Capital Flows and Financial System Stability in Asia

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OPENING ADDRESS

Toyoo Gyohten

Good afternoon, ladies and gentlemen. Thank you for attending this "Symposium on Capital Flows and Financial System Stability" which is jointly sponsored by the Institute for International Monetary Affairs and the International Monetary Fund.

Our Institute conducts this type of symposium twice a year, selecting the most topical theme, and inviting world experts to address the subject. The theme of the last symposium, held in April of this year, was "Currency Integration in Europe."

Planning for this symposium began in late April, immediately following the last symposium, under the premise that financial problems in Asia would become more crucial, given that the Thai baht was then experiencing large-scale selling pressure.

At the time, we were discussing what should be the title of the symposium, and were considering whether to call it "The Approaching Asian Financial Crisis." However, the general view was that this would be too sensational a title to use, and that it could cause market chaos. The proposal was scrapped, and the decision was made to settle for the safer title that we now have.

However, ensuing developments in the Asian financial and foreign exchange markets went well beyond what we were expecting back in April. The crisis passed the stage of being "approaching" and became a reality. Asian financial markets are now facing a crisis of immense

proportions. Furthermore, in terms of the speed with which it occurred, its severity and its scale, the current financial crisis has far exceeded our predictions of seven months ago, becoming a much more serious problem than we ever imagined possible.

As you will be aware, while the present financial crisis has had a strong influence on Asia, it has also had a major impact on the advanced economies, including Japan, and in turn, on the entire world economy. Today, we want to analyze the Asian financial crisis in global terms from various different perspectives, and exchange views on the future outlook and corrective measures that should be taken.

As co-sponsors, we are delighted to be able to welcome here the best possible panelists to address this issue who have specially assigned their valuable time to be with us today.

There are several points we would very much like them to cover. First, how did the Asian currency crisis come about, and could it have been avoided if appropriate corrective measures had been taken beforehand? There has been strong criticism of international financial speculation, particularly in Asia, and we should ask how the issue of international speculation should be tackled. This issue is closely related to the question of international capital movements, especially the transfer of short-term capital. We will be interested to know what the panelists' thoughts on this are.

Second, we would like you to consider why this currency crisis spread so rapidly through Asia; the so-called "contagion problem". When Mexico experienced a crisis in 1995, the general view was that Asia would never face a similar situation; however, the Thai currency

crisis spread throughout the surrounding nations very quickly. How did this happen? We are also naturally very interested in what effect, in the future, the currency crisis will have on China via Hong Kong.

Third, do you consider the various corrective measures taken by each country since the crisis hit to have been adequate, and how should they be judged?

Fourth, the mechanisms for international cooperation are being closely scrutinized in the Asian currency crisis. We are very much interested to learn how these international efforts should be evaluated, whether they are adequate as they stand, and, if they are to develop in the future, what direction and form those developments should take.

Fifth, how long will the present currency crisis last? We are very keen to hear your outlook for the future, and to learn whether East Asia will experience the same high level of growth as before.

As we have indicated in the program, the symposium will begin with some ideas and discussions from our four panelists. After the coffee break, we will hear addresses from the Asian panelists who have been at the center of the crisis. Afterwards, there will be some discussion among the panelists, which will be followed by a question and answer session in which everyone is welcome to participate.

The Asian Financial Turmoil and Required Policy Actions

Shigemitsu Sugisaki

I. What Caused the Crisis?

The crisis in Thailand came as no surprise. The erosion of Thailand's international competitiveness resulting from the pegging of the baht to the rising U.S. dollar, and insufficient progress on structural reforms compared with competing countries, accounted for a collapse of export growth last year and a widening of the already large external current account deficit. The large capital inflows, including an increasing share of short-term external debt, were intermediated through a weak banking sector and partly invested in the property market, thereby grossly inflating property prices. These macroeconomic warning signals had been evident for some time, and particularly since 1996. The IMF had provided repeated warnings to the Thai authorities. But unfortunately the advice was not followed and adequate remedial action was delayed until the crisis had occurred. This proved very costly for both Thailand and its regional partners.

