# Korea and the IMF

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## Introduction

Mr. Chairman, Ladies and Gentlemen.

It is a great pleasure to be here today and to speak before such a distinguished audience. As you may know, I will soon be stepping down as the First Deputy Managing Director of the IMF. And so I am very happy to have this opportunity to visit Korea for the last time in my official capacity.

Happily, this visit is much less dramatic than my visit to Korea on November 20, 1997. This was a few days before the formal start of negotiations between the Korean government and the IMF, and at a time when the depths of the crisis that was about to engulf Korea were just becoming clear. On that occasion I was barricaded in my room by the press – which, while inconvenient, was at least convincing evidence of the strength of Korean democracy.

Now the crisis is three years behind us and Korea has made a remarkable recovery after a period of considerable economic pain and dislocation. Economic growth resumed just three quarters after the start of the crisis, and the lost ground had been recovered in less than two years. National output now stands 13 percent above its level prior to the crisis: Korea has recovered more powerfully than any other major economy which fell victim to financial turmoil during the 1990s.

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Growth in Korea has of course slowed significantly over the last year or so. To some extent this was inevitable given the sharp V-shape of the recovery from the crisis. But Korea has also been affected by the slowdown in the global economy. Export values are down sharply from last year, reflecting weaker demand growth in Korea's trading partners, and particularly weakness in the demand for semiconductors and electronics. At the same time, domestic spending remains sluggish, with strengthening business and consumer confidence not yet feeding through into investment and consumer spending.

The challenge now is to put the economy back on a path of stronger and sustainable growth. I will begin today by talking about some of the key policy challenges that Korea has confronted since the crisis. In most of them important progress has been made, although here – as everywhere – there is more that can and should be done.

I will then look back briefly at the Korean and other recent economic programs, to try to identify some of the lessons that should be drawn from that experience. I will conclude by talking about the relationship between Korea and the IMF in the future – how the Fund can help Korea, and how Korea can help the Fund.

## Policy Challenges

### *Political Leadership*

The key to Korea's recovery since 1998 has without doubt been the commitment of the country's political leaders and people to the course of sound macroeconomic policies and far-reaching structural reform. President Kim Dae-Jung's leadership was crucial. He publicly supported the program in the darkest days of the crisis and never hid from the public the gravity of the situation they faced. The Korean people rose to the challenge, demonstrating remarkable solidarity in the face of very difficult circumstances. Labor unions, employers and the government worked together to implement what were often painful changes. And it was moving indeed to see on TV ordinary people handing over prized belongings as their own personal contribution to the national recovery effort.

This sense of solidarity has served Korea well in the past, and it will no doubt serve it well in the future too. As the next election approaches, it is vital that the commitment to reform is maintained and that – despite the difficult global economic situation – the momentum of current efforts is not lost. Past experience suggests we have good reason to be hopeful on that score.

*Reducing Macroeconomic Vulnerabilities*

Now let me turn to macroeconomic policy. The recent weak growth performance should not blind us to some impressive achievements on this score.

First, the authorities have learned one of the most important lessons of the crises of the 1990s, and allowed exchange rate flexibility in both directions. Every major financial crisis of the last few years – from Mexico in 1994/5 to Argentina and Turkey most recently – has in some way involved a fixed or pegged exchange rate. Countries with more flexible regimes were by no means unscathed, but they suffered to nothing like the same degree. This was no coincidence.

To favor a flexible exchange rate is not to say that the level of the exchange rate should not be a matter of policy concern. The more open the economy, the more important the exchange rate is as a determinant of both inflation and output. Both monetary and fiscal policy can be deployed to affect it. Intervening to calm disorderly market conditions – as the authorities have done on occasion – may be entirely appropriate. But it is important to ensure that market forces continue to determine the exchange rate and that the authorities do not squander their reserves in an attempt to defend the currency at any particular level. That would be counterproductive and give speculators a target that they will be only too happy to shoot at.

A second, and related, achievement has been to increase official reserves to close to $100 billion. Countries in Asia with very large reserves did better in avoiding the worst of the crisis than those with smaller reserves. The traditional IMF reserve indicator was the ratio of reserves to imports, with reserves equivalent to three or four months of imports seen as a rough benchmark. But in an era in which crises are more likely to arise from the capital than the current account, it makes more sense – as a first approximation – to argue that countries need reserves sufficient to cover their short-term debt. Korea's reserves now stand at around 165 per cent of short-term liabilities, comfortably exceeding that benchmark. Short-term debt has also been substantially reduced – indeed Korea is now a net external creditor.

