Putting lessons from Asia to good use in Europe

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International Monetary Fund (IMF) programmes in Europe now are quite similar to those in Asia a decade ago, but there are important differences in approach. These are largely attributable to the valuable lessons the IMF had learned from its experience in Asia.

Hungary, Iceland, Latvia and Ukraine were among the 15 recipients of IMF help, this time around, between November 2008 and May this year. The European economies under review are luckier than their Asian counterparts a decade earlier - their problems are somewhat smaller, and the IMF assistance extended to them was a lot bigger and much faster.

The problems these European economies currently face are partly cyclical and partly structural. As these emerging economies have yet to integrate fully into the global economy, their direct exposure to the US-led global economic crisis has been minimal.

The IMF has generally been slow to offer its help, often blamed on its cumbersome bureaucratic procedures, as in Latin and Central America. The IMF has learned from the Asian financial crisis that timely intervention does matter, as exemplified by South Korea, which could receive IMF help sooner and recover faster than the rest.

But the Asian countries must share the blame for the slow pace, as they were in a denial mode for too long.

The IMF also learned from the Asian financial crisis that massive capital exodus causes not only severe currency depreciation but also sharp output contraction that forces the current account deficit to shrink through import compression. Hence, the need for international support to offset the negative balance-sheet effect of currency depreciation. The European programmes of the IMF are three to five times larger than those of its Asian initiatives, relative to gross domestic product (GDP).

IMF assistance has been reinforced by similar moves by the European Union, the European Central Bank and the World Bank. This debunks the argument that the proposed Asian Monetary Fund would duplicate or undermine the IMF.

The IMF has been criticised for its conditionality, but no one can reasonably expect the IMF to lend without conditions. What irks is the IMF’s insistence on conditionality unrelated to crisis management, especially with regard to structural reforms.

In the case of macroeconomic conditionality, there is a near-consensus that the IMF moved in the wrong direction in Asia by insisting on interest rate hikes and fiscal tightening, which made the crisis all the more painful.

The IMF learned the hard way in Asia that conventional wisdom need not apply during extraordinary times. Thus, the advocacy of higher interest rates when the exchange rates were falling (which would make sense in normal circumstances) loses its appeal in abnormal times when the market overshoots irrationally. No interest-rate hikes would arrest such a downward spiral.

No doubt, there were fears that currency turmoil unchecked by higher interest rates,would exacerbate the banking crisis, but the Asian experience has shown that such crises can be contained without having to raise interest rates, by establishing "special purpose vehicles" to re-capitalise anaemic banks and mop up bad loans.

Although the IMF had later conceded that monetary tightening could have been avoided in Asia during 1997-98, it has made tight monetary policy an integral part of the IMF package in Europe, where there has traditionally been little resistance to high interest rate regimes.

On the fiscal front, the IMF stance in Europe seems less stringent, as it has allowed deficits to continue, unlike initially in the Asian programmes. Most economies in East Asia exhibit considerable fiscal discipl ine, either by running surpluses or keeping their deficits small relative to GDP. The IMF fiscal conditionality was therefore seen as unwarranted.

Lessons from East Asia have become very useful for the IMF in Europe 10 years on. Hindsight has shown that the IMF grossly underestimated the capital flow reversals in Indonesia, South Korea and Thailand in the late 1990s.

In Asia, structural conditionality went way beyond addressing the weaknesses in the financial sector that were central to the crisis. IMF programmes included reforms to capital account, corporate governance and labour market, among others.

This does not mean that the IMF has sidestepped its own structural reform agenda. If the European programme is any measure, there have been four major shifts on the part of the IMF.

First, structural conditionality has become more focused on a few critical areas. The so-called "targeted conditionality", deemed crucial for the success of the overall programme, seems more acceptable to national policy makers than the ones attempted by the IMF in Asia.

Second, it has dawned on the IMF that structural reforms cannot work without "national ownership". Such reforms must be "home-grown", not imposed. Experience has shown that IMF-imposed reforms have failed mainly because the implementers were not on board. In Europe, the IMF has been working closely with national policy makers, based on a mutual recognition of the need for such reforms.

Third, the IMF seems to have finally come out of the “one size fits all” mindset in Europe, as structural conditionality in Europe varies from country to country, although bank restructuring is common to all. This is also the case with macroeconomic conditionality, as Iceland and Ukraine are allowed to retain their capital controls.

Finally, the IMF appears to have learnt that heavy-handed, abrasive approaches were counter-productive. The “soft” approach used by the IMF in Europe seems to be winning more hearts and minds.

But there is no need for an IMF apology to Asia. Mistakes were made, but they were unintentional. It was all “learning by doing”. East Asia benefited from the IMF-sponsored reforms, judging by the remarkable resilience these countries have shown in the wake of the global financial crisis.

Indonesia, an outstanding case in point, has been transformed from a basket case into a powerhouse. Its economy continues to grow at respectable rates, with financial stability, even under a heavy weather. South Korea exited from the global recession in the second quarter of this year without IMF assistance.

The IMF saved South Korea from sinking in 1998. In return, South Korea saved the IMF by emerging from the recession fast, while IMF-bashing was still in vogue. That South Korea could repay IMF loans ahead of schedule speaks well for the efficacy of the IMF programme.

The Asian financial crisis of 1997-98 was a humbling experience more for the IMF than for East Asia. The current global recession is a humbling experience for many, especially the US and Europe, but not for the IMF, which is putting the invaluable lessons from Asia to good use.

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