The contagion effects have been large, both regionally and globally. The crisis in Thailand has spread to, and continued to affect, financial and currency markets in Hong Kong SAR, Indonesia, Malaysia, the Philippines, and most recently Korea. But the effects on regional economies were not due only to contagion. It is true that the other East Asian countries were characterized by lower external current account deficits than in Thailand, but market expectations were also affected by concern about the fundamental health of these economies. Let me mention three factors:

First, the other East Asian countries suffered from many of the same structural and governance weaknesses, as did Thailand, including the soundness of the financial sector and overvalued property markets.

Second, once the exchange rates were no longer pegged to the U.S. dollar, market participants have paid close attention to the tightness of monetary policy and the willingness of the authorities in the concerned countries to raise interest rates. The legacy of low interest rates in these countries is only too well-known.

Third, East Asian countries have a long tradition of government intervention in the development process. This may have served them well in the past, in particular when markets were less integrated than now. However, in a globalized world with integrated trade and capital flows, market participants—both domestic and foreign—fear government interference in the operations of financial institutions and in the enterprise sector and the reimposition of controls that are inconsistent with a level playing field. Historical links between the government, banks, and enterprises in East Asian economies have typically been close. For those Asian governments, there is a need for a fundamental revisiting of these links to match the requirements of a globalized world economy.

What will be the Impact on the World Economy?

We are in the process of revising our projections. The short-term growth prospects for the countries affected by the financial crisis are

being revised down because of reduced funding by private investors abroad and contractions in domestic demand. But as experience in Mexico has shown, the slowdown need not be prolonged. The direct effect of the crisis on net exports of the industrial countries and activity in their economies as a group is expected to be moderate, although for some countries such as Japan it will not be insignificant. Fortunately, growth has proven stronger than expected this year in North America and Europe. But clearly in Japan the problem of an already weak cyclical position is compounded by difficulties in the financial sector, falling equity prices, and the impact of problems in region.

These short-term forecasts are subject to great uncertainties. Much will depend on the full implementation of adjustment policies in the East Asian economies themselves. In addition, it will be important that no further withdrawal of fiscal stimulus take place in Japan although further efforts will be needed later on to make progress toward fiscal consolidation. I welcome the consideration that is being given to the use of public money to restore the health of the financial system. It will be important that such public support be extended to protect depositors and to promote an effective restructuring of the banking system in a transparent manner. For other major industrial countries, the temptation to tighten monetary policy should be resisted. Finally, a great deal will depend on restoration of the confidence of international capital markets in emerging market economies. Clearly, investors and portfolio managers are reevaluating the risks of all borrowing countries and this poses a major downside risk to any projections that assume a resumption of capital flows at their earlier high levels in the near term.

II. Lessons—Policy Action at the National Level

What are the key policy lessons? Let me briefly recall the main areas at the national level where the authorities need to be alert to imminent risks in the economic situation.

First, the authorities should pursue sound macroeconomic policies. In particular, if required by changes in economic fundamentals, authorities should not cling too long to a pegged exchange system but be prepared to pursue a flexible exchange rate policy conbined with a supportive tight monetary policy immediately following the floating of the exchange rate to stem capital outflows. There is often no viable alternative to this painful measure. But we also recognize that this imposes a difficult dilemma for most authorities since high interest rates are likely to slow down economic growth in the short term. In addition, a prudent fiscal policy needs to be pursued so that the private sector is not alone in being responsible for a correction in the external current account deficit. It also has to take account of the costs of possible restructuring of the financial and enterprise sectors.

Second, the authorities should pay due attention to structural policies, including the soundness of the domestic banking system. Financial system problems were at the heart of the recent crisis. There is a need for authorities to take prompt action to close insolvent financial institutions and improve banking supervision and prudential standards. This is a sine qua non in a world of globalized financial markets.

