

THE INTERNATIONAL MONETARY FUND AND EXCHANGE RATE CRISIS MANAGEMENT*

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The article analyzes the limits of the IMF as a global multilateral economic agency to handle serious balance of payments disequilibria. Capital control and growth rates in developing Asia and the twin deficit problem of the United States are also discussed. It also assesses the probability of the reemergence of an exchange rate crisis in Southeast Asia and the wisdom of having an Asian IMF.

“Lenin was right. There is no subtler, no surer means of overturning the existing basis of society than to debauch the currency.”

— John Maynard Keynes
The Economic Consequences of Peace

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1. Post-Crisis Per Capita Income

A not well-known fact is that *all* the six economies in Southeast Asia adversely affected by the 1997/1998 financial crisis have not, until today (November 2005), some eight years later, recovered from the pre-crisis per capita income level in US dollar terms (see Table 1). Thailand’s per capita income in 1996 was US\$3,084. After the impressive post-crisis recovery eight years later in 2004, it decreased by 18.3% to US\$2,519. Indonesia’s per capita income declined by 10.4%. In other words, the damage the exchange rate crisis did to the Southeast Asian economies is serious enough that utmost attempts must be made to prevent its recurrence. However, should there be another massive speculative attack on the exchange rate, and should external help be required, where could these countries turn to?

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Table 1. Per Capita Income of Crisis ASEAN Countries, 1996 and 2004 (US\$)

Countries	1996	2004	% Change
Brunei	17,361	14,454	-16.7
Indonesia	1,141	1,022	-10.4
Malaysia	4,827	4,731	-2.0
Philippines	1,186	1,059	-10.7
Singapore	25,681	25,002	-2.6
Thailand	3,084	2,519	-18.3

Source: United Nations (<http://unstats.un.org>).

It is also a not well-known fact that the exchange-rate-based crisis hit *only* the old ASEAN 6 — namely Thailand, Malaysia, Singapore, Indonesia, the Philippines and Brunei — but not the new ASEAN 4, namely, Myanmar, Laos, Cambodia and Vietnam. What is the explanation? The answer is that the new four all had exchange and capital control before the crisis struck. Today, in November 2005, some eight years later, contrary to some expectations, all four of them have, by way of contrast, much higher levels of per capita income in US dollar terms than before the crisis. Vietnam, for example, had in 2004 a per capita income that was 66% higher than the pre-crisis level, and Laos, 56% higher (see Table 2).

2. China and Capital Control

China had (and still has) exchange and capital control before, during and after the 1997 crisis. The economy continued to gallop, in real terms, at around 9% to 10% per annum, despite the existence of capital control. Or, is it because of the existence of capital control? If capital control shielded China from the Asian exchange and financial crisis of 1997/1998, the capital control mechanism must have contributed importantly to the continuation of the phenomenal income growth in China. Put differently, capital control certainly did not disenable China from attaining phenomenal real GDP growth rates from the time China went through the economic reforms of the opening-up process in 1979. IMF (International Monetary Fund) statistics show that China's per capita income in 1996, before the crisis, was US\$667, and

Table 2. Increase in Per Capita Income of Non-Crisis ASEAN Countries, 1996 and 2004 (US\$)

Countries	% Increase
Cambodia	+9.0
Laos	+56.3
Myanmar	+17.7
Vietnam	+66.0

Source: United Nations (<http://unstats.un.org>).

this increased steadily to US\$1,269 by 2004. Throughout this metamorphosis, including the Asian financial crisis years, China had capital control.

It is also often claimed that capital control would inhibit the inflow of foreign direct investment (FDI). China, as is well-known, attracted very much more foreign investments than all the six non-capital control Southeast Asian economies combined. Indeed, the massive inflow of FDI for the 1990s and thereafter came to as high as 3.9% of China's GDP (see Figure 1). This massive FDI inflow must have significantly contributed to China's most spectacular GDP advance, the phenomenal increase in external trade, and the impressive accumulation of foreign exchange reserves. Throughout the period of phenomenal capital inflow, China had capital control. There was no FDI in China before the 1979 "opening-up" period.

