Lessons from the Asian crisis

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Dinner remarks prepared for the conference “The Asian Financial Crisis Revisited: Challenges over the next Decade”, San Francisco, September 6, 2007

* The opinions expressed in this paper are in a personal capacity, and do not necessarily represent the views of JPMorgan Chase.

Introduction

It is a little over ten years since the Asian crisis broke out. Most of the badly-hit economies have now recovered, and it is becoming hard to recall the devastating economic and psychological consequences of the crisis. Indeed, it is tempting to regard it as an aberration that should be put out of mind as the countries concerned focus on the tasks of managing renewed growth.

That would be a mistake, I believe. The crisis demonstrated not only weaknesses in the economies concerned, but also the vulnerability of financial markets to extremes of optimism and pessimism, and consequent chronic tendency to overshoot. These tendencies have not gone away, as recent events have forcefully reminded us. There is much to learn from a study of history about what gives rise to economic and financial vulnerabilities, and what kind of triggers can set off financial turmoil.

I therefore congratulate the Federal Reserve Bank of San Francisco for convening this series of conferences. I welcome the opportunity to reflect on lessons that I trust will help make the international financial architecture more robust for the future.

The outbreak of the Asian crisis in Thailand in mid 1997 came largely as a surprise to market participants. It would be wrong, though, to say there were no warning signs. In international bodies such as the IMF and BIS, concerns had been voiced for some time about growing balance of payments deficits, seemingly unsustainable rises in domestic asset prices, and rapid growth in credit from the banking system. But these observers were hesitant to make public their reservations, particularly in view of the spectacular successes of the Asian countries, and the resounding vote of confidence they were receiving from private markets.

In the face of market euphoria, I can remember myself wondering if things might not indeed be different that time around. Perhaps balance of payments deficits, even large ones, would prove sustainable, given the new openness of international capital markets, the greater debt-bearing capacity of fast-growing economies, and the fact that much borrowing was undertaken by the private sector.

In fact, as we now know, while the world in 1997 may have been different from earlier, it was not sufficiently different to accommodate the kinds of financial imbalances that had built up. The laws of gravity still applied.

Now, in 2007, we are again in uncharted waters. International financial imbalances are, on some measures, even greater than they were in 1997. Once again, predictions of potential trouble have been made and, at least until recently, have proved unfounded. Is this because, on this occasion, things really are different? Or have vulnerabilities built up that will sooner or later return to haunt us?

So it is timely to look back on the Asian crisis ten years after, to see what lessons it offers for current policy making. By now, we have gained additional perspective to judge some of the underlying causes of the crisis, as well as how it could have been avoided and, once it had broken out, whether it could have been handled better. On the basis of this analysis, what suggestions can we make to strengthen individual country decision-making, as well as to improve the international financial architecture?

The scope of what I have to say covers mainly the emerging markets. Some of it may have resonance for the turbulence that has recently plagued financial markets in mature economies, but that is not my main focus.

To anticipate some of my conclusions, I will argue in what follows that greater flexibility in financial systems and policies has already strengthened resilience. There is no inevitability that large payments imbalances, by themselves, will provoke disruptive adjustment. Nevertheless, markets are fickle, and official policies need to take account of the potential for sudden changes in market sentiment. So it remains important to build efficient, robust and transparent national financial systems, capable of withstanding such shifts. There is also work to be done in improving the resilience of the international financial architecture and strengthening its legitimacy.

Before getting to lessons, however, let me start with a brief review of what actually happened in the Asian crisis. Most of this is pretty familiar, but if I put it in my own words, it will help frame the context for the points I want to make later about sources of vulnerability and how to address them.

The Asian crisis: historical background

By the mid 1990s most East Asian countries had been enjoying high rates of investment and rapid economic growth for a protracted period (Chart 1). Combined with stable exchange rates and relatively high interest rates on domestic currency, this had attracted growing foreign capital inflows (Chart 2), which easily financed a rising current account deficit.