Third, since a strong adjustment program might be associated with a slowdown of economic activity in the short run, albeit less than

in the absence of such policies, there is a need to consider the social implications of policy options and possibly build in a social safety net and in some cases protect government expenditure on basic education and health care and other social services.

Fourth, greater transparency in the provision of economic information is necessary, both internally within the government and vis-a-vis the general public. Private markets cannot function efficiently without such information.

Finally, the importance of good governance cannot be overemphasized. Transparency is only one element of good governance. Others pertain to the creation of institutions and systems that limit the scope for ad hoc decision making, for rent seeking activities, and for undesirable preferential treatment of economic entities. Good governance is essential for restoring market confidence in an economy.

This has been a learning process for us all. Even countries that have been the envy of other developing countries in terms of strong macroeconomic performance for more than a decade need to be alert to imminent risks stemming from those key areas, and to be prepared to take policy action on a timely basis once required by the economic situation. There is no room for complacency.

Ⅲ. Policy Coordination at the Regional Level

Recent events have demonstrated that countries in the region can be severely affected by adverse developments in other countries in the region. This suggests to us that regional surveillance and peer pressure by the closest neighbors of the country concerned may have an

important role in promoting timely policy action. It is possible, for example, that Thailand would have taken earlier action if it had been exposed to peer pressure from neighboring countries. It is therefore important that countries in the region exchange information, discuss policy responses to economic developments, and provide policy advice to each other. This has worked well in other fora such as the European Union, and in the G-7 where the IMF has also helped the process of regional surveillance.

I therefore welcome the agreement reached in Manila on November 18-19 at the meeting of Asian Finance and Central Bank Deputies on a new framework for Enhanced Asian Regional Cooperation to Promote Financial Stability, which was subsequently endorsed by APEC's economic leaders in Vancouver. We, in the IMF, are certainly willing to play a central role contributing to regional surveillance, including through our newly opened Tokyo office.

Ⅳ. International Coordination

The problems of East Asia have global ramifications that require international coordination. The IMF has the responsibility to assist in reducing the considerable systemic risks to the entire international financial system. The assistance of the IMF in the current crisis has taken several forms :

* The IMF has provided immediate response to support the governments' reform efforts, including through the use of IMF resources, through the emergency financing mechanism in the case of the Philippines, Thailand, Indonesia, and lastly Korea. With forceful implementation of the agreed adjustment policies, the countries should be

able to pull out of the current crisis and once again record strong economic growth in line with past performance.

* The IMF performs on a continuous basis an important function in surveillance, which has recently been strengthened to help us identify problems as they emerge. This involves an ongoing policy dialogue with the country authorities and discussions in the Executive Board and emphasis on the timely provision of economic data.

* In this context, and in response to the Mexico crisis, where disclosure of economic information was also a problem, the IMF has established the Special Data Dissemination Standard for members having or seeking access to international financial markets. So far, 43 members have subscribed to this system.

* Recently, the IMF has developed a general framework for a sound and effective banking system focusing on issues of macroeconomic importance. We also help disseminate internationally agreed principles or standards of other institutions, e.g., the Core Principles for Effective Banking Supervision released by the Basle Committee in April 1997.

* The IMF is also seeking to make capital markets function better. Following the successful liberalization of current account transactions in most member countries, we are now turning to the issue of liberalization of capital transactions. The Southeast Asian economies themselves are testimony to the great benefits that can be reaped from foreign direct investment. Liberalization needs to be phased in each particular case taking into account the balance of payment situation and the strength of domestic institutions, including the banking system.

At the recent Annual Meetings in Hong Kong, it was agreed that the Fund's charter should be amended to make liberalization of capital movements one of the purposes of the Fund and to extend the Fund's jurisdiction to capital transactions. This would provide the IMF with an historic opportunity to foster more efficient capital markets.