Third, the authorities have made good progress implementing their inflation-targeting framework for monetary policy – a framework that has the added advantage of allowing exchange rate movements to be taken into account in the setting of monetary policy in so far as they affect the outlook for inflation. The task of monetary policy, and the credibility of the framework, has been made slightly more difficult by the fact that inflation is likely to overshoot the target this year by about half a percentage point. This recent increase in inflation has largely been the result of temporary factors like the weakness of the won, higher public service charges and the lagged impact of oil prices. But there is no evidence of demand pressure. The authorities should explain that the breach will be temporary and that it should be accommodated, and should focus on the implications for future policy.

Fourth, Korean fiscal policy has been conservative – in fact, tighter than intended. Fiscal policy was supposed to be mildly expansionary this year, but in the first quarter the surplus actually increased. It is important that this tightening does not continue with the economy as weak as it is at present. The authorities have had some difficulty implementing fiscal policy in recent years and are now looking at ways to revamp the budgeting process. The IMF would be happy to help in this endeavor if that would be useful.

*Structural Policies*

Now let me turn to structural policies.

I will focus on three areas: improving the infrastructure of the market economy; corporate restructuring, and; strengthening the financial sector. Further progress in each of these areas is essential to complete the task of reform and restore the long-term growth capacity of the Korean economy.

But first let me note that on these fronts Korea has been trying to carry out within the space of a few years what the older industrial economies took many decades or even centuries to achieve. For them it was a process of evolution, for Korea it is a process of revolution. Naturally this is neither easy nor comfortable.

First, let me talk about putting the **infrastructure of the market economy** in place. By this I mean the legal, regulatory and institutional framework – sometimes called the *software* of the economy – that allows the invisible hand of the market to operate effectively.

For example, we are familiar with the notion, introduced by Hayek and made precise by modern contributions to economics, that markets are efficient processors and aggregators of information. But for this purpose, they require accurate information to function effectively. This underlines the importance of bringing disclosure requirements and accounting standards into line with international best practice. The crucial point is that it is not enough to bring *rules and regulations* up to international standards, which Korea has by and large done. It is essential as well to bring *actual practices* up to international standards.

Here the picture is less reassuring. It is said, for example, that Korea has 8,000 listed companies, but only 4,000 qualified and experienced auditors. This must mean that it is difficult to ensure that the accounts of most of the listed companies are audited correctly, which in turn means that the information available to investors and creditor banks must be less accurate than it should be.

Corporate governance is a second example. Korea has taken important steps to protect investor rights, promote the appointment of outside directors, and improve disclosure and transparency. But fully implementing and capitalizing on the framework may take some time. It is regrettable to hear reports that some corporations are trying to undermine some of the corporate governance reforms. The authorities should stick by their guns.

Other important elements of market infrastructure include insolvency procedures and financial supervision, which I will examine as I take up next the topics of corporate and financial sector reform.

So, **corporate restructuring**.

Corporate weaknesses remain an important source of vulnerability, thanks to low profitability and excessive debt levels. Debt-to-equity ratios remain high. A quarter of Korea's large companies are earning too little to meet their interest payments. And many lower-rated companies have been having difficulty getting financing.

The focus of corporate restructuring has so far been on a few high-profile cases. Restructuring has often involved debt-equity swaps, asset sales, replacement of top management, spin-offs from the rest of the chaebol, and creditors providing new financing or rolling over loans. Notwithstanding these efforts, it is clear that Korea needs to move more aggressively to restructure the corporate sector. Large distressed firms still have the capacity to destabilize financial markets and nonviable firms remain a drag on the economy.

The process has been hampered by disagreements among creditors, and by unrealistic valuations that have held up the sale of assets. Another problem has been the conflict of interest between the government's role as supervisor of the financial system and its role as a major shareholder in banks with large exposures to the corporate sector. This has weakened regulation and delayed the recognition of losses, thereby slowing the return of corporations and the economy as a whole to economic health.

Priorities now include stronger efforts to identify and deal with large firms in distress. Creditors need to conduct detailed examinations of firms in trouble and act on the results. This means coming to an objective judgment as to which are viable and then doing what needs to be done in terms of operational and financial restructuring to ensure that they can stand on their own two feet again.

To the extent that markets are unwilling to provide financing to troubled countries, this is a clear signal that they doubt the viability of those companies in their current form. In those circumstances, the authorities should be prepared to allow the firm to fail. It follows that the authorities should press ahead with their plans to stop underwriting the corporate bond market.