In the light of this easy finance, Asian governments discounted the concerns expressed by some observers, including the international financial institutions. Both borrowers and investors seemed to reason, with some justification, that rapid growth made rising debt levels sustainable, since debt *ratios* were not rising (Chart 3). In any event, what was wrong with borrowing to finance productive investment? Finally, most of the borrowing

was being done by the private sector, so there didn't seem to be any danger from fiscal positions.

Under the surface, however, things were more fragile. Much of the borrowing that indirectly financed current account deficits was in foreign currency and at relatively short maturity. This did not create any problems so long as exchange rates were fixed and the liquidity was available to roll over short-term loans. Unfortunately, however, things would be quite different if exchange rates depreciated or if liquidity dried up, as of course they eventually did.

Domestic banks may have thought they had a matched book. However, their borrowers faced significant currency mismatches and had debt that was too short term. Domestic investment to meet local demand was financed by short term foreign currency borrowing and did not generate a cash flow that was aligned with its debt servicing requirement. Short-term dollar-based financing of construction is only the most obvious example. The rental or mortgage income from construction is generally in local currency and amortization is long-term. When rising interest rates and/or currency depreciation raised local currency borrowing costs, there was no way in which these higher costs could be met by the borrowers. The vulnerability fell back on the banking system.

Still, the situation was sustainable for as long as confidence was sustained. Indeed, there was every incentive for imbalances to widen. Investors in Asian economies seemed to have the best of all worlds. High interest rates gave them an above average return, and the continuing inflow of funds preserved fixed exchange rates without obvious strain. Risk seemed to be negligible.

With the benefit of hindsight, however, it is easy to see that this arrangement was vulnerable to anything that undermined the continuation of confidence. In the case of East Asia, the trigger was the discovery that Thailand's reserves had been overstated. One small plank in the edifice of confidence – the belief that official resources were sufficient to underpin the maintenance of the exchange rate – was removed. Thereafter, doubts about other countries surfaced and rapidly became self-fulfilling, a classic instance of the capital market equivalent of a bank run. Lack of transparency bred uncertainty and risk aversion.

Countries that had not seemed especially vulnerable were also caught up in the panic. Indonesia, for example, whose macroeconomic policies were described by the IMF as "exemplary" after the crisis had hit Thailand, suffered a huge outflow of capital that easily overturned the exchange rate band and brought the value of the Indonesian rupiah, at one point, to less than a quarter of its pre-crisis level.

The spread of the crisis reflected two phenomena that had not previously been seen in such extreme form. One was the existence of an unstable financial equilibrium. So long as confidence was maintained, the pre-crisis exchange rate could be sustained with little or no official intervention. But once confidence evaporated, a vicious circle took hold. Selling provoked declines in value, which in turn led to more selling. In the domestic

economy, leveraged companies saw their values plummet, and their access to additional credit dry up.

The second, and related, phenomenon was the close linkage between the currency and the health of the financial sector. Each downward movement in the currency exacerbated the liquidity and solvency problems of the banks. And the growing weakness of the domestic financial sector contributed in turn to the pressures on the currency.

The resolution of the crisis was painful and still colours the views of East Asian countries to the international organizations involved, particularly the IMF. The IMF used its conditionality to insist on fiscal austerity and monetary restraint. In the Fund's view, only the pursuit of orthodox policies would restore confidence and prevent a further erosion of local currency values. The IMF imposed policies were, and still are, controversial. Some outsiders, such as Joseph Stiglitz, have argued that they deepened, or even caused recessions that were not strictly necessary. Less rigorous policies would, these observers argue, have lessened the costs of balance of payments adjustment, by cushioning the associated decline in economic output.

There is still no consensus as to which of these two views is the more correct. For what it is worth, my hunch, based now on forty years in financial markets, is that it is hard for a country's government to convince markets that its currency is worth holding unless it is prepared to take strong (and inevitably unpalatable) measures to defend it. Once a downward spiral of the currency is underway, it is likely to continue until something dramatic happens to stop it. The psychology of markets in such circumstances resists purely rational analysis.