* These are major tasks. For the IMF, it will be important to have adequate resources. The increased attention to banking soundness, governance issues, and capital account liberalization will imply increasing demand for the IMF's technical assistance. For example, in Thailand, Indonesia, and Korea, reform of the financial system was a key element in program design from the very beginning, facilitated through a close coordination between an intensive technical assistance effort provided by the IMF and program negotiations. The major lending programs with East Asian countries, in addition to those with other IMF members, make it important that the recently agreed increase in the IMF quotas be implemented, as well as necessary legislative action in members to activate the New Arrangements to Borrow. These steps will go a long way towards ensuring that the IMF is able to meet the challenges of a globalized world.

The Asian Currency Crisis: What Happened and What Comes Next?

Rudiger Dornbusch

Asian leaders claim that a new kind of crisis has happened: countries with sound fundamentals, good budgets, hard work, decades of high saving were toppled by a financial accident or, as some would have it, an American conspiracy executed by sharp speculators. Too few comment on the mind-boggling policy mismanagement or outright corruption present everywhere from Japan to Thailand or Indonesia and Korea, the unbelievably sloppy if not willfully negligent supervision of banks, the condoning of unacceptable funding risks on the part of banks and companies in the world market.

Asia has alleged systemic failure and the need for a new IMF. Washington has countered "pull up your socks; clean up your banks; get moving." And if there is such a thing as special "Asian values", as Singaporean officials have untiringly told us, they don't look quite as good just now. Here is an attempt to sort out the issues.

Vulnerability as the Basic Cause

Over and over again, officials in the region protest: "We are not like Latin America, all this cannot be happening". Of course, Asia is just like Latin America. Mexico, too, had a balanced budget in 1994/95, and had modernized, and had little inflation. Just like Asia, Mexico had gambled in foreign exchange and took a big hit.

The Asian crisis is not a surprise. Two years ago, MIT's Paul

Krugman had painted a very unflattering picture of Asia, foreshadowing the end of the miracle. He noted that much of Asian success was not productivity growth, skills and governance, but rather Stalinist capital accumulation (ouch! That hurt). He predicted that consumption would pick up and growth would go away. Of course, that was a long term prediction, but it was nevertheless a strong point to make.

Krugman's predictions should have invited a fresh look at the Asian economies as they were in the midst of plunging into the world capital market where money was slushing around looking for late hour takers. And they all helped themselves to build money temples, commodity businesses like chips and automobiles or just enjoy plain consumption from Gucci to BMW. Frenetically, Asia's skyline changed to reveal the great banking temples of Bangkok and Jakarta or any other capital city. Asia was pigging out. Anyone who had seen financial crises in Scandinavia, the US or Latin America could see the hand writing on the wall, more so if they paid attention to the role of banking systems as the link between world capital markets and local real estate and consumer finance.

The key word in understanding the transmission of the crisis is vulnerability. Countries that run large current account deficits need a steady supply of fresh loans. They become vulnerable if they are financed from day to day, more so if an impaired banking system makes it tricky to raise interest rates in defense of the currency. Similarly, countries that have allowed a large short-term dollar exposure of banks or corporations who have taken advantage of low world rates and financial liberalization to import money en masse. The exposure is short term and therefore needs to be rolled by the week or month. Adverse events lead in no time to a funding crisis: debt is not rolled

over, funds are pulled out just as in a bank run, and that process puts the entire economy in jeopardy because it is plain hard to come up with $50 billion in the late afternoon. Finally, countries that have allowed banks to go unsupervised and undercapitalized risk vulnerability because when banks come under suspicion, the bank run is straight into foreign exchange simply because there are no other assets. Asia has done all of the above and the exceptions are few.

Table 1: Selected Asian Economies: External Indicators (1996 data)

	Hong Kong	Korea	Malaysia	Philippines	Indonesia	Thailand
Budget	−1.8	−0.5	−0.9	0	1.5	1.3
Curr Account	−4.9	−6.4	−2.9	−3.4	−7.4	1.9
External Debt	20.3	38.7	62.0	52.7	50.4	n.a.
Short Term Debt	360	76	196	181	164	n.a.
Credit Rating	A1	A1	Ba1	Baa3	A3	n.a.