The restructuring of corporate debts is being delayed by weakness in the insolvency framework, an important element of the infrastructure for a market economy. According to the experts who have studied this situation, under the current insolvency regime, small holdout creditors and even equity holders have too much power to hold up the resolution of problem cases. Amending the bankruptcy law to give more power to senior creditors is an important priority. The authorities recognize these problems and work to amend bankruptcy procedures is under way.

Voluntary out-of-court restructuring can play a role, but action in this area is no alternative to improving the court-based insolvency regime. With their legal mandate, clearly defined procedures, and powers to appoint a receiver, the courts are the best setting in which to agree and implement restructuring plans.

Corporate sector weaknesses threaten to spill over into the financial sector. Commercial bank profitability and provisioning for loans have both improved, and the proportion of impaired loans has fallen as a result of securitization, write-offs and loan recovery. But further corporate restructuring is likely to reveal additional losses.

Banks have increased their provisions for exposure to some problem companies, and the supervisory framework now requires banks to pay more attention to maturity and exchange rate mismatches in their balance sheets. But there is widespread suspicion of underprovisioning. Big corporate failures could significantly reduce capital adequacy ratios, so aggressive operational and balance sheet restructuring is essential.

Government ownership of large parts of the financial sector creates the risk that credit decisions are not based on commercial judgments, but rather to prop up failing companies. It is only recently that the government has begun to force banks to call in loans, which in turn is forcing some companies to sell assets in order to repay them. Partly as a result, last month foreign direct investment more than doubled to $1.23bn, its first monthly rise since January.

Nonetheless, getting government out of the banking sector is important to improve management and remove the conflict of interest in corporate restructuring. It is important for the authorities to take concrete steps to demonstrate their commitment to exiting the financial system, and to allow banks and other private sector institutions to drive the restructuring process. Although the precise timing of privatizations depends somewhat on market conditions, it is not worth keeping institutions under state ownership simply in the hope that the price they can be sold for will be higher in future. The sale of the Seoul Bank will be an important step. The rehabilitation of other financial institutions – banks, investment trust companies, and insurance companies – needs to be stepped up to get them ready for privatization.

Much work has been done to strengthen the supervisory process, another part of the infrastructure for an effective market economy, but further improvements are necessary.

Looking at this set of macroeconomic and structural reform challenges, we should not underestimate how much has been achieved; but nor should we underemphasize that more remains to be done. A common theme of much of what I have said is the need to put more faith in the market – which implies less intervention in the economy.

## Lessons from the Program

As I am coming to the end of my time at the Fund, I hope you will allow me to look back briefly on the role we played in Korea and elsewhere in Asia during the resolution of the financial crises and at some of the lessons we and others have learned.

Let me begin with the lessons we have learned about preventing crises – which everyone knows is better than having to cure them.

The first lesson is that Fund **surveillance** should have been more vigilant and more attuned to market developments, particularly in Korea. One explanation for the failure to predict the crisis is that previous crises elsewhere had largely stemmed from the current account of the balance of payments, reflecting poor macroeconomic fundamentals and excessive government budget deficits. We and other observers looking for similar weaknesses found few of the signs of a classic external crisis in Korea: the crisis arose more from the mismanagement of companies and banks, than from macroeconomic mismanagement.

What is more, the economy had managed to perform strongly for a long time, even in the presence of what were after all widely-recognized corporate and financial weaknesses. That fact – Korea's amazing growth record – may have created a sense of complacency, not only among policymakers, but also among analysts and observers of the economy. In the event, as Korea advanced and became more integrated with the world economy, the government- and chaebol-led system that had functioned so effectively during periods of rapid growth proved unexpectedly vulnerable to unfamiliar shocks.

Effective surveillance also requires adequate information. To varying degrees, the IMF, investors and the authorities were hampered by incomplete information on the magnitude of non-performing loans, the health of the corporate sector, the maturity profile of external debt, and – especially in the last few months before the crisis burst out – the level of official reserves. The lack of information meant that investors reacted more violently than they otherwise would have done when the realities of the situation suddenly became clear.

Notwithstanding these lessons, it would be naïve to believe that better surveillance and early-warning systems will allow us to prevent every crisis. Sometimes we will miss the warning signs. And sometimes we will see the warning signs but be unable to persuade policymakers to act. Some of the Asian and other crises – for example those in Thailand, Russia, and Brazil – were foreseen, but the authorities would not or could not take the necessary action in time. But if our surveillance infrastructure and procedures were as strong in 1997 as they are now – and as strong as they should be once our International Capital Markets Department is up and running – then our alarm bells would probably have rung about the situation in Korea somewhat earlier, perhaps allowing some preemptive action – though, again, we need to remember that there was an election coming up at the time.