With this brief background, I now turn to turn to some of the lessons we can draw from all this. I will discuss these lessons under two main headings: (i) what countries can do to reduce their vulnerability to sudden reversals in market sentiment; (ii) what changes need to be made in international monetary arrangements to improve the efficiency and increase the resilience of the overall system.

Lessons for individual countries

I will group the lessons for individual countries under two main headings:

(i) the need to strengthen domestic financial systems; and
(ii) macroeconomic policy requirements, including exchange rate and reserve management policies

Perhaps the key lesson from the Asian crisis is that weaknesses in the **banking and financial sector** can feed into a balance of payments crisis and intensify disruptions in the wider economy. Asian banking systems, it is now realized, had several sources of vulnerability. Governance structures were weak. Many banks had an ownership

structure that encouraged "connected lending" to favored borrowers. There were weaknesses in risk management, which supervisors did not identify and correct. Finally there was a lack of transparency that meant that, when trouble surfaced, outsiders had no way of gauging how bad things really were.

Financial system weaknesses not only made Asian countries more crisis-prone. They also hampered the efficient allocation of resources in more normal times. The absence of a true credit culture meant that finance was channeled to less productive sectors and enterprises, just because they had favored access to sources of credit. More investment was needed to achieve a given growth rate than if the financial system had been working more efficiently.

The key lesson from this is the need to foster the development of a financial sector which is capable of making efficient credit judgments; which holds an appropriate cushion of capital against adverse contingencies; which enables end users of finance to match their sources of finance with their prospective cash flow returns from investment, and which transparently allows outsiders to judge its overall health. This requires actions in three main aspects of the financial ecosystem: strengthening the *institutions* which act as financial intermediaries; developing a transparent and robust network of financial *markets*; and providing an *infrastructure* of legal certainty, information availability and settlement efficiency.

Asian countries have come a long way in making their banking systems conform to international best practice and in improving supervisory oversight. They have adopted the Basel "Core Principles", strengthened regulatory oversight, increased capital cushions and accepted more comprehensive risk management practices. While overall standards of financial management are not perfect, they are much better than they were.

But it will be necessary to remain vigilant. Basel II capital adequacy requirements are being put in place. But Basel II, it should be remembered, contains three "pillars". A minimum capital adequacy requirement is only one of these. The other two are strengthened supervisory oversight; and market discipline. Continuing efforts are needed to ensure to make sure that supervisory oversight reinforces a "credit culture" and that the informational basis is available to allow market discipline to be enforced.

In recent years, household borrowing has been rising rapidly in Asian countries and banks have been exposed to new credit risks. The Korean credit card crisis is one example; other potential danger spots are overheated property markets in China, India and Thailand, to mention just three countries. Are Asian banking systems yet sufficiently well-equipped to manage new types of household credit and market risks?

I will not deal in depth with the other two aspects of what I have called the financial ecosystem – markets and infrastructures. But there is work to be done in Asia in both respects. A robust financial system requires more than just a strong banking system. It needs a balanced set of intermediation mechanisms, of which equity and fixed interest markets are an integral part. The two "Asian Bond Fund" initiatives launched by Asian

countries demonstrate that governments are aware of the need to develop further the capacity of the economies concerned to generate long term bond finance for investment. Concerning equity markets, in several Asian countries a successful equity market is regarded as one in which prices go up. Much more important, of course, is the development of a market that accurately prices the cost of equity, mobilizes saving and efficiently channels new finance to productive investment.

By financial infrastructure, I mean the legal framework in which contracts are drawn up and enforced (including bankruptcy provisions); the arrangements for providing markets with credible information (accounting conventions, auditing standards, rating agencies and so on); and a settlement system by which exchange of value can be speedily and risklessly effected. Here, too, perhaps because it is less glamorous work, a considerable amount remains to be done.

