DRAFT – Not for quotation

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Comments on paper by Anne O. Krueger

"LESSONS FROM ASIAN FINANCIAL EXPERIENCE"

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Chief Adviser,
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President Janet Yellen,
Distinguished Guests,
Ladies and Gentlemen,

I am very honoured and privileged to be invited by the San Francisco Fed to join this prestigious Conference and to provide comments on the Asian financial experience by former IMF Deputy Managing Director Anne Krueger.

Ms Krueger has provided us with an authoritative analysis of the Asian experience, particularly focusing on the Korean and Japanese experience that are common to Asian and the current global crisis. She has drawn on a wealth of recent papers and drawn important common lessons, divided into four major parts – the relevance of rapid growth leading up to crisis and importance of a well-functioning financial system; a second set of lessons relevant mainly for emerging markets; key financial sector issues from Japan and Korea that are relevant to the crisis economies in Asia and today and fourthly, crisis and post-crisis management issues.

Ms Krueger's analysis stems from the mainstream of economic analysis, which has focused attention on the importance of well-functioning financial systems, their capital adequacy and their contribution to financial stability. Financial systems have four important functions that policy makers neglect to their peril – resource allocation, risk management, transparency and corporate governance. Weaknesses in any four of these functions would contribute to the weakening of the real sector, leading to crisis and losses in output and employment.

Common Lessons for Emerging Markets

As Ms Krueger has recognized and pointed out, financial crises are complex and have many origins. They all start with prosperity, in the Asian countries case very rapid growth, policy mistakes and complacency that led to asset bubbles, then collapse of the bubbles, large capital outflows, insolvency in the real and banking systems and then losses in output, devaluation and huge fiscal deficits arising from the rescue efforts.

[1] The views expressed are purely personal and not associated with CBRC.

The common lessons for all emerging markets appear to be the need to have consistent macro-economic policy regimes, in particular a flexible exchange rate regime consistent with fiscal and monetary policies. Secondly, one should avoid mismatches between banking assets and liabilities in terms of maturity and also foreign exchange (the famous Double Mismatch in the Asian financial crisis). Thirdly, one should eliminate financial repression after rapid growth and deepen the capital and debt markets. Fourthly, policy makers and financial regulators should change their mindsets towards more market-oriented policies and complacency, as former rapid growth and success never guarantees future success. Indeed, the 1997/98 Asian crisis was the crisis of highly successful countries, not failed economies.

Fifthly, immediate credible strong action (removal of toxic assets, recapitalization of banks and deleveraging of firms, and fiscal stimulus) should result in lower losses, limited length and severity of downturn, while economic upturn should be sooner and stronger.

Lessons from Japan

Ms Krueger rightly point out that the East Asian financial crisis encompassed the prolonged Japanese crisis that resulted in under two decades of low growth, deflation, huge fiscal debt and zero interest rates. Her analyses of the Japanese and Korean experience are important, because they draw significant implications for the resolution of the current global crisis. As can be seen from Table 1, Japan was the largest economy by far in East Asia, and was nearly five times larger than China and double the size of the rest of East Asia in 1996.

Table 1: GDP of Selected Countries (current exchange rate in USD bn)

	1990	1995	1996	1998	2006
Japan	3,031	5,278	4,638	3,872	4,367
China	388	728	856	1019	2,630
Korea	264	517	558	348	888
Indonesia	126	223	251	105	364
Thailand	86	168	182	111	206
Hong Kong	77	144	159	167	189
Malaysia	44	89	101	72	151
USA	4,268	7,398	7,817	8,747	13,245

Source: IMF data

Specifically, there was a marked difference between Japan and the rest of the East Asian crisis economies because she had mostly domestic debt and a flexible exchange rate, whilst the others were accused of violating the Impossible Trinity of Fixed exchange rates, monetary policy and no capital controls. But the Japanese experience had similarities with the others in her pre-crisis rapid economic growth resulting in a real estate and stock market bubble, with problematic connected lending. Like almost all other East Asian economies, Japan still has a bank-dominated financial system, and mistakes of forbearance, ever-greening and lateness in bank failure resolution delayed the economic recovery.

Indeed, Ms Krueger perceptively pointed out a mistaken policy assumption that if only economic growth were to resume, the debtors would regain profitability and banks would grow out of their non-performing loans. Somehow I suspect that this growth assumption rests even with the present rescue plans. The Japanese experience was one of repeated stimulus packages, with annual fiscal deficits of over 5 percent, leading to the accumulation of nearly 200% of GDP of fiscal debt, owed mainly to residents, but sustainable only with zero interest rates.

Ms Krueger shares the common Western view that Japanese reaction to the crisis was "too little, too late". I know that many of my Japanese friends beg to differ. Their difficulty was not a technical issue of response, but how to garner public, political and legislative support for the bank rescue. Exactly like the reaction of the US Congress that initially rejected the Treasury rescue plan, the Japanese electorate felt not without good reason that overpaid bankers got themselves into trouble and should therefore get themselves out. Hence, the bank write-offs of credit losses were 19% of GDP compared with fiscal support of only 3% of GDP. The biggest support was through the zero interest rate policy, which gave the banks a positive interest rate spread, a similar policy being adopted currently. In other words, the Japanese and the current solution relied on a guarantee of stock and flow bank rescue policy, rather than a "carve out bad loans" balance sheet surgery.