A second lesson is that **capital account and financial liberalization** must be carefully sequenced if it is not to make the economy more vulnerable to shocks. A more balanced approach in Korea, opening up earlier to foreign direct investment, and later to short-term capital flows, might have limited the danger of liquidity problems. Opening up to the presence of foreign banks would have improved banking practices and strengthened the banking system.

A third lesson, which I referred to earlier, is that the crisis would have been much less significant – or might not have happened at all – if **exchange rates** in Asia had been more flexible. The won and other Asian currencies would not then have appreciated as far in effective terms in late 1996 as they did as the dollar appreciated. The balance of payments problems faced in early 1997 would have been less severe. The inflow and outflow of short-term capital would likely have been smaller. And Korea might not have spent almost all its reserves trying to defend the exchange rate peg.

What about the lessons for crisis management?

The most important lesson – and it is actually an old one – is that **ownership** of the reform and adjustment program by the country implementing it is important to its success and to convincing financial markets that the program will succeed. Given the complexities of politics, especially in crisis situations, the concept of ownership is not simple, but the general notion that ownership is important is correct. As I mentioned at the outset of my talk, in this respect Korea was exceptional in the commitment of its political leadership and its people to what needed to be done. It was of course fortuitous that the President who had to push through the reforms could not have been blamed for the problems. But even so, Korea's performance stands out.

A second set of lessons concerns **macroeconomic policy**. When countries face a financial crisis and a currency crisis simultaneously, monetary policy naturally confronts a dilemma. Other things being equal, the cure for the first is looser policy, the cure for the latter is tighter policy. This dilemma lies behind some of the strongest criticisms of IMF policy recommendations at the start of the crises. We concluded that an unchecked devaluation would have been catastrophic for Korea's banks and corporations, and that a *temporary* hike in interest rates was therefore necessary to stabilize the currency and the economy. I stick by this view, emphasizing that we expected and were correct that interest rates would have to stay high for a short time, to stabilize the exchange rate, whereas a failure to defend the currency would have led to a greater nominal depreciation and greater debt problems for firms that had borrowed in dollars. We were by no means unaware or unconcerned about the pain the higher interest rates would impose. And we supported a range of measures to mitigate their impact that were put in place, including emergency liquidity support from the Bank of Korea.

Critics of this approach argue that higher interest rates actually exacerbated the capital outflow and weakened the currency, by raising debt servicing costs for firms and increasing the probability of default. On this view, there should have been less monetary tightening and a bigger package of financial support. A related argument is that even if interest rates did have to rise, they were kept too high for too long.

Numerous research studies have investigated whether monetary tightening is effective in supporting the exchange rate during financial crises of this sort. Results differ, but I read them as broadly supporting the view that – so long as interest rates are in a reasonable range – monetary tightening will help strengthen the currency. I also recall the controversy in the early days of the crisis, as dollars continued to pour out of the country, over whether the central bank should raise the rate on its dollar loans. When it did, the outflows slowed.

It is also hard to argue that interest rates were kept too high for too long in Korea. First, the 35 percent peak in the call rate was not large for an economy that has seen its currency halve in value in just two months. Second, interest rates were at their peak for a very short time: within two months they began to come down, three months later they were already in the teens, and they reached single digits three months after that. Third, the fact that cases of corporate distress continued to emerge once interest rates had been lowered, suggests that many problems in the sector were the result of underlying weaknesses rather than short-term policy pressures.

Finally, the option of increasing the size of what was already a very large package of international financial support was simply not on the table – nor, I believe, should it have been.

On the fiscal policy front, Korea has long taken a conservative approach that has served it very well. When the crisis hit, the program called for this conservatism to be maintained by somewhat tightening fiscal policy. There were at least three reasons. First, and most important, we did not anticipate the depth of the recession. Second, the government faced a costly financial sector restructuring. And third, fiscal conservatism was thought to be good for the rapid revival of investor confidence. However, confidence took some time to revive – and once the extent of the crisis became clear, within a few months, fiscal policy was loosened to take account of the unexpected weakness of activity and the need to strengthen the social safety net.

