

COMMENTARY

Lessons from Asian Financial Experience

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Anne Krueger has provided us with an authoritative analysis of the Asian financial experience, particularly focusing on the Korean and Japanese experiences that are common to the 1997–98 Asian crisis and the current global crisis. She has drawn on a wealth of recent papers and drawn important common lessons, divided into four major parts: first, the relevance of rapid growth leading up to crisis and the importance of a well-functioning financial system; second, a set of lessons relevant mainly for emerging markets; third, key financial sector issues from Japan and Korea that are relevant to the crisis economies in Asia; and fourth, crisis and post-crisis management issues.

Krueger's analysis stems from the mainstream of economic analysis, which has focused on the importance of well-functioning financial systems, their capital adequacy, and their contribution to financial stability. Financial systems have four important functions that policymakers neglect to their peril: resource allocation, risk management, transparency, and corporate governance. Weaknesses in any 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 Krueger has pointed out, financial crises are complex and have many origins. They all start with prosperity. In the case of Asian countries, they started with very rapid growth, policy mistakes, and complacency that led to asset bubbles; once the bubbles collapsed, there followed large capital outflows, insolvency in the real and banking systems, and losses in output, with huge fiscal deficits arising from the rescue efforts.

Among the common lessons for all emerging markets, the first is the need for a consistent macroeconomic policy regime, in particular a flexible exchange rate regime consistent with fiscal and monetary policies. The second is to avoid mismatches between banking assets and liabilities in terms of both maturity

Author's note: *The views expressed are purely personal and not associated with the China Banking Regulatory Commission.*

and foreign exchange (consider, for example, the famous double mismatch in the Asian financial crisis). Third, emerging markets should eliminate financial repression after rapid growth and deepen the capital and debt markets. Fourth, policymakers and financial regulators should avoid complacency and favor more market-oriented policies, because rapid growth and success does not necessarily guarantee future success. Indeed, the 1997–98 Asian crisis affected some highly successful countries, not failed economies.

A final common lesson for emerging markets is that immediate, credible, and forceful action (such as removal of toxic assets, recapitalization of banks, deleveraging of firms, and fiscal stimulus) can result in lower losses, can limit the length and severity of downturns, and can speed up and strengthen economic upturns.

Lessons from Japan

Krueger rightly points out that the 1997–98 Asian financial crisis encompassed the prolonged Japanese crisis, which resulted in nearly two decades of low growth, deflation, huge fiscal debt, and zero interest rates. Her analysis of the Japanese and Korean experiences draws significant implications for the resolution of the current global crisis. As shown in Table 1, Japan was the largest economy by far in East Asia in 1996, nearly five times larger than China and double the size of the rest of East Asia.

There was a marked difference between Japan and the rest of the East Asian crisis economies: Japan had mostly domestic debt and a flexible exchange rate, while other countries were accused of pursuing the “impossible trinity” of fixed exchange rates, independent monetary policy, and no capital controls.

TABLE 1
GDP of Selected Countries
(current exchange rate in USD billions)

	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.

But the Japanese experience was similar to others during the pre-crisis period of rapid economic growth that resulted in real estate and stock market bubbles accompanied by problematic lending. Like almost all other East Asian economies, Japan still has a bank-dominated financial system, and mistakes of forbearance, evergreening, and late resolution of bank failures delayed the economic recovery.

Indeed, 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 nonperforming loans. I suspect that this growth assumption persists even in current rescue plans. The Japanese experience was one of repeated stimulus packages, with annual fiscal deficits of over 5 percent that led the country's debt to grow to nearly 200 percent of GDP. This debt was owed mainly to residents, but was sustainable only with zero interest rates.

