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DOWN THE DRAIN: WHY THE IMF BAILOUT IN ASIA IS WASTEFUL AND WON'T WORK

Bryan T. Johnson
Policy Analyst

John Sweeney
Policy Analyst

The International Monetary Fund (IMF) is bailing out Indonesia, Thailand, the Philippines, and South Korea, the world's 11th-largest economy. The current estimated cost of these four financial rescue projects is $118 billion, but many financial analysts fear this amount could rise to as much as $163 billion—about five times more than it cost the IMF and the U.S. Treasury to bail out Mexico in 1995.[1]

Decades of onerous government regulation and corruption, restrictions on foreign capital and competition, a concentration of power in family-owned business groups with close ties to government, and closed financial systems have contributed to a weakening of economies some of whom were thought to be the next "Asian Tigers." Rather than acknowledge the consequences of their own actions, however, some of these countries have been quick to blame foreign causes such as international currency traders, some of whom determined that the Asian governments had demonstrated no real desire to correct the underlying causes of the crisis and therefore targeted their investments elsewhere.

Now these Asian governments are running to the IMF to bail out their economies. In return for giving these countries billions of dollars in emergency financial aid, the IMF presumably will require them to liberalize their closed financial systems while undertaking other reforms which call for less government spending, slower economic growth, a

1 The IMF has given $22 billion thus far to Thailand. The bailouts of Indonesia and the Philippines may cost up to $40 billion and $1 billion, respectively. South Korea initially asked the IMF for $20 billion, then raised the amount to $55 billion; it may yet may wind up asking for as much as $75 billion to $100 billion. Although Malaysia is not yet in financial crisis, it has a large current account deficit, big foreign borrowings, and a soft real estate market, all of which put the Malaysian financial system at considerable risk.

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pledge not to prop up weak banks and companies, and acceptance of higher unemployment rates. How these nations will handle these changes remains to be seen.

Few policymakers in the United States (or, for that matter, the rest of the world) have paid much attention to the root causes of this crisis, which include excessive government intervention in the economy, the lack of free and competitive financial institutions, close economic relationships between government and business, and corruption involving both governments and family-owned conglomerates. Moreover, few have asked whether the IMF is equipped to help these economies and whether its involvement ultimately will do more harm than good.

An IMF bailout is not likely to help these countries in the long term. Although it may provide some short-term relief, history has shown that countries are more likely to repeat the mistakes that created a financial crisis if they receive IMF aid.[2] Most countries that received IMF aid in the past have been back in line to receive more aid. The solution to the Asian financial crisis is not to condemn these troubled economies to long-term dependence on the IMF. To reach economic stability, these countries must institute fundamental reforms.

U.S. policymakers should not support the IMF bailout in Asia. Instead, the United States should move to alleviate the current crisis in these countries by helping them to lay down a foundation that will prevent such a crisis from recurring. Specifically, U.S. policymakers should:

- **Seek an international agreement on financial services.** Government restrictions on the financial services industry in many Asian countries stifle competition and subject banks and other institutions to undue influence by the state. An international agreement—perhaps like the one currently being negotiated by the World Trade Organization (WTO)—could open these financial systems to competition and reduce the level of government influence.
- **Seek an international agreement to eliminate government corruption.** Corruption in many of these Asian governments has caused them to exert pressure on banks and businesses to steer capital toward preferential business deals. The United States is working through the international forum of the Organization for Economic Cooperation and Development (OECD) to finalize an international agreement to curtail government corruption. This agreement is slated to be signed in December 1997, and the United States should ensure that there are no last-minute postponements.
- **Deny additional funding increases for the IMF.** In order to prevent IMF aid from condemning Asian economies to long-term dependence, which has happened to countries like Mexico in the past, the United States should move immediately to withhold additional funding for the IMF.
- **Formulate a strategic withdrawal from the IMF.** In the longer term, the United States should develop a plan to withdraw all financial support of the IMF. To this date, the U.S. has pledged some $47 billion to the IMF, approximately $23 billion of

2 See Bryan T. Johnson and Brett D. Schaefer, "The International Monetary Fund: Outdated, Ineffective, and Unnecessary," Heritage Foundation *Backgrounder* No. 1113, May 6, 1997.

which has gone to the IMF's main account. The U.S. should seek reimbursement for *all* the money it has contributed to the IMF.

CAUSES OF THE ECONOMIC CRISIS

The financial crisis in Asia is the culmination of decades of hands-on government regulation of the region's economies, distrust of foreign capital and competition, concentration of power in family-owned business groups with close ties to government, and closed financial systems. In the case of South Korea, the government also followed a policy of funneling capital to some export industries. This industrial policy of attempting to pick "winners" backfired as many of these export industries fell victim to diminishing global demand, leaving South Korea with a manufacturing over-capacity in some areas. These factors were not great problems during the 1980s because some of the East Asian economies kept inflation at bay by pegging their currencies to the U.S. dollar. In addition, export-driven growth strategies spurred the highest economic growth rates in the world over the past decade.