Setting monetary and fiscal policy in crisis situations is by no means an easy task and reasonable people can disagree about the precise course chosen. Perhaps the most important lesson is that in a situation of pervasive uncertainty, it is essential to monitor the program closely through regular reviews so that it can be modified in line with changing circumstances. In Asia, this is what was done, and by early 1998 the thrust of fiscal policy had been reversed in all the Asian Fund-supported programs.

A third lesson concerns the role of **structural policies** in the program. It was clear from the outset that the crises that confronted Korea in late 1997 were more the result of structural problems than macroeconomic weaknesses or budget deficits. It was therefore inevitable and appropriate that the response to the crisis should contain a significant element of structural reform. The program would have lacked credibility if it had ignored these issues, because it would have left Korea vulnerable to another crisis further down the road. Neither the large volume of official support, nor the support of foreign commercial banks in rolling over their loans, would have been forthcoming if the structural agenda had been left unaddressed.

But what of the argument that structural conditionality was too detailed and too intrusive? In the case of the Korea program, the vast bulk of structural reforms centered on the core areas of financial and corporate restructuring. A few measures outside these core areas were included in the letters of intent, but the structural performance criteria – the formal requirements that had to be met to disburse the loan – were almost exclusively in the financial sector area. Nonetheless, the sheer volume of detail in the LOIs and the policy matrices was probably excessive and it could have been streamlined without materially affecting the quality of the program.

We should note that there would probably have been just as much controversy over structural conditionality in the IMF-supported programs even if they had focused purely on financial sector and corporate restructuring – for those were *the* most difficult parts of the programs. Even now they are far from complete, and resistance to implementing these reforms remains despite widespread recognition that they are essential. This problem is not unique to Korea. Financial sector restructuring is always difficult, and policymakers often avoid dealing with the problem in the hope that it will go away. But usually the problem gets worse, not better, when it is not dealt with.

A fourth lesson is the importance when necessary of securing **private sector involvement** in the resolution of financial crises. Private sector involvement was relatively heavy handed in the case of Korea, with leading bankers subjected to vigorous moral suasion over their Christmas dinner tables in late 1997. It is possible that we might have saved a few weeks by moving earlier on this front, although it is far from clear whether the banks would have been prepared to play ball until the situation had become as serious as it was on Christmas Eve.

The final lesson I want to refer to regards the Fund's **lending facilities**.

Capital account crises require a different lending capacity in the Fund than current account crises, if we are to fulfill the responsibility laid down in our Articles of Agreement to "give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards".

Coping with huge and sudden reversals of capital inflows is a much bigger challenge than helping fill a current account financing gap. We had to learn this lesson on the run.

In December 1997 we created the Supplemental Reserve Facility to provide larger quantities of support, over shorter time periods, and at higher interest rates than was the case under traditional IMF stand-by arrangements. This facility – which embodies some of the rules for a lender of last resort set out by Bagehot – was pioneered in Korea and it is an extremely valuable addition to our lending armory.

In addition, we have now introduced the Contingent Credit Line facility. The CCL deploys the Fund's finances in an effort to help prevent crises. It is available to countries with demonstrably sound policies, and makes a potentially large line of credit available to them, to be drawn on in the event they are affected by contagion from a crisis elsewhere. The cost of the line of credit is quite modest, so it in effect allows countries the opportunity to augment their reserves at very low cost. This facility has recently been revamped to make it more user-friendly and more financially attractive and I am confident that it will have its first takers later this year.

## The Future

Now let me conclude by talking briefly about future relationships between the Fund and Korea.

First, I hope that the Fund in its surveillance and technical assistance activities can be a trusted policy adviser to Korea. This is inevitably a happier relationship when a country is not borrowing from the Fund than when it is having to negotiate a program, and meet performance requirements.

This role has a number of elements:

The comprehensive advice offered regarding policy options and economic developments through Article IV consultations or post-program monitoring;

Identifying weaknesses and potential improvements in financial sectors, through the Financial Sector Assessment Programs we carry out with the World Bank and experts from national central banks and financial regulators;

Assessments of performance relative to international standards and codes of conduct, for example on statistical dissemination, and financial and fiscal transparency. These assessments are now being gathered together and published in Reports on the Observance of Standards and Codes (or ROSCs). This provides a spur to good policies and a source of information to investors. Korea's fiscal ROSC is already completed and available on the IMF website. The country's statistics ROSC should be completed in the next few months;

Providing help as required on specific policy topics, for example the work that our Fiscal Affairs Department has carried out to help the authorities identify possible improvements to its budgetary processes;

The insights that can be derived from the regular multilateral surveillance discussions on the IMF board and from the discussions of other countries' prospects and problems.