My second broad point concerns the need is to pursue sustainable **macroeconomic policies.** In this connection, the basic requirement is a strong fiscal and monetary position. There is no firm guide to what constitutes an appropriate fiscal position. But we have seen how quickly confidence can evaporate when trends in debt-to-GDP ratios are judged to be unsustainable. Countries need to plan to have a strong position over the whole cycle. This means having a sufficient "cushion" in favorable times, so that the inevitable fiscal deterioration in periods of weak growth does not lead to a "sudden stop" in the willingness of lenders to provide funding. To apply this lesson to the present day, one would have to question whether fiscal positions in many countries, both in the industrialized and emerging worlds, were strong enough to weather the deterioration that would result from a slowdown in economic activity, or the needs of an aging population.

As far as monetary policy is concerned, the key requirement is a credible anchor and an independent central bank. In the period leading up to the Asian crisis, most countries in the region used an exchange rate peg as the anchor for monetary policy. The dangers of that became evident as currency pegs came under pressure, and subsequently had to be abandoned. Most countries have moved now to greater flexibility in their exchange rates, and have adopted some form of inflation-targeting regime.

Inflation targeting is probably the best option for a country seeking a credible anchor for its monetary policy. And so far, most countries adopting this regime have been remarkably successful. However, we should remember that these new monetary policy regimes have not really been tested under stress. Moreover, whatever the formal legal position, doubts remain as to how independent in practice central banks will turn out to be in such a stress situation.

Perhaps the central macroeconomic lesson of the Asian crisis for emerging markets, however, is the importance of exchange rate flexibility. Provided that monetary policy is effectively anchored to an inflation target, allowing the exchange rate to move in response to external pressures is of key importance in preventing the build up of speculative pressure. This need not mean, I want to emphasize, free floating with no

intervention. But it does mean a focus on permitting exchange rate flexibility to play an appropriate role in the medium term adjustment process.

At the present time, it is not fully clear how committed Asian countries are to exchange rate flexibility. Many of them have in fact intervened heavily to prevent their rates from rising. What are we to make of these policy choices? On the one hand, it is clear that intervention to hold down a currency's value is more sustainable that using reserves to prop it up. In addition, holding down the exchange rate has allowed the countries concerned to run balance of payments surpluses and to build up substantial reserves. All of this could be said to make their situations more resilient.

But intervention and reserve accumulation also come with costs. The domestic financing counterpart of the official accumulation of reserves is now so large that it is distorting capital and banking markets. This substantial increase in liquidity is evident in the unsustainable credit and monetary growth now seen in many parts of Asia. Inflationary pressures are very real.

Reserve accumulation moreover, involves investing part of the nation's gross assets in relatively low-yielding securities. And if pegging is persisted in when market conditions change, it could become a source of vulnerability. For all these reasons, it will be important for countries to conduct intervention policies in a way that does not reintroduce rigidity in exchange rates; to find ways to effectively sterilize the consequences of intervention, and to gradually curtail reserve accumulation once foreign currency holdings are adequate for the precautionary function they are designed to serve.

Lessons for the International Financial Architecture

The Asian financial crisis was not just a crisis for the countries involved. It also demonstrated deep shortcomings in the architecture for international economic cooperation and for preventing and managing financial crises. In this, it confirmed the lessons of other crises of the 1990s, including the ERM crises of 1992-93, the Mexican crisis of 1994-95, and the subsequent crises in Russia, Argentina and Brazil.

What all these episodes demonstrated was the role of confidence in determining capital flows, the vulnerability of financial systems to sudden changes in confidence, and the inadequacy of financial support, alone, to deal with crises. In the eyes of some, they also demonstrated a number of shortcomings of the institutions established to manage crises, notably the IMF. I will group my comments of this set of issues under three headings:

- (i) the role of the international financial architecture in preventing crises;
- (ii) the role of the international community in coordinating broader economic policies; and
- (iii) the reform of the IMF

Let me begin with **crisis prevention**. Crisis prevention is obviously primarily the responsibility of individual countries. However the international community can help by providing policy guidance and an early warning system for impending difficulties. The IMF's regular consultations with member countries provide the opportunity for communicating to individual countries the advice and concerns of the international community. But more is needed to identify the emergence of broader vulnerabilities in the international financial system.