The prevalent view among Western economists is that this "Asian miracle" occurred because the region was positioned during the past decade to capitalize on increasing direct investment from Japan and other countries.[3] As foreign investment capital flooded the Asian economies in the 1990s, the value of their currencies increased relative to the dollar. In order to maintain their currencies' peg to the U.S. dollar, the central banks of these countries needed to remove some of their currency from circulation. Normally, a government does this by raising interest rates, which has the effect of reducing the circulation of currency and bringing the currency's peg into balance with the U.S. dollar. The central banks of these countries, however, accelerated domestic monetary supply in an attempt to make exports cheaper on the world market. This has had a very destabilizing effect by causing the recent major currency devaluations in many Asian countries.

The financial crisis assailing the economies of Thailand, Indonesia, the Philippines, and South Korea, as an analysis for The Heritage Foundation/Wall Street Journal *Index of Economic Freedom* has shown, is rooted in the fact that economic reform in various sectors has been uneven.[4] Although these countries have reduced trade barriers and tax rates, and although they have made progress in scaling back government regulations in some sectors, very little progress has been made in attacking widespread corruption and reforming the over-regulated and heavily protected financial services industries. Thus, the problem is not that these economies are too free; it is that they are not free enough. Indeed, the four annual surveys of the *Index of Economic Freedom* show that none of the economies currently under siege can be classified as "free" because they still maintain restrictions on economic freedom.

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3 Tom Petruno, "Reforms Seen as Key to Asia's Fiscal Recovery," *Los Angeles Times* (Washington, D.C., edition), December 1, 1977, p. 1.

4 Bryan T. Johnson, Kim R. Holmes, and Melanie Kirkpatrick, *1998 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 1998).

Effects of the Economic Crisis

As loans made by inefficient Asian banks insulated from competition increased throughout the past decade, many borrowers defaulted on their payments, prompting poorly managed banks repeatedly to roll over bad loans. This amounted to piling new bad loans on top of older bad ones. The banks chose this route because many of these loans were the result of deals between bankers, governments, and family-owned conglomerates to finance over-valued industrial projects and real estate development. Moreover, some of the loans made to build industrial projects in South Korea under the government's industrial policy caused some companies to default on their loans as global demand decreased.

The East Asian governments initially denied the severity of their problems. They conveniently blamed others, such as international currency traders who were simply reacting to the poor economic practice of inflating currency. Following Japan's pattern of financial collapse in 1991, the East Asian bubble finally burst in Thailand in mid-1997, after which the trend rolled swiftly across the rest of the region.

Both the severity of this financial crisis and the extent to which it could undermine the financial stability of countries like Japan, Malaysia, and Brazil are largely misunderstood by U.S. policymakers. At the end of 1996, East Asia's outstanding international debt was $752 billion, making this region the international banking system's biggest potential liability. The bad loans made by East Asian banks account for 10 percent to 20 percent of their loan portfolios today. Even if the region's financial woes do not worsen, the total cost of the bailout of Thailand, Indonesia, the Philippines, and South Korea already amounts to more than 14 percent of East Asia's gross domestic product (GDP).

This figure could increase quickly if South Korea asks for and receives a larger bailout amount, and if Malaysia and Japan are swept up by the financial turmoil. Japan, in particular, is especially vulnerable to the financial turmoil in East Asia since one-third of its imports originate there, 37 percent of its exports go to East Asian countries, and its banks hold more than $250 billion in outstanding loans to East Asian economies. By contrast, the banking crisis in Mexico during 1995 cost the equivalent of 12 percent of that country's GDP, and the savings and loan crisis in the United States during the 1980s cost between 2 percent and 3 percent of U.S. GDP.

The Counterproductive Response

In the past, the IMF provided financial assistance in exchange for macro-economic policy changes—such as raising taxes and devaluing currencies to gain a temporary export advantage—which were often counterproductive. More recently, it has been paying greater attention to the policy changes that are needed to revive and sustain long-term economic growth, such as lowering tariffs, reducing barriers to foreign investment, eliminating unnecessary regulations, and privatizing state-owned enterprises. This emphasis on free-market policy reforms is a commendable change, and is partly the result of decades of criticism of the IMF for engaging in counterproductive economic meddling.