Second, in the wake of the crises, Asian countries are putting in place new regional arrangements, including swap lines, and are discussing new currency arrangements. The IMF welcomes this enhanced regional cooperation, which should be complementary to the global arrangements in place in the Fund and elsewhere.

We are ready to cooperate fully to help make these regional endeavors a success, for example by assisting in the surveillance process (as we already do in several regional fora), and by cooperating in the financing arrangements envisaged under ASEAN+3, where the activation of loans beyond 10 percent of the agreed lines will take place in the context of IMF-supported programs.

Third, in addition to providing policy advice, we also stand as an advocate of best-practice policies. The Fund embodies a commitment to open, stability-oriented, pro-market policies that the international community has learned from experience to be the best way to deliver strong and sustainable increases in living standards for its member countries and a stable global economic and financial environment. And needless to say, as our Articles of Agreement commit us to, we stand ready to provide all our members financial support when they need it.

Finally let me say that the Fund as a global institution is incomplete if Asia is not playing a full role in it. Much attention has been focused on the underrepresentation of Asia in the IMF's quota, and Korea is of course the leading case of a quota that is seriously too small. Korea's quota should be increased.

The quota matters because it determines the normal size of borrowing – though Koreans know that in exceptional circumstances those limits can be exceeded. The quota also determines the country's voting share in the Executive Board of the IMF. But votes are rare in our Board and the effectiveness of Executive Directors is more a function of their persuasiveness than their formal voting power. It is important that these posts are occupied consistently by candidates of the highest quality – and your recent representatives have been very good – and that national capitals take a close interest in what is being discussed in the Board.

Korea has strong universities and a large number of PhD economists, many of them foreign-trained, many of them more interested in theory than in policy problems. But economists usually entered the field in part because they were interested in the real world, and I am sure that there is room for more of your excellent PhD's to be more involved in both domestic and international policy analysis. Given this, and Korea's own remarkable growth and stabilization experience, your country surely has an important role to play in thinking about and influencing the international economy.

It will be to Korea's benefit – and to the world's – if it plays that role as fully as possible in the future.

In closing, let me say what a privilege and challenge it has been to be able to work on the Korean program over the last four years. What your country has achieved is truly remarkable. And I am sure that what you will achieve in the future is equally remarkable.

Thank you, and good luck, and good policies.

## Questions & Answers

**Q:** When the Korean government and the IMF jointly announced the IMF-supported restructuring program, you assumed that under the program the growth rate of the economy would stand at around 2-3% for 1998. In the event, it turned out to be minus 6%. This was a gross mis-projection of macroeconomic performance. Did that play a role in prescribing a macroeconomic policy that was rather harsh and too contractionary?

**A:** At the beginning of the program we thought that a growth assumption of 0% to minus 2% would have been more realistic, but at the time the Korean government could not bring itself to predict that there would be a significant slowdown. Having said that, even we did not anticipate that the outturn would be as weak as minus 6%.

I don't believe that having an unrealistically optimistic growth assumption in itself led to macroeconomic policy being set too tight – if anything the opposite. For one thing, it meant that the target for money growth was higher than it would have been if we had assumed that the economy would grow less quickly. In addition, by setting spending and tax policy on the basis of a high growth forecast, you create room for automatic stabilizers to work if activity turns out weaker. Overall, I think the policies that emerged were probably a bit more expansionary - certainly on the monetary side - than they would have been if we had assumed a lower growth-rate.

Assuming too high a growth rate causes more problems politically and for market expectations. Politically, it is a problem because the policymakers may not understand the depth of the crisis, and may not be willing to do as much as necessary. For market expectations, it is a problem because when growth comes in lower than assumed in the program, investors conclude that the program is not working. In some later programs, notably Brazil in 1999, the assumed growth rate was *lower* than the actual result. We forecast minus 3% and the outcome was 0%. We did not do that deliberately, but it did seem to work out better.

**Q:** You mentioned that the Korean government has played a role in slowing corporate restructuring over the past 1-2 years. Many Koreans share this criticism. However, I think the government has to be concerned with the implication of the speed of corporate reform on the labor market. This is the inevitable political reality: that the government has to be concerned about the social consequences of such restructuring. From the IMF's perspective, how do you think our government could have better handled this problem?

**A:** The more quickly corporate restructuring is undertaken, the less difficult it is likely to be. It would probably have been easier to restructure companies in the immediate aftermath of the crisis, when there were agreements among labor, business, and the government. The longer you go on and the more things get back to normal, the more difficult it becomes to undertake necessary but painful reforms. Every restructuring creates disruptions, but the Korean unemployment rate is quite low at the present, and there will probably not be a better time.