Following the Asian crisis, two new bodies were set up to improve international cooperation in this respect. One was the G20, which brought together the ministers of finance and central bank Governors of the twenty systemically most important countries to discuss, in a more restricted setting than other international bodies, threats to international stability and how to deal with them.

The other new body was the Financial Stability Forum (FSF). At its outset the FSF was given two tasks. One was to help develop, along with the IMF, a set of codes and standards for the management of financial systems. This involved encouraging and synthesizing internationally agreed standards in fields such as supervision of financial institutions, corporate governance, accounting and auditing, policy transparency and so on. These standards then became a focus for the IMF's work with member countries in reviewing the efficiency and resilience of their financial systems.

The second task was to regularly monitor the build up of vulnerabilities in national and international financial systems. The members of the Forum are senior central bankers, finance ministry officials and regulators from key countries. In addition, the Forum has developed outreach mechanisms to gain insights from market participants, emerging market officials and regulators, and outside experts. The FSF has done much useful work and is becoming a key feature of the international financial architecture. However, as recent events demonstrate, it is not possible to prevent or foresee all sources of financial stress.

I come now to **policy coordination.** It would be unrealistic, and perhaps even undesirable, to look for any very formalized coordination of national economic policies. This has been tried at various times in the past, with mixed success, at best. The broad model of coordination that seems practicable in current circumstances is for individual countries to pursue responsible, open and transparent policies, and to allow their exchange rates to move in a way that promotes the international adjustment process. Mutual consistency of policy can be aided by regular exchange of information in bodies such as the IMF and BIS.

Responsible domestic policies would normally be interpreted to mean a monetary policy aimed at achieving low and stable inflation, a fiscal policy that keeps the debt-to-GDP ratio in a range that is sustainable over time, an external trade and payments regime that facilitates international transactions, and an exchange rate that is flexible enough to maintain long-term external equilibrium. Of these, the most frequent source of disagreement internationally arises from exchange rate policies.

Among the responsibilities of the IMF are to "exercise firm surveillance over the exchange rate policies of members". This has to be seen within the context of the adjustment process more generally. One lesson of the Asian crisis is that exchange rates that appear perfectly sustainable in one environment can provoke massive capital flight in another. So it is important that the international architecture provide mechanisms for discussing and resolving differences of view about the responsibilities of the various players. Exchange rate policy is obviously a big part of this, but the issue is more complicated than simply asserting that all countries should allow their rates to float freely.

Finally, what about the **IMF** itself? A lot has been written about how the IMF should change, mostly focused on governance and legitimacy, and rather less on what the institution should actually do.

Governance is important, no doubt. An unfortunate fallout from the Asian crisis has been an unwillingness of Asian countries to view the IMF as a potentially useful instrument for helping them resolve financial crises. Asian countries have expressed their desire to avoid IMF conditionality, both in what they have said and in their actions, notably their massive reserve accumulation in recent years. These reserves have made the IMF largely irrelevant to them, at least as a source of financial assistance.

It is not clear whether the Asian countries would be willing to come to the Fund in any circumstances in the foreseeable future, but they are certainly likely to remain reluctant when their representation in the institution is as small, relative to their economic weight, as it is now. Thus, a key requirement is speedy action to implement the Managing Director's recommendations in the field of quota distribution.

Even more important, in my view, than how the Fund is governed is *what it is to do*. Here, I want to end with two observations that I feel are not adequately reflected in the present debate. One concerns the relative shift of emphasis in the Fund's work from being a manager of crises to helping improve the efficiency of the financial system. The second, which is related, is a relative shift in the Fund's role from being an independent policy advisor to being a coordinator of policy advice provided by others. Let me explain what I mean.

