As you know, the U.S. economy just completed another stellar year, marked by strong growth and declining inflation. Indeed, the low inflation of recent years has been instrumental in reinvigorating the U.S. economy, helping unleash a new vibrancy and confidence across the country. However, the shock wave working its way toward us from the Western Pacific will likely be a countervailing force in our economy.

Financial turmoil in a handful of Asian countries should slow the growth of spending by foreigners on U.S. goods and services. On balance, most economists— and I would include myself in this group—are currently guessing that reduced demand for our exports will trim perhaps a half percentage point off our overall growth rate over the next year. Of course, the degree of uncertainty surrounding this estimate is large. The actual slowdown will depend on how developments in Asia play out—including the policy response there and abroad.

Even those of us in the Tenth District are not immune from events in Asia. Many local industries—such as agriculture, technology, and manufacturing—are global competitors and will be affected by these events. Allowing the Asian crisis to go unchecked would surely have had an increasingly harmful effect on the economies of our district.

The origins of the crisis

Three elements lay at the foundation of the Asian financial crisis. First, to finance growth in their economies, some Asian countries relied on a large amount of short-term debt relative to equity. While debt plays an important role in the efficiency of a market economy, carrying a large amount of debt also involves high risk. In times of economic stress, short-term debt is an unstable source of funding. In today’s global financial marketplace, investors can quickly move their capital out of an economy. This is what happened in these Asian countries.
Second, each of these countries with a large deficit load maintained a fixed exchange rate. The fixed exchange rate tended to give businesses and financial institutions in these countries a false sense of security with regard to exchange rate risk, leading them to hold a significant part of their short-term debt in dollars. The volatile nature of dollar-denominated short-term debt made these Asian economies especially vulnerable to a crisis in the event of a sudden loss of confidence by investors or an unexpected exchange rate depreciation.

Third, the banking system in each economy was subject to lax lending standards and weak supervision. With short-term foreign capital flowing into a country, a weak banking system allowed loans to be diverted to questionable investment projects and real estate deals. When the Asian crisis hit, the questionable loans threatened to bankrupt a sizable number of firms and domestic financial institutions.

Thailand provides a good example of how these forces came together to cause a crisis. After many years of strong growth, Thailand’s economy suffered a slowdown in 1996 and the first half of 1997. As a result, many questionable investments became unprofitable. When Thailand floated the baht on July 2, the belief that there was no foreign exchange rate risk quickly disappeared. Investors lost confidence in the baht and quickly tried to convert their bahts to dollars. When the local currency rapidly depreciated, the cost to Thai businesses of servicing their dollar-denominated debt increased. Then, as domestic residents rushed to hedge their external exposure, exchange rate pressures intensified and the crisis spread to other countries in the region. Some of the contagion was rational since the depreciation of the Thai baht reduced the competitiveness of Thailand’s trade competitors. In addition, investors saw the same three elements in other Asian countries such as Indonesia and South Korea—a high degree of debt, a pegged exchange rate, and a weak financial system. Against this backdrop, the IMF-led response has attempted to regain economic order by systematically addressing the underlying elements of the crisis.

International response to the crisis

The first aim of the IMF-led response has been to restore investor confidence. The IMF agreed to make loans to these countries contingent on the implementation of needed economic reforms. The IMF program first required these countries to stabilize their exchange rates by temporarily raising domestic interest rates. At the same time, these countries, in consultation with the IMF, agreed to implement longer term structural reforms necessary to put their economies back on the path to more permanent stability.

The most important reform has been to place their financial systems on a sound footing. This requires closing insolvent financial institutions; recapitalizing weak, but solvent, institutions; strengthening financial regulation and supervision; increasing transparency in corporate and government sectors; and opening markets to international trade.

Also, an important part of the IMF-led program has been to ensure that all parties involved in the creation of the crisis share in its negative effects and the cost of reform. Each government must find and set aside funds to pay the cost of the economic restructuring. These costs can be large. For example, the cost of resolving the U.S. S&L crisis in the 1980s is estimated to have been 3 percent of our GDP. Moreover, as the necessary restructuring occurs, economic growth will slow. In this instance, Asian stock markets have already fallen about 50 percent, causing sizable losses for investors. Also, many firms and financial institutions have gone bankrupt. And yes, large money center banks in the United States have seen earnings drop, as they have incurred
trading losses on currency swaps and have had to increase reserves against future currency and loan losses.

The role of the IMF

Given the impact of the shock on Asia and the role played by the IMF, there has been a great deal of discussion about the IMF. Such discussions play an integral role in democratic societies. In fact, Congress is now debating whether to increase funding for the IMF. As suggested in my remarks, I believe the IMF has played an important role in managing and controlling the impact of the shock on the world economy. The IMF-led response has helped the crisis-ridden countries stabilize their economies and take their first steps toward financial recovery. More important, from my point of view, the IMF-led effort appears to have contained the crisis and lessened its impact on the rest of the world.

With upheaval in Asia, there have come renewed calls for dismantling the IMF. While certainly we should review the IMF’s role in Asia, I would suggest we not seriously consider abolishing it. There is no question that our world in 1998 is very different from that in 1944 when the IMF was created. All organizations must continually evaluate their goals, objectives, missions, and methods of operation. The IMF is no different. Moreover, the IMF recognizes the need for changes, as do Treasury Secretary Rubin and Deputy Treasury Secretary Summers.

But, we must also confront today’s crisis with the mechanisms and institutions we have in place. It is important to keep in mind that the IMF is the best institution in place to play an important and useful role when the next financial crisis occurs—not if another crisis occurs. In this context, I believe it important that additional funding for the IMF be provided. Indeed, the IMF and the international community must continue to work together to modify and update the mechanisms and institutions needed to reduce the risk of future crises, a risk that is inherent in today’s complex, global economy.

Conclusion

In closing, I believe that the IMF has performed a valuable role in dealing with the Asian crisis by coordinating the efforts of international agencies and governments to deal with a complex and unfolding crisis. Allowing the Asian crisis to go unchecked would surely have had an increasingly harmful effect on the world economy, the U.S. economy, and the Wyoming economy.