Krueger shares the common Western view that Japanese reaction to the crisis was “too little, too late.” Many of my Japanese friends beg to differ. Their difficulty was not a technical issue of how to respond, but how to garner public, political, and legislative support for the rescue of banks. Exactly like the reaction of the U.S. Congress, which initially rejected the Treasury's rescue plan in the fall of 2008, 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 percent of GDP compared with fiscal support of only 3 percent of GDP. But the biggest support of banks came through the zero interest rate policy, which gave the banks a positive interest rate spread, similar to the current U.S. policy. In other words, both the past Japanese solution and the current U.S. solution relied on a guarantee of stock and flow bank rescue policy, rather than balance sheet surgery to “carve out bad loans.”

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 evergreening 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 delay recovery but can create uncertainty and a lack of confidence about the financial system as a whole. Thus, Krueger subscribes to the “whatever it takes” approach, using sufficiently large measures to restore banks to healthy positions. She noted correctly that bank deleveraging starved new entrants (small and medium enterprises) 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 credibility, built through financial condition transparency and decisive actions. There must be consistency between exchange rate, monetary, and regulatory policies. She believes that the most important lesson is the need to recapitalize banks and address nonperforming loans. 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 analysis provided by Krueger, but I would like to widen her 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 during the post-crisis resolution and reform efforts, I wrote a book, *From Asian to Global Financial Crisis*,¹ which was published this year. My research into individual crisis countries and into the group as a whole showed that, in addition to the commonalities identified by Krueger and others, the interactivity and interdependency within the region complicated collective action and created dilemmas which led to the crisis and hindered the recovery.

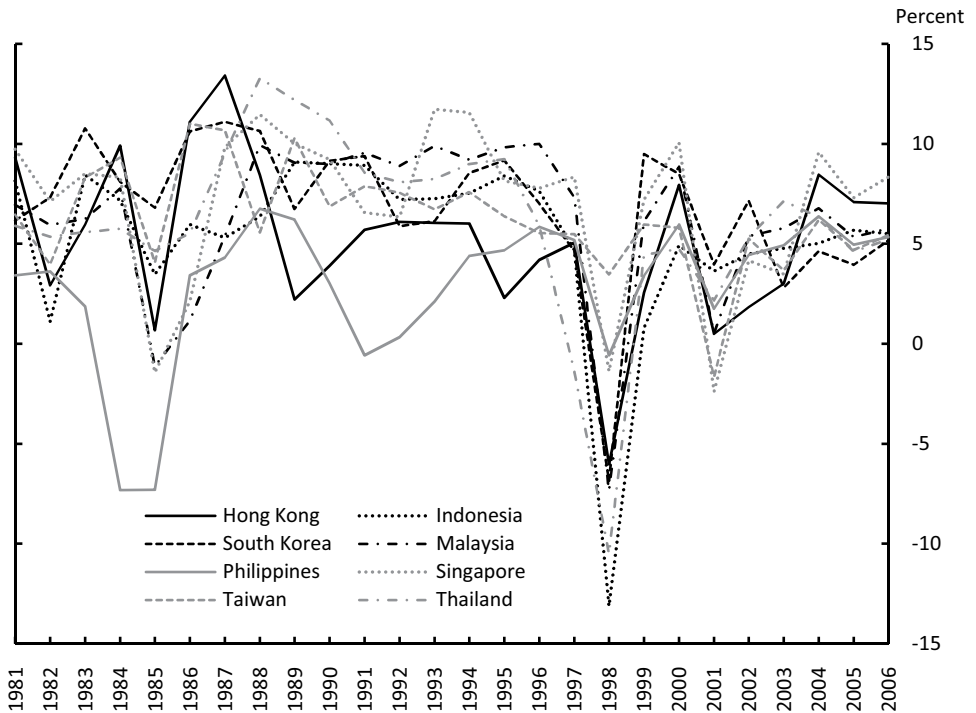
The fact that the Asian crisis contagion hit several countries at roughly the same time demonstrates that this was a relatively new phenomenon. I call this a network crisis, because East Asia networked to form the global supply chain with Japan at its head. The main customer was the U.S. market, which explains why the global supply chain basically linked to the dollar through either a fixed peg or a managed float. Basically, the supply chain required member economies to adopt stable parities against each other. I do not justify pursuit of the impossible trinity, but I understand why, for various political reasons, central banks were reluctant or unable to exit a previously successful policy and adopt 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 gives us a holistic view of the complex, highly concentrated, interconnected, interactive/interdependent, opaque financial system with incentives that were procyclical and contained highly systemic risks.² We need this network type of analysis because all social institutions, including banks and financial systems, are ecosystems, which are dynamic and formed through the interaction of the human and bureaucratic behavior of participants.