Note: All numbers are shares of GDP, except short-term debt plus amortization which is expressed as a share of reserves, and credit rating. Source JPMorgan

In fact, a striking exception is precisely Hong Kong. There was a real estate problem and exposure to competitive depreciation on the part of competing South East Asia. But even so, the currency held up. The reason is that banks were extremely well supervised and well provisioned. Of course, they took a hit on their investments but they are still there, as is the currency.

The central role of the banks and their sudden demise deserves special comment. In the late 1980s the US suffered a banking crisis. In Massachusetts, in the aftermath of a bank-financed real estate boom and bust, 70 banks were closed. In a post-mortem, the Federal Reserve

Bank of Boston had some interesting conclusions. A year before being closed, virtually all 70 banks were well-provisioned in terms of capital—they were good banks. More strikingly, almost two thirds of the banks that were closed died within a single quarter. When real estate meets banks, assume the worst and in no time. Asia has reenacted that experience.

Malaysia stands out as prudent: the very large current account deficit, in itself a problem, was much less so because it was financed by direct investment rather than hot money. At the other end, Thailand did everything wrong, as did Korea: large current account deficits, large short term exposure, and terrible banks. That produces the ingredients for sudden death as we have witnessed, in fact. Korea is especially interesting in its mismanagement: the country was obsessively focused on keeping foreign money out: no direct investment, no investment in the stock market, no foreign purchases of high-yield Korean bonds. Instead they allowed their merchant banks to borrow abroad to invest in Thailand and buy Brazilian and Russian Brady bonds. Totally mind-boggling, but that's exactly what happened. Japan, even though it has not suffered an external attack, is no different: banks that made their losses in real exchange and stocks are being kept in business even though they are threatening to economic prosperity.

Contamination as the Mechanism

Conspiracy theories would seem to work so well. New York financiers have a grand design: they want to destroy Asia, the great competitor. They find the weakest link and break it, and they go on, one after the other, forcing Tigers to their knees. A more plausible story

has to do with the mechanics of foreign investment by Emerging Market Funds and bank lending to Asia.

Thailand was an obvious problem, as everybody admits. For well over a year, the real estate crisis had gotten underway and made the bank look bad. The fall in export prices, chips and all, had made a large external deficit worse. Staying with the dollar on a big upswing caused a major loss in competitiveness with possibly more to come, over and above steep wage increases at home. To keep the money coming in to finance the Ponzi game and hold the exchange rate, interest rates had to go up to reward foreign lenders for the risk, but that made real estate and banks even worse. To keep banks alive, interest rates had to go down. The government could not have it both ways. They cut rates, made it free to speculate against the currency and that is what happened. Not just New York speculators but a large part of the Thai borrowers covered their dollar positions at the expense of the Thai authorities. Reserves ran out and the rest is history. The story then starts with a government getting itself into a corner, taking the soft option and crashing. Mismanagement of reserves made everything much worse.

If we accept that story, why the Philippines, Indonesia, Malaysia, Hong Kong and Korea? Investors looked beyond Thailand to ask whether there is genuine vulnerability elsewhere: big current account deficits, bad banks, loss of competitiveness as a result of the Thai devaluation. Were there countries that were unlikely to be able to raise interest rates because of domestic constraints and hence could not defend their currency? If so, then these exposures had suddenly moved to high risk category and needed watching or even liquidating. That is the first wave of selling. Soon it turned out that speculators were

right, currencies started moving simply because there was no taste for defending them by high interest rates.

