In conclusion, these are trying times in Southeast Asia. But the mechanisms are in place at the national and multilateral levels—and soon, I hope, at the regional level -- to enable your countries not just to pull through this crisis, but to emerge stronger than before. The only other pre-requisite for your success is the resolve to put current problems behind you. I see no reason why we will not see the same determination in Southeast Asia in the future as we have seen in the past.