Implicit in the Krueger analysis is that an undercapitalized banking system can retard an incipient recovery even when fiscal policy is expansionary and forbearance and ever-greening of loans by banks generally lead to disaster. In other words, efforts by banks (and acquiescence by the government) to hide their difficulties not only delayed the recovery but create uncertainty and lack of confidence about the financial system as a whole. Thus, Krueger subscribes to the "whatever it takes" approach to have sufficiently large measures to restore banks to healthy positions in order to have problem resolution. She noted correctly that bank de-leveraging starved new entrants (SMEs) of credit and hence reduced growth.

Post-crisis policy and management

Based upon the above survey, Krueger draws the conclusion that delays in recognizing and confronting the difficulties are costly. Crisis management requires action credibility, with high transparency of financial condition and decisive measures taken. One must maintain consistency between policies toward exchange rates and monetary, fiscal and regulatory policies. She felt that the strongest lesson is the necessity of recapitalizing the banks and addressing the NPLs. As in the case of

Japan in the last 20 years, fiscal stimulus can provide a temporary boost, "but if the financial system remains crippled, recovery is not sustainable".

I agree with the broad analysis provided by Ms Krueger, but would like to use this opportunity to widen the analysis, beyond one or two countries and beyond economics to politics, since flawed politics are always the root causes of financial crisis. Having been in the trenches during the Asian crisis 12 years ago and also in the post-crisis resolution and reform efforts, I completed a book called "From Asian to Global Financial Crisis[2]" which has been published only this month. The research into each crisis country and also looking at them as a whole showed that whilst there were commonalities, as identified by Krueger and others, there were interactivity and interdependencies that derive from the interconnectivity in a regional or global system that created the collective action dilemmas which led to crisis and hindered the recovery.

The fact that the Asian crisis hit several countries at roughly the same time with contagion demonstrated that this was a relatively new phenomenon. I call this a network crisis, because East Asia got networked together to form the global supply chain with Japan at its head. The main customer was the US market, which explained why the global supply chain basically used the dollar as either a fixed peg or managed float. Basically, the supply chain required member economies to have stable parities against each other, which was exactly the practical policies adopted. I do not justify violations of the Impossible Trinity, but understood why for various political reasons, central banks were reluctant or unable to exit a previously successful policy to a floating regime. With high Dollar-Yen volatility, the Asian supply chain was a network with two standards.

Indeed, the analytical framework of a network crisis is useful because it enables us to have a holistic view of the complex, highly concentrated, inter-connected, interactive/interdependent, opaque financial system with incentives that were pro-cyclical and contained highly systemic risks[3]. The reason why we need to have a network type analysis is because all social institutions, including banks and financial systems, are ecosystems, which are dynamic and formed through the interaction of the human and bureaucratic behaviour of its participants.

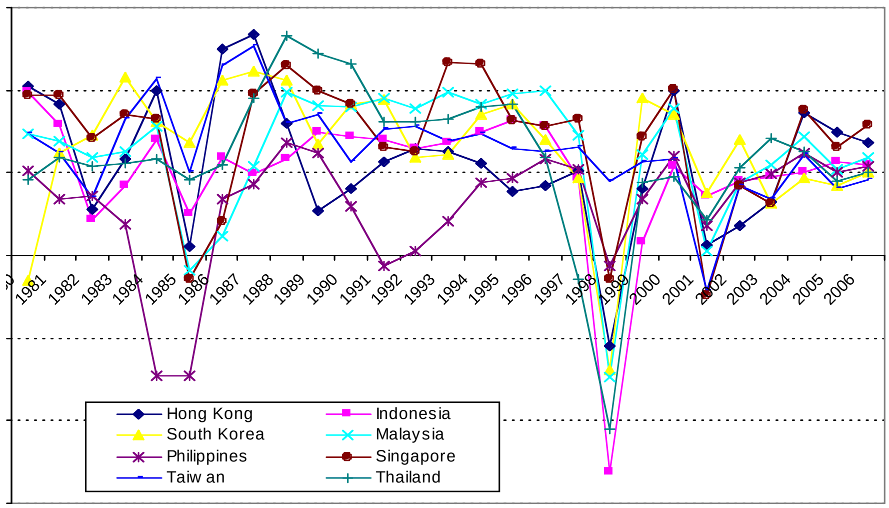
The highly interdependency between East Asian economies and the US can be seen from Chart 1, which illustrated the synchronization of the Asian trade cycle. As they said, if the US sneezes, Japan catches a cold and Asia gets pneumonia. This time round, the US has had more than a cold, Japan and the exporting nations in Asia are badly hurt, but due to their healthier macro-economic conditions (partly because they learnt from the mistakes 12 years ago), their recovery has been more marked.