**Q:** There is intensive debate going on in Korea nowadays about the approach to the chaebol problem. Thus far, the government's approach has been highly regulatory, consisting of many minor and major regulatory restrictions on chaebol performance. We are wondering whether it is time to review this approach and rely more on market discipline rather than on regulation itself. However, if we start moving toward this new track, the international capital market will begin to believe that our political will has weakened. What would be your recommendations on this?

**A:** If the government announced that it was allowing the capital markets to work on the chaebol and reduce the extent of regulation, investors would be more likely to conclude that political will has strengthened rather than weakened. What might cause concern would be if the government announced that it would be allowing the capital markets to work on the chaebol, but then failed to do so.

**Q:** What would be the worst possible scenario for the Japanese economy, and what would be the impact on Korea and Asia in general?

**A:** I do not want to describe nightmare scenarios, but there is a problem: normal macroeconomic policies have run out of steam in Japan. The Bank of Japan could do a bit more on monetary policy - by buying Japanese government bonds at the long-end or buying foreign exchange, which would result in a weakening of the yen. This would be somewhat expansionary. You cannot do very much with fiscal policy. So all that is left is restructuring, and that is costly in the short-run. Prime Minister Koizumi has said that he understands that the policies he is proposing would be painful in the short-run and I think he is right.

Some observers would say the economy is so weak that restructuring should be delayed. But the economy has been weak for a very long time in part *because* restructuring has been delayed, so it is a very difficult situation. There is a ray of hope though. Consumer and business expectations would move in a more optimistic direction if the government was seen to have a coherent program to deal with the situation and the determination to carry it out.

**Q:** Regarding structural adjustments in Korea, I think switching to an easy monetary policy came too early in hindsight and because of that our structural adjustment program was not implemented quick enough. What is your view of this?

**A:** That is a question of political economy. In essence you are saying that Korea should have kept macroeconomic activity more suppressed and had a slower recovery. That would have encouraged structural adjustment. The same argument has been made in Japan: that they should raise interest rates in order to encourage restructuring. You may well be right that more restructuring would have been done if the macroeconomic situation had been worse. But I do not know how strong that effect would have been, and I not at all sure that outside advisors have the right to make political economy judgments of that sort.

While the point you make is an interesting one, I don't think that the switch to easy monetary policy came too soon from the macroeconomic viewpoint.

**Q:** In hindsight, would you have put more emphasis on structural adjustments rather than macroeconomic tightening?

**A:** I do not know if we could have put any more emphasis on structural policies – after all, one of the criticisms of the IMF-supported program and the Letters of Intent was that there was too much structural policy in them. Maybe the question is: "Should we have gone immediately in December-January to an easier fiscal and monetary policy?" We probably should have recommended an easier fiscal policy, but in terms of monetary policy you had to stop the collapse of the currency. So having an easier monetary policy in January would have been a bit too soon. Once the basic course of macroeconomic policy was determined, the emphasis later was on structural policies.

**Q:** My question is regarding personnel. You said that the Korean quota at the IMF is too small, or underrepresented. When will you be elected as governor of the IMF and, after you have become governor, would you be prepared to recommend a Korean financial expert to your current position? What would be an adequate or reasonable interest rate during the period of economic or financial crisis in your view, considering past experiences?

**A:** The question of allocating certain positions on the basis of nationality is a very complicated one and there is a general equilibrium problem: if you change it in one place, you have to change it in a lot of others. I can see many advantages to not having these nationality restrictions, but I am struck that this has not made it any easier to pick a leader for the WTO. We need to think about this question, and I expect that the nationality restrictions will eventually change, and that they should – but we need to be sure we have a good system in place for making future choices. And in the meantime, for now we have a system that more or less works.

I would certainly like to see many more Koreans and Asians on the staff at the IMF – and the number of Koreans is already rising. There is a real problem in that some nationalities obviously enjoy going home after an education in the US and some do not. It seems that Koreans like Korea and so many of your PhDs go home. As a professor at MIT, I could predict from the nationality of newly arrived students whether they were likely to stay in the States or not. Indonesians and Australians, as well as Koreans, for example, seem to go home. But we do need to get more Asians and particularly East Asians into the IMF and I am happy to say that we are making some progress.

Turning to your question of what is an adequate interest rate in a crisis, there is no easy answer. You have to balance the need to stabilize the currency against the need to revive economic activity. In a closed economy, you can cut interest rates without much difficulty. In an open economy, it is a far more complicated choice.