3. East Asia and Capital Control

The other East Asian economies that showed phenomenal economic advance at an earlier period, namely Japan, South Korea and Taiwan, all had important capital control and for a long period at that. Of course, capital control *per se* was, and never is, the magic wand for economic and social development. Nor is it *per se* the most desirable option or target to pursue. It was just a means to an end. At the early stage of economic growth, when speculative attacks on their currencies can be frequent and disastrous, capital control could contribute to the stability of the exchange rate. It could also allow for orderly exchange rate adjustments and the orderly shifting of gears. Hopefully, this phase could and should usher in the liberalization of the domestic economy, particularly the strengthening of the financial infrastructure and the liberalization of trade, both foreign and domestic trade. The

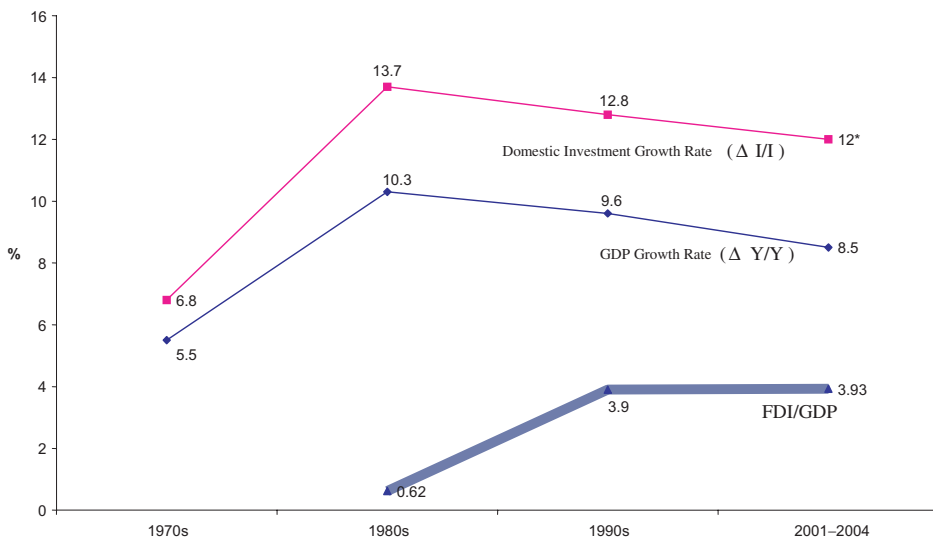


Figure 1. China: Relationship between Growth and Investment
 Source: Lim (2005).

sequence should *not* be the opposite: exchange rate liberalization before domestic economic liberalization.

When IMF was invited by the Thai and Indonesian governments to help them halt their exchange rates from further precipitous fall in 1997, IMF unfortunately did not succeed. With hindsight, IMF was doomed to failure. Their exchange rates continued the precipitous slides (see Table 3, particularly column 7). Two main reasons why IMF did not succeed will be discussed here: one reason was doctrinaire, and the other, wrong timing or doing the right things at the wrong time. Ideologically, IMF was and still is anathema to any form of capital control, including any restriction on very short-term speculative capital movements, including by hedge funds. IMF has, therefore, in our view, deprived itself of a very useful and powerful instrument of exchange stabilization and orderly exchange adjustment. It is analogous to saying that IMF does not believe in the use of anesthesia, when modern surgery requires it. As is well-known, at the time of the crisis, Malaysia rightly broke rank. Much against the strong advice of IMF and others, Malaysia introduced selective capital control (Lim, 2004). As shown in Table 3, Malaysia succeeded in stopping the serious foreign exchange hemorrhage. Thailand lost so much foreign exchange reserves that the amount far exceeded the IMF loan she later received as a rescue operation (Lim, 2004).

In addition, when Thailand and Indonesia were faced with a serious crisis of confidence in the baht and the rupiah, the IMF advised the Thai and Indonesian governments to close down 56 finance companies in Thailand and 16 commercial banks in Indonesia (Djiwandono, 2005). These were done in the midst of the crisis of confidence in the financial system in these countries. As expected, there were runs on the banks in both countries. The already badly eroded confidence in the baht and the rupiah were further badly eroded. As Table 3 shows, at the beginning of the crisis, the exchange rate for the baht was US\$1 = 25.8 bahts. By January 1998, it fell to US\$1 = 53.8 bahts, a loss of 52% in value. In Indonesia, it began with US\$1 to 2,450 rupiahs. It fell to 14,900 rupiah; a depreciation of as much as 84% of the already greatly depreciated original value. The IMF could not stop the serious depreciation. Indeed, the then Indonesian government had invited IMF in to save the rupiah exchange rate, and it ended with the host government being overthrown instead. True, the telling diagnosis is now all water under the bridge. True, we should all, so to speak, “let the dead past bury its dead”, and look forward to a new and more rational and less doctrinaire beginning.