However, the fact that the IMF has included requirements in its austerity package to force productive economic policies does not offset its past advocacy of unwise economic policies. In addition, there are indications that the IMF is now asking some recipients to raise taxes, mainly their value-added taxes. But higher taxes are precisely what these

economies do *not* need: They will only hinder long-term economic growth. Instead of increasing taxes, Asian governments should reduce their level of government spending.

Mexican Bailout Lessons. Since 1976, the United States has bailed out the Mexican economy four times, and each bailout has been more costly to American taxpayers. Instead of increasing pressure on the Mexican government to reform weak financial institutions and the monetary policies responsible for the country's economic crises, these bailouts created incentives for government officials and foreign investors to continue policies and investment practices that led to new financial crises—on an ever larger scale.

The bailouts of Mexico offer policymakers two important lessons:

- **First,** IMF loans, usually with U.S. government backing, create a moral hazard: IMF bailouts of countries experiencing financial difficulty underwrite otherwise unsustainable policies and reduce the pressure on governments to implement needed institutional and policy reforms. In Mexico, successive bailouts have encouraged the ruling bureaucracy and business to avoid vital institutional reforms for two decades.
- **Second,** IMF loans allow the political and business interests responsible for causing financial crises to circumvent less expensive market solutions in which creditors and governments (in the absence of a bailout) would have an incentive to renegotiate their debts. Although investors would suffer some losses without an IMF bailout, IMF involvement places the burden of loans on U.S. taxpayers and the citizens of other countries who bear no responsibility for the unwise monetary policies which are the true cause of these financial crises.

The IMF's Dismal Record. Mexico is not the only example of the IMF's faulty bailouts. In fact, the evidence shows that, instead of putting recipient economies on solid financial ground, IMF aid to less-developed countries has created further dependence on the IMF.[5] Between 1965 and 1995, for example, 137 countries received loans from the IMF. The number of times 81 of these countries borrowed from the IMF between 1981 and 1995 increased an average of nearly 50 percent over the number of times they borrowed between 1965 and 1980. Only 44 countries reduced the number of times they borrowed during these same periods.

Not only does the IMF have a poor record of guiding countries onto the right economic track, but it also has not helped struggling economies grow. For example, of the 89 less-developed countries that received IMF loans between 1965 and 1995, 48 are no better off economically today than they were before receiving the IMF loans. Moreover, of these 48, 32 are poorer than they were before receiving IMF loans.[6] Thus, there is no evidence that IMF aid helps countries achieve long-term economic prosperity.

The evidence shows instead that no amount of IMF aid is likely to force governments to make the changes needed to put their economies back on track. Such aid is likely to remove the economic consequences of their past actions and allow these governments to put off the hard choices they would have had to make without IMF aid.

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5 Doug Bandow, "A Record of Addiction and Failure," in *Perpetuating Poverty: The World Bank, the IMF, and the Developing World* (Washington, D.C.: Cato Institute, 1994), p. 19.

6 Johnson and Schaefer, "The International Monetary Fund," *op. cit.*

HOW THE U.S. CAN HELP THE ASIAN ECONOMIES

An IMF aid package could well create a Mexico-like scenario in which the Asian economies need financial assistance repeatedly in the future. If a country with a struggling economy knows it will be bailed out by the IMF, it has little incentive to change its unwise policies and investment practices. The solution to the Asian financial crisis, then, is not to condemn these countries to long-term dependence on the IMF. Rather, it is to encourage them to institute necessary and fundamental reforms in their financial systems.

Rather than rely on the IMF, the United States should use this opportunity to help Asian countries by pursuing steps that will help steer their economies toward greater stability. Specifically, the U.S. government should:

1. **Seek an international agreement on financial services.** A major problem underlying the current economic crisis in these Asian countries is the lack of competitive financial services that are free from government influence. Governments can influence lending decisions when banks are protected from competition, whether foreign or domestic. Foreign investment in banking services is often curtailed and sometimes prohibited. In addition to restrictions and regulations on foreign banks, governments restrict the kinds of financial services in which banks may engage, such as selling investments and real estate and providing insurance policies. The lack of competition in financial services and the presence of onerous government regulations, coupled with government corruption, have resulted in a system in which the government influences the allocation of credit, mainly to unsound and unwise construction and real estate projects.