**Q:** In your presentation you mentioned about the regional cooperation and regional arrangements and you specifically mentioned ASEAN +3 swap arrangements. In my view, this swap arrangement represented by ASEAN +3 is the beginning of the institutionalization of regional-level cooperation. Do you remember that at the very beginning of the Asian financial crisis, there was a claim that Asia needed an Asian Monetary Fund, a much more institutionalized form of regional level cooperation.

If ASEAN+3 – what is called the Chiang Mai Initiative -- developed into a more institutionalized Asian monetary fund, would you still support that idea and under what conditions would you support it?

**A:** Regional cooperation in Asia is a process that is just getting underway and it will take a long time to fully develop. It is hampered to some degree by the fact that Asian economies are in many ways competitors in third markets rather than complementary, but there is a lot that can be done to build up economic cooperation within the region.

It is hard to predict how Asia's economies will evolve over the next 20 to 30 years. Much will depend on the relative roles of China and Japan in the region: how open they are to trade, and to financial arrangements with their neighbors and with each other. We should remember that economic integration in Europe was in many ways driven not by economics, but by the politics of trying to ensure a stable and peaceful continent. There is no reason why similar motivations should not operate in the Asian context. That would be useful.

As to the ASEAN+3 and Asian Monetary Fund, the key question is whether future regional arrangements complement other international institutions and cooperate with them. The arrangements created in Europe were never seen as an alternative to global ones and rightly so. If that is the way in which regional cooperation develops in Asia, then I am sure there would be full cooperation with and support from the IMF, the World Bank, and the WTO. The ASEAN+3 initiative certainly seems to reflect this spirit.

Regional cooperation should not be seen as an alternative to full participation in the global economy. I am surprised sometimes to see it discussed in those terms in Asia, probably for political reasons. Of all regions in the world this is by far the one that has benefited most from integration into the global economy. It would be a mistake to move from integration into the world economy to a more inward-looking regional focus. You can build up regional cooperation and at the same time strengthen your links with the global economy. That requires a sensible approach from Asia, but also from the global institutions. And it is one reason why Asia should have a greater voice in the IMF.

**Q:** Regarding the Meltzer report, do you agree with the recommendations to reform the IMF?

**A:** The Meltzer report has more radical implications for the World Bank than for us; but let me talk about the IMF. The report recommends that we move much more towards a system in which countries pre-qualify for loans. Rather than waiting to respond when countries get into a crisis, we should encourage them to take action beforehand. In particular, we should have a list of countries that can receive IMF loans if they get into a crisis. To get onto this list, countries would have to meet certain conditions, such as a strong financial system and a floating exchange rate. Countries that meet these conditions can borrow from us if they get into trouble, and it is tough luck for those that do not.

This approach is very good for incentives - it would certainly encourage countries to do the right thing, and in that sense we are in favor of it. Indeed, we have introduced the so-called Contingent Credit Line facility, which is very much in line with what the Meltzer report is recommending. But I doubt we should confine ourselves to doing all our lending this way.

I think we will be lucky if end up doing as much as 40% of our lending this way. What happens if a government gets a country into trouble and then gets replaced? The new government is a member of the IMF and our Articles of Agreement say quite clearly: “Our purpose is to give confidence to our members by making the general resources of the Fund temporarily available to them under adequate safeguards.”

The rules of the IMF mean that we should be willing to lend to countries that are in trouble, provided they are taking measures to fix the underlying problems in the economy. It is sometimes said that the possibility of IMF lending encourages bad policies, because countries know the IMF will be there to lend if they get into trouble. I think that is wrong, because I have never found a country that wants to be in a position where it has to borrow from the IMF. I don't think we encourage bad policies – rather I know we encourage good policies, both in IMF-supported programs, and through our surveillance. IMF lending is a way for the international community to extend a helping hand. It says: "If you play by the rules and join the system, we will try to help you if you get into trouble." I think we should continue that way.

I do not agree with those who say, for example, that if Korea gets into trouble, we should not reward bad policymakers by lending to them. It is not just the policymakers who will suffer, and not even mainly them. Should we refuse to help millions of Korean people just because a few members of the Finance Ministry made a mistake? So while the Meltzer report points to a sensible way to do some of our lending, we cannot and should not give up helping countries in crisis, even if they did not prequalify. But I am in favor of providing incentives to prequalify – for instance by charging higher interest rates to countries that do not prequalify.