4. IMF and New Exchange Crises

But, should there be another global or regional exchange rate crisis, would it be wise for countries to turn to IMF for a similar surgical operation? If IMF declares that it has since adopted a new strategy, a new approach that includes selective capital control and the avoidance of untimely operations, the answer would be different from the continuance of the same remedy, which some, such as Joseph Stiglitz, have rightly called “one-size-fits-all” approach (Stiglitz, 2002). Others complain that the IMF’s hands are tied by the so-called “Washington Consensus”, which includes no capital control under any circumstances. IMF loan is conditional on the liberalization and further liberalization of the exchange rate. But the Washington Consensus also advocates the liberalization of the domestic economy and

Table 3. IMF and Depreciation of Exchange Rate (Per US\$)

(1) Some Crisis Currencies	(2) Rates Before Crisis (June 1997)	(3) Rate at Time of IMF Intervention	(4) Lowest Rate	(5) Lowest Month	(6) First Depreciation [(2) – (3)/(3)]× 100%	(7) Depreciation Since IMF Intervention [(3) – (4)/(4)]× 100%	(8) Total Depreciation [(2) – (4)/(4)]× 100%
Indonesian Rupiah	2,450	3,648 (Nov 97)	14,900	Jun 98	–33%	–76%	–84%
Thai Baht	25.78	32.48 (Aug 97)	53.82	Jan 98	–21%	–40%	–52%
Korean Won	890.5	1,484.1 (Dec 97)	1,707	Jan 98	–40%	–13%	–48%
Malaysian Ringgit	2.57		4.39	Jan 98		0%	–42%
			3.8 (ringgit peg)	Sep 98 (start of capital control)		(after capital control)	(before capital control)

Source: CEIC database.

Note: Malaysia did not adopt an IMF-supported program, unlike Indonesia, Thailand and South Korea.

the strengthening of the domestic financial infrastructure, which in our view, should come first before the crisis: otherwise, according to the S-Curve sequential theory (Lim, 2004), it would amount to putting the cart before the horse.

If the domestic value of a currency is not placed under a *laissez faire* footing, why should the external value be thus placed? It is good food for thought for the currency regulators, particularly IMF, especially in relation to serious short-term speculative capital movements. Money, including the exchange rate, is a means of exchange. If the internal value of money is subject to regulation in its supply by the central bank, why not the external value?

5. Future Exchange Crises

Is there a danger of a global exchange rate crisis, say, within the next five years, engulfing the Southeast Asian economies as well? There is some real danger, and this danger has not faded away with the persistent twin deficits in the USA.

One danger, hanging like the sword of Domiciles, is the selling away of a substantial US dollar stockpile from their huge accumulated US dollar reserves by important creditor nations like China, Japan and South Korea. This action may result, or is likely to result, in the serious depreciation of the US dollar generating adverse contagion effect all round, including all of Southeast Asia. The sizeable selling of US dollar reserves need not necessarily mean the swapping of US dollars for other currencies like the Euro dollar or the Japanese yen. They can be exchanged into other stockpiles of imports of irreplaceable assets like gold and fossil oil.

Another danger lies in the persistent and significant rise in the price of fossil oil, seriously aggravating further the balance of payments position of the USA. An important and persistent rise in fossil oil price will increase this danger, as never before in US post-war history has the US been so dependent on oil imports than she is today. Oil is an important common input in all modern production processes, and could easily trigger a cost-push and demand-pull circular cumulative inflationary process. The symptom is the frequent increases in interest rate to cut inflationary pressures or, exchange rate depreciation, or both.

The important increase in oil price can arise from many causes that result in the sudden and persistent or long-term curtailment of world supply. However, in the last few years, in response to persistent high fossil oil prices, the search for alternative energy sources has resulted in the discovery of replaceable bio-diesel fuels such as from the perennial oil palms. Besides, important new sources of fossil oil and gas outside the Middle East such as in Northeast China and Sichuan province are likely to moderate too great a jump in current fossil oil prices.

Thus far, the US has been able to maintain a fairly strong and stable US dollar, despite serious balance of payment disequilibrium on current account. Three factors are involved here. One, the use of interest rate differentials to stamp out the outflow of US dollars. Two, the very important, substantial autonomous long-term capital inflow (FDI) into the USA. Debates on the US dollar often miss this very important point. Three, the willingness and ability of balance of payments surplus and high savings nations such as China and Japan to lend to the US to finance its twin deficits, thus strengthening the external value of the US dollar.

Let us now pause for a minute to recall that in August 1971, the US was forced to abandon the international gold exchange standard. No longer could the US dollar be changed at a fixed rate of US\$35 to one fine ounce of gold. A serious global exchange rate crisis thus erupted. The gold price is now US\$672.64 to the same one fine ounce of gold. The world then moved to today's floating exchange system, with varying degrees of floating. What was once condemned as "dirty float" by the IMF has become acceptable "managed float". In short, most unfortunately, the US dollar today is not immune from originating and generating a global financial crisis, as it had come to pass in August 1971.