I am not among those that believe that financial crises belong to the past. There will undoubtedly be financial crises, and resolving these crises will require international cooperation. There is no better, or more legitimate forum for this cooperation than the IMF. But future crises, in my view, are less likely to be balance of payments crises of the kind we have seen in the past. They are much more likely to have their origins in capital markets. To resolve such crises will require, not so much a modest injection of financial support to cover a current account gap, but direct cooperation among monetary authorities to restore confidence and stabilize markets. The IMF, in my view, is an indispensable forum and facilitator of such cooperation, but is not likely to be a key independent actor, nor is crisis management likely to be its main ongoing activity.

The second change in the Fund's role reflects the fact that there are now many more institutions devoted to international economic and financial collaboration than there were in the past. The BIS has become a key focus for Central bank cooperation; international organizations of financial supervisors have grown up; accounting and auditing standards, codes of good governance, and so on, have all been recognized to be an integral part of an effectively functioning financial system.

The IMF cannot be the source of rule making in all these areas. Appropriately, financial codes and standards are drawn up by specialists, rather than by the Fund. We now have, for better or worse (and I believe it is for the better) a market based international financial system. Key financial decisions are the outcome of the collective actions of market participants. The principal role of the official sector is to identify sources of market failure and act to remove their causes. This brings into play the supervisory authorities of the key financial markets, acting on the basis of established rules of financial regulation. The macroeconomic expertise associated with the IMF is now only a part of a much larger picture.

In one sense, this could be said to diminish the role of the IMF. Yet in another sense it is an opportunity for the international community to use the Fund, the only truly legitimate source of international economic cooperation, to bring together the contributions now being made by a large number of disparate bodies. The world is not short of financial expertise. What it needs is a greater ability to harness various sources of expertise and to bring them to bear on the task of improving the efficiency and resilience of financial systems.

I believe the Fund could become an even more indispensable part of the international financial architecture if it devoted itself to coordinating the activities of expert bodies, as well as to the task of crisis management.

Chart 1.

Source: IMF – World Economic Outlook Online Database, April 2007 edition.