The extensive interdependency between East Asian economies and the U.S. can be seen from Chart 1, which illustrates the synchronization of the Asian trade cycle. As the saying goes, if the U.S. sneezes, Japan catches a cold, and Asia gets pneumonia. This time around, the U.S. has had more than a cold, and Japan and the exporting nations in Asia are badly hurt, but due to their healthier macroeconomic conditions (partly because they learned from their mistakes 12 years ago), their recovery has been more marked.

Ecosystems are complex institutions, but to work effectively and stably they need simple rules that are easy to enforce. Enforcement shapes the incentive structure to ensure stability. However, lack of enforcement against risky or arbitraging behavior can build up huge opaque risks and imbalances that ultimately lead to crisis. I liken crisis to warfare because war leads to loss, just like financial crisis. To paraphrase German strategist von Clausewitz, substituting

CHART 1
Gross Domestic Product in Constant 2000 US\$



Source: World development indicators online.

“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.”

One of the reasons why everyone failed to detect or prevent the Asian crisis and the current crisis is that our academic and bureaucratic disciplines are so specialized and compartmentalized that we see only part of the picture, rather than linking its parts together.³

For example, most economists still look at flows to explain behavior, 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.⁴ This is very evident from Table 2, which shows that almost all the crisis economies (with the exception of South Korea) had net international debt positions of more than 50 percent of GDP in 1996. If the IMF had emphasized 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 is not surprising that collapses in the real estate and stock markets led to huge losses and undercapitalization of the banking system.

This is one reason 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 overleveraged corporate sector more distressed, leading to even larger losses in the banking system. However, because of the openness in the capital account, 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

TABLE 2
Net International Position (NIP) (+asset/–liability) of Various Economies

	NIP 1996 (USD billions)	NIP as % of GDP, 1996	Fall in GDP 1997/98 (%)	Change in exchange rate (+/-) 1998/97	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 Lane and Milesi-Ferretti (2006).

inextricably tied to the policy dilemmas of globalization, in which most countries were not sure how to create the right blend of policies, given that large volatile capital flows (now identified as the leveraged carry trade) could lead to excess liquidity and highly distorted domestic sectors.

Conclusions

If we accept that financial crises have origins that are complex and are tied to the whole range of policies, flawed institutions, and feedback through interaction across borders, then we should recognize that their resolution requires much better international cooperation than previously thought. In many ways, a collective action problem already exists in coordinating the many silos within domestic financial systems that regulate 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 protect strong vested interests and may not be willing to respond with the speed required at the technical level. These collective action traps delay or impede many actions or policies that can be identified at the technical level, but cannot be enforced or implemented at the political or bureaucratic level.

If the collective action problem of coordinating policies is difficult at the national level, the difficulties at the regional and global levels are even more Herculean. Hence, the biggest lesson that I draw from the global financial crises is that countries must accept that they have to work together 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 the difficulties, from identification, diagnosis, and prognosis to implementation, enforcement, and action, and these can lead 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 Krueger during the Japanese crisis.

The only way we can achieve common collective action is through simplicity, sometimes unfortunately through a race to the lowest common denominator. If individual countries seek to flee and exit for the door, it may create massive panic and large public loss unless prevented by a collective response.

If we do not simplify our financial structures and make the difficult choices on which standards to enforce, so that the financial institutions will not exploit a massive moral hazard, then we will not have learned any lessons from the past and we will be more likely to experience future crises.

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NOTES

- 1 Andrew Sheng (2009c).
- 2 See Haldane (2009) and Sheng (2009b)
- 3 Capra (1982).
- 4 Koo (2009)