   Although some progress has been made in the World Trade Organization toward an effective international financial services agreement, no international agreement at this point has been far-reaching enough to deal with the kinds of reforms necessary to abate the financial crisis now occurring in Asia. The United States should direct all efforts to reach a financial services agreement that includes provisions to increase competition in all sectors of financial services. Specifically, the United States should insist on the following competition-broadening policies:

   - **Elimination of regulations preventing the full establishment of foreign banking operations in all signing countries.** Foreign banks should be free to establish wholly owned branches and subsidiaries in other countries, with few regulations on their operations. This policy would attract more foreign banks and increase private-sector competition. Such competition would also make it harder for governments to influence lending decisions.
   - **Legal treatment of foreign banks equal to domestic banks.** Many developing countries, while partially welcoming foreign banks, tend to treat them differently than they treat domestic banks. For example, certain government regulations may apply only to foreign banks. These regulations often are established to make foreign banks less competitive than domestic banks. Equal treatment would attract foreign banks to these countries and thereby increase competition.
   - **Elimination of laws differentiating investment banking from commercial banking.** Even laws in the United States prevent banks from offering a host of financial services, such as savings accounts, loans, real estate, insurance poli-

cies, and investments. Many European governments, however, have removed some regulations that impose such barriers. The United States and other countries should follow suit. This would increase competition among all banks.

2. **Seek an international agreement to eliminate government corruption.** The United States, working through the Organization for Economic Cooperation and Development, is trying to reach an international agreement to curtail government corruption. Corruption often takes the form of government direction of credit to political friends and allies. An international agreement to end these practices would go a long way toward reducing the ability of governments to affect the lending decisions of their banking institutions—and this, in turn, would reduce the likelihood of banks' funding over-valued projects. This agreement is slated to be signed in December 1997, and the United States should ensure that there are no last-minute postponements.

3. **Deny additional funding increases for the IMF.** Before Congress recessed in November 1997, it rejected the Clinton Administration's request for a $3.5 billion increase in funding for the IMF. The President is expected to try again when Congress reconvenes in January, presumably by arguing that more taxpayer money should be granted to the IMF to avoid a global financial meltdown.

   Currently, the IMF does not have enough funds to borrow the billions of dollars the East Asian governments are seeking. Increasing IMF funding would permit the IMF to borrow more internationally in order to transfer these borrowings to troubled economies. Essentially, the IMF has reached its financial ceiling; it cannot expand its emergency aid to East Asia unless funding by member governments increases by many billions of dollars. The first step Congress should take to rein in an ineffective IMF should be to reject all Administration requests for further funding increases.

4. **Formulate a strategic withdrawal from the IMF.** The United States is the IMF's largest donor. The U.S. taxpayer is liable for some $47 billion in IMF contributions. Moreover, the IMF, with the Clinton Administration's blessing, has decided to increase its total capital resources (referred to as quota subscriptions) by 40 percent over current levels. Under this plan, the U.S. would be obligated to contribute an additional $15 billion over its current obligations.[7] Instead of supporting a search for additional funds that will increase American taxpayers' indebtedness to the IMF, the U.S. government should formulate a strategic plan to withdraw all financial assistance from this institution and seek reimbursement for the money it already has contributed.

CONCLUSION

It is estimated that the International Monetary Fund's bailout of Indonesia, Thailand, the Philippines, and South Korea will cost $118 billion—an amount that will grow if South Korea asks for and receives a larger bailout and if the region's financial earthquake spreads to Malaysia and Japan. Many Asian leaders have tried to blame foreigners for their own financial crisis, including international currency traders who generated the capital flows which fueled Asia's spectacular growth rates in the past. These leaders are wrong. The true causes of the crisis in Asia are domestic, including decades of hands-on government regulation of the region's economies, a distrust of foreign capital and compe-

7 *Ibid.*

tition, the concentration of power in family-owned conglomerates with close ties to government, and closed financial systems.

International bailouts engineered by the IMF may improve the cash flow of these Asian economies, buying time for these countries to export their way of out their financial crisis. But without major domestic reforms, the structural and institutional causes of the Asian financial crisis will not be corrected, and new and much larger crises eventually will occur. An IMF bailout is no guarantee of a better tomorrow. In fact, the historical record shows that wasteful IMF bailouts have never worked.

Since the Asian financial crisis was caused by the poor economic and financial policies of East Asian governments, no amount of IMF and U.S. financial aid will compel them to make the fundamental reforms in their economic and financial institutions that would enable them to avoid financial crisis in the future. All an IMF bailout backed by the U.S. government will do is to give these governments a cushion on which to postpone true reform.

Instead of relying on an IMF bailout, the United States should help these countries by insisting on market-driven, private solutions. By removing the IMF from the equation, the United States would help create incentives for these governments to implement effective reforms in their economic institutions, and for foreign investors to renegotiate privately their outstanding loans with these governments. This is a far better strategy than placing the burden on the backs of American taxpayers and Asian consumers who were not responsible for causing this crisis.

In the near term, such an approach undoubtedly would cause a slowdown in Asian growth, and foreign investors would suffer losses on their investments. Over the longer term, however, U.S. advocacy of market-driven solutions to the Asian crisis would increase the pressure on these Asian governments to implement domestic institutional reforms which they have managed to avoid for more than two decades.

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