Chart 2

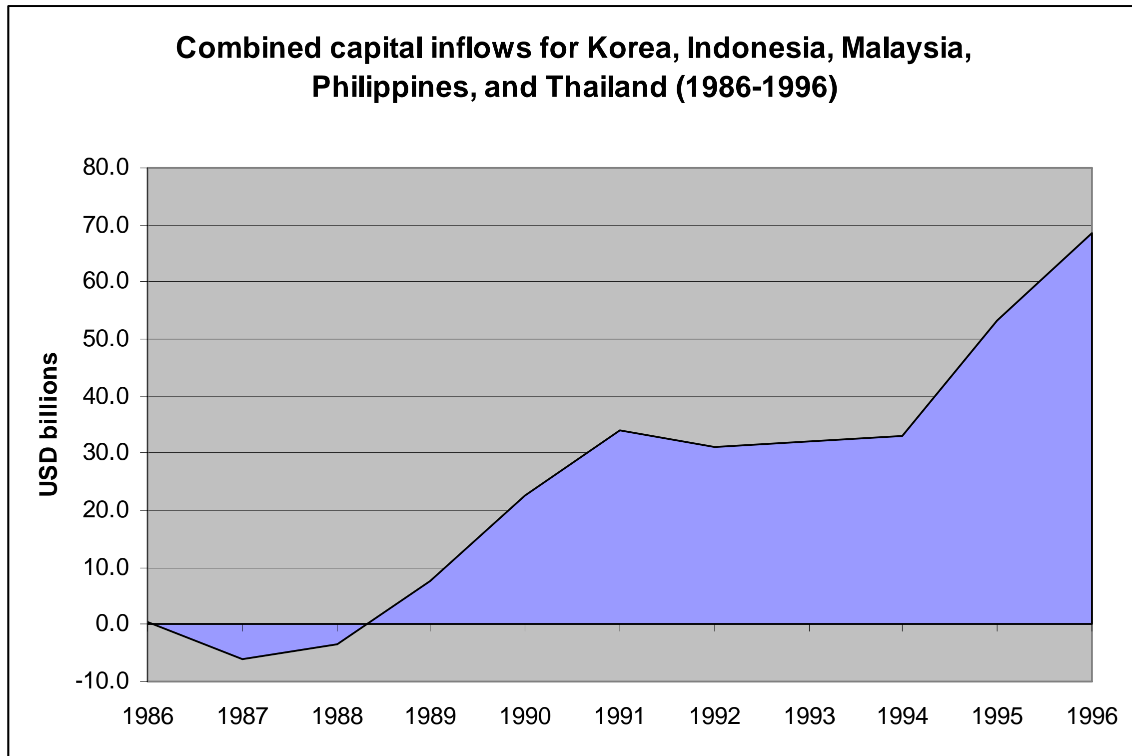
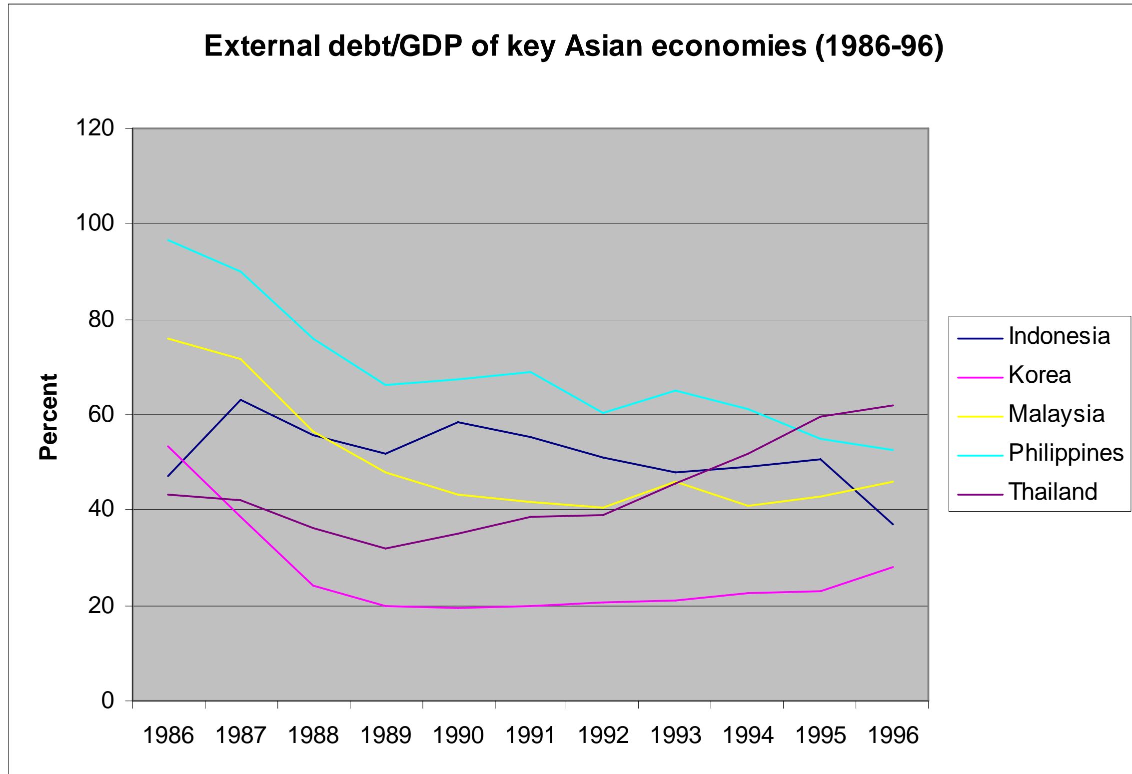


Chart 3.



Source: International Institute of Finance.