Ecosystems are complex institutions, but in order to work effectively and stably, they need simple rules facilitate enforcement. Enforcement shapes the incentive structure to ensure stability. However, lack of enforcement against risky or arbitraging behaviour can build up huge opaque risks and imbalances that ultimately lead to crisis. I liken crisis to warfare because war leads to loss, just as financial crisis. To

[2] Andrew Sheng (2009c).
[3] See Haldane (2009) and Sheng (2009b)

paraphrase German strategist von Clausewitz and substituting ‘war’ with ‘crisis’, you get “Everything in crisis is very simple, but the simplest thing is difficult. The difficulties accumulate and end by producing a kind of friction that is inconceivable unless one has experienced crisis.”

Chart 1: Synchronized Business Cycle of East Asian economies



One of the reasons why everyone failed to detect or prevent the Asian crisis and the current crisis is the fact that our academic and bureaucratic disciplines are so specialized and compartmentalized that we are only seeing part of the picture, rather linking its parts together[4].

For example, most economists still look at flows to explain behaviour, whereas Nomura’s Richard Koo was the first to point out that the Japanese crisis and the current crisis can be labeled a balance sheet crisis[5]. This is very evident from Table 2, which showed that almost all the crisis economies (with the exception of South Korea) had net international deficit position of more than 50% of GDP in 1996. If the IMF had produced this earlier than 2006, we might have been more sensitive to unsustainable foreign exchange imbalances.

Given the fact that the East Asian economies had large banking systems relative to GDP and that the banks lent heavily to finance the stock and real estate markets, it was not surprising that collapses in the real estate and stock markets led to huge losses and under-capitalization of the banking system.

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[4] Capra (1982).
[5] Koo (2009)

This was one reason why high interest rates and cuts in fiscal expenditure were clearly the wrong policies to pursue during the early stages of the Asian crisis. High real interest rates would make the over-leveraged corporate sector more distressed leading to even larger losses in the banking system. However, because of the openness in the capital account, the East Asian economies could not use higher interest rates for fear of inviting even more hot money that would inflate the domestic bubbles even more. In other words, the Asian crisis was inextricably tied to the policy dilemmas of globalization, in which most countries were not sure how to have the right blend of policies, given the fact that large volatile capital flows (now identified as the leveraged carry trade) could lead to excess liquidity and highly distorted domestic sector.

Conclusions

If we accept that financial crises have origins that are complex and are tied to the whole range of policies, flawed institutions and feedbacks through interaction across borders, then their resolution would require much better international cooperation than previously thought. In many ways, there already exist a difficult collective action problem in coordinating many silos within domestic financial systems that regulate and impact on financial stability, not least the ministry of finance, the central bank, the financial regulators and increasingly the influence of the legislature that must approve legal and structural changes. Legislatures can also protect strong vested interests and may not be willing to respond with the same speed required at the technical level. Such collective action traps delay or impede many action or policies that can be identified at the technical level, but could not be enforced or implemented at the political or bureaucratic level.

If the collective action problem of coordinating domestic policies is difficult, the collective action problem of coordinating policies at the regional and global levels are even more Herculean. Hence, the biggest lesson that I draw from the global financial crises is that one must accept that increasingly we have to work in a complex ecosystem with many vested interests that require lots of carrots and sticks to get everyone to cooperate for the common good. We have to recognize that the greater the complexity of issues, the greater the costs and difficulties of identification, diagnosis and prognosis of implementation, enforcement and action, leading to more opportunities for arbitrage, fraud and further distortions that benefit some factions and vested interests. Patchwork and partial solutions are more likely to delay real action, a problem identified by Ms Krueger during the Japanese crisis.

The only way we can get common collective action is through simplicity, sometimes unfortunately a race to the lowest common denominator of inaction. Crisis creates simple individual action, a flight or exit for the door that creates massive panic and large public loss.

If we do not simplify our financial structures and make difficult choices on which standards to enforce, so that the financial institutions will not exploit a massive moral hazard that has been confirmed by the rescue of almost all financial institutions, then financial crisis will be repeated and we would not have learnt from two very costly crises.

9 October 2009.

Table 2: Net International Position (+asset/-liability) of various economies

	NIP 1996 (USD bn)	NIP as % of GDP 1996	Fall in GDP 1997/98 (%)	Change in exchange rate (+/-) 98/97	Remarks
Japan	**+890.0**	**+19.0**	**-8.5%**	**-10.7%**	
China	**-122.9**	**-15.1%**	**+5.3%**	**+0.2%**	Protected by exchange control
Indonesia	**-129.4**	**-56.1%**	**-55.8%**	**-51.4%**	
Korea	**-50.2**	**- 9.0%**	**-33.1%**	**-50.2%**	Bank run causing exchange overshoot
Malaysia	**-55.9**	**-55.4%**	**-27.9%**	**-35.0%**	
Philippines	**-41.6**	**-49.2%**	**-20.5%**	**-34.2%**	Already under IMF Program in 1997
Singapore	**+80.2**	**+87.0%**	**-14.2%**	**-14.9%**	Contagion effect
Thailand	**-101.8**	**-55.9%**	**-25.9%**	**-45.8%**	

Source: Calculations from Milessi-Ferreti and Lane (2006)

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