Oil price in 1971 was US\$1.90 per barrel. Today, it is about US\$65 per barrel. In 1973 and 1974, when oil price went up to US\$2.80 and US\$10.40 per barrel respectively, serious global inflation followed. If oil price today were to escalate from US\$65 per barrel, to say, US\$120 per barrel within the next few years, for sure, serious global inflation or global stagflation would follow. Then, in the early 1970s, US was self-sufficient in oil. Today, US imports 25% of its domestic oil demand. An oil crisis, with further adverse impact on US balance of payments deficit, can thus easily turn to a US dollar crisis, with a serious downside in the US dollar. If countries cannot pay for the high oil import price, an exchange crisis can also develop. (The Indonesian experience in August 2005 confirms this possibility, nay, probability.) Then, when a global or regional crisis breaks, where do the crisis countries turn to for help? The IMF, as in 1997/1998?

One most frequently discussed US balance of payments problem is her serious trade deficit with China (the PRC). The solution often advocated by the US, and supported by the IMF, is the deliberate appreciation of the Chinese yuan. But the facts are that the US has trade deficit problems, in varying degrees of seriousness, with nearly all, if not all, its major trading partners (see Table 4). In fact, as Table 4 shows, the US's trade deficit in 2006 with the European Union and Mexico and Canada (\$253 billion) even exceeded that of China (\$232 billion). Thus, a more flexible exchange rate policy of China is no guarantee

Table 4. United States' Merchandise Trade Deficits, 2005 and 2006 (US\$ bn)

Country/Region	Balance on Visible Trade	
	2005	2006
China	-218	-232
Japan	-87	-87
East Asian countries*	-58	-50
Middle East	-34	-31
European Union	-131	-116
North America (Canada, Mexico)	-81	-137
Africa	-52	-62
Deficit with the world	-782	-818

*East Asian countries here refer to Hong Kong, Malaysia, Korea, Singapore, Taiwan and Thailand.

Source: US Census Bureau.

that the overall trade deficit of the US will disappear, from serious overall disequilibrium to equilibrium or surpluses. Is the gradual orderly depreciation of the US dollar the solution for the USA and for the whole world? Can this orderly gradual depreciation be brought about, if other important trading partners also depreciate *pari passu*, as would automatically be the case, if their currencies are rigidly pegged to the US dollar, as in the case of China before 1979?

6. Asian IMF Proposal

Under the circumstances, will an Asian IMF (AMF) be helpful? During the 1997/1998 Asian exchange rate crisis, Japan, then with by far the largest foreign exchange reserves in Asia and in the world, proposed the setting up of an AMF. The proposal received hardly any support from the USA or from Asia. A regional IMF using the same tools for stabilization and following the same policy options as the IMF obviously could not be of benefit to member countries in Asia or the world. The AMF, when constituted, must stick to the original Keynesian objective of the IMF, with the mission for an orderly exchange rate adjustment arising from fundamental disequilibrium in the balance of payments. This means the AMF must not be a regional replica of the present IMF, together with its blemishes and self-imposed handicaps. But if the global IMF adopts a new policy of strategic pragmatism, the case against an AMF should, in my view, be considerably weakened. But an Asian IMF too could hardly be expected to solve the serious US balance of payments problem without the orderly depreciation of the US dollar.

7. Another Southeast Asian Crisis

However, as it is, if for any reason the US dollar, which is the world's pivotal currency, strengthens significantly or weakens significantly, it does not follow in the present circumstances that Southeast Asian countries would *pari passu* come under serious exchange rate pressure. As Figure 2 shows, one, unlike in 1997/1998 when many of the Southeast Asian countries had had serious long-term balance of payments disequilibria, they all have had impressive yearly balance of payments surpluses after the catastrophic collapse of their exchange rates. Two, contrary to the pessimistic forecast of natural rubber price by the World Bank (World Bank website), rubber price has steadily increased from US\$0.58 per kilo in 2001 to US\$1.50 per kilo in 2004 and US\$1.66 per kilo in 2005 (see Table 5). With a spectacular increase in rubber price, and given that Thailand, Indonesia, Malaysia and Vietnam are the largest producers and exporters of natural rubber in the world, a rubber export boom in Southeast Asia is not off the cards. The inflated export earnings would be a direct or indirect boon to many Southeast Asian economies, though not to the extent of the Korean War boom in the early 1950s.

However, also of immense importance is the spectacular increase in palm oil prices (see Table 5). Southeast Asia, particularly Indonesia and Malaysia, produces nearly all the palm oil supply in the world. As a large part of this supply is expected to take the form of replaceable bio-diesel fuels from palm oil, the factor would further boost up the commodity

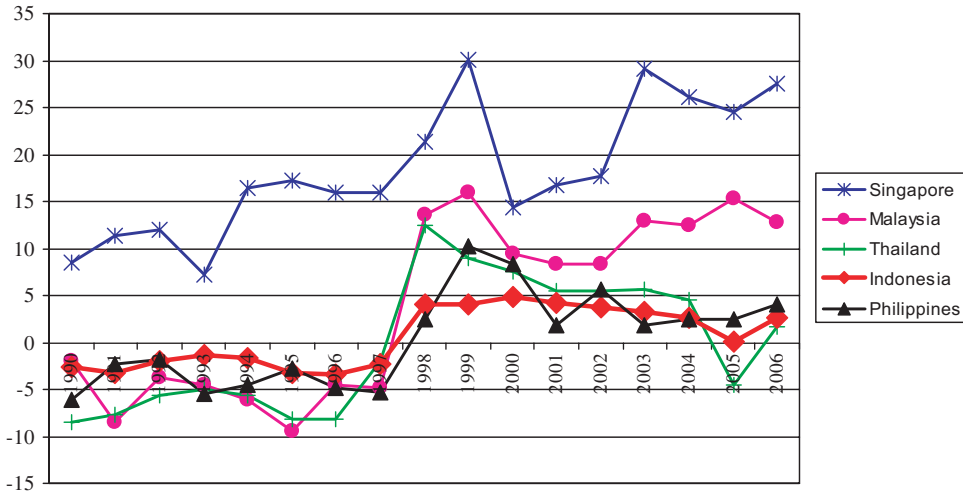


Figure 2. Current Account Balance as a Percentage of GDP, 1990–2006

Source: Lim (2001, p. 313).

Note: 2000–2006 data extracted from ADB, *Asian Development Outlook 2005, 2007*.

Table 5. Natural Rubber and Palm Oil Prices (US\$)

Year	Natural Rubber	Palm Oil
2001	\$0.58/kg	\$286 mt
2003	\$1.08/kg	\$443 mt
2004	\$1.50/kg	\$471 mt
2005	\$1.66/kg	\$422 mt
2006	\$2.31/kg	\$478 mt
2007 (April)	\$2.48/kg	\$708 mt

Source: International Rubber Study Group (IRSG); United Nations Conference on Trade and Development (UNCTAD); World Bank.

export boom of Southeast Asia, reducing further the fear of a foreign exchange disaster of the sort experienced in 1997/1998.

Nonetheless, the conclusion is that should any of the Southeast Asian countries be faced with an exchange rate crisis, the wisdom to turn to IMF for help is still in serious doubt. If IMF adopts a more flexible policy in handling crisis management, that doubt might disappear. If an AMF is formed, it must abandon the two basic pillars of the Washington Consensus strategy and policy, adopting instead a New IMF Consensus based on strategic pragmatism. With so many Asian nations now flushed with so much foreign exchange reserves, perhaps the time is ripe for Japan, China and South Korea to take the lead to form a new Asian Monetary Fund as a precautionary and preemptive move. The new regional institution must be based on

strategic pragmatism, on orderly adjustments of exchange rates, not on exchange rate *laissez faire*-ism. It must have room for regulation on short-term highly speculative capital flow. It should allow managed floats and not just free float. If the very rich Gulf States, flushed with so much petrodollars, and another very fast-growing Asian economy, India, support the move, the joint Northeast Asian initiative would have been sown on very fertile soil, not on slippery rocks. Asian countries would have another multilateral institution to turn to for help in time of crisis, other than the self-emasculated IMF. Asian countries too would not then be that inclined to individually accumulate so much foreign exchange reserves to satisfy the precautionary and speculative motives if the need for such massive accumulations could be perceived to be considerably reduced. However, an Asian IMF is not the best solution to the global imbalance problem, particularly one that involves the USA. It is only good in providing a regional solution.

Asian nations, particularly ASEAN nations, at times have proposed swap arrangements as a precautionary mechanism. There is no commonly agreed institution to look after its implementation. Prior to the 1997/1998 Asian financial crisis, ASEAN too had initiated an exchange swap arrangement. It turned out to be toothless when the crisis emerged. That Asian nations have continued each to stockpile huge foreign exchange reserves is indicative of their trust in their own individual responsibility and individual solution to any possible exchange storm, rather than to regional or global arrangements such as the IMF.

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