There is another mechanism at work. Emerging market funds, after Thailand, and increasingly as the spectacle unfolded, experienced run offs. Investors who thought Asia was safe and easy investing had second thoughts. As funds experienced withdrawals, they had to sell off their investments in turn to pay out their investors. What to sell? Obviously the countries that were still good but already coming under suspicion, not the countries that had already tanked and might have some upside. Thus the crisis is spread automatically to those countries in the gray area of suspicion but with a chance, too, of making it. The same is true for bank lenders who must pay attention to their own credit rating. When a region goes under it deteriorates a bank's credit standing, funding cost and stock market value. As Asian loans became a negative, calling back loans is the routine response. Reducing Asian exposure became mandatory not only in the countries where debtors were already on the ropes, but preemptively in the places where they might soon be and where the money could still be gotten. This is just another form of bank run, this one by the lending banks.

Of course, contamination was not limited to Asia: Russia came under pressure for the same vulnerability, as did Brazil. No doubt, there is more to come. Once lenders and investors move into defensive mode they retreat from the periphery until the dust settles. After the compression of spreads and the stock booms of the past 3 years, normality is coming back with a fair dose of overshooting.

The extent of the sell-off in currencies and stock markets is extraordinary, nothing short of a fire sale where everything goes half

price. That is always the case, at least in the short run, when finance is the dominant part of a crisis. Yet, even at these much-reduced prices, speculators don't seem to have any appetite.

Where Is Stabilizing Speculation?

There are three reasons why, in the face of the large decline in asset prices, speculators are not rushing in for bottom fishing or to build "scavenger funds" to buy up distressed real estate as they did in the US in the aftermath of our banking crisis. The first reason is that there are possibly more dominos to come. That was the case of Korea until a month ago and it remains a possibility in Japan and China.

China is, of course, special. The country is very unlikely to experience an external attack: there is a current account surplus, no short term debt and massive exchange control. None of the overborrowing and the short maturities that put other countries in the hot seat. But China does have a huge banking problem, most likely the worst in Asia. The way China could get into trouble is with an internal bank run, the kind of thing that is under way in Japan. If the Chinese public starts fearing for their deposits and tries to pull the money out of the banks, what happens next?

Note, the Chinese at this point might just want *their* money, in renminbi not dollars. They can have their money, no problem. The benign interpretation is that the government prints enough money or in fact has it already in the basement of every bank. It pays out people until everybody realizes there is no problem. End of story. But if all this is bungled, becomes a big riot and so on, then investment in

Asia will all of a sudden look even less promising than now. Any sign of China getting into political problems is a dramatic downer for Asian investment .

There are softer versions of the China problem. For example, Chinese growth has been slowing down. Recession in the region, including Japan, reduced exports and the competitive devaluation of everybody makes the problem worse. So when will China devalue, the markets ask? And if China does, will there be second helpings for everyone else? The question is enough to cool off any enthusiasm for Asian bottom fishing.

The other problem, real and big, is Japan. There is a banking crisis and a growth crisis. Both are totally mismanaged with the consequence that Japan is slipping into recession. Just how bad the recession will be, including a further collapse of stocks and, as a result, quick and sudden death of banks, is wide open. Japan is dragging Asia down, it puts in question the export-led recovery strategy prescribed by the IMF for each of the troubled countries. Japan's crisis does so in two ways. First, Japan is an important market and it is clearly shrinking. That means less exports and less of an increase in current account surpluses for all the IMF cases. Second, the Japanese demise pushes down the Yen and with it all Asian currencies. Bargain hunters must not buy too early, the prices are getting better and better! Finally, the Asian onslaught of exports to the US risks an outright crisis of free trade. The US administration is firmly committed to free trade and so is much of the public, but if Asian mismanagement becomes a trade crisis in the US, protectionist talk is certain. Investors will view that as a negative for Asia and another reason to hold off. Contamination is a critical obstacle to stabilizing speculation. It will continue until Ja-

pan gets its act together which does not seem to be around the corner.

There are two other reasons why investors will hold off. First there is obviously the dramatic lack of transparency. Investors simply will not know what they are buying or how solvent their loan clients are. The idea of reliable accounts does not exist, not in Japan as the last few weeks make clear, not in Korea nor anywhere else. Perhaps investors did not appreciate that fact before the crisis and it did not matter much because everything was smooth sailing. But now, who wants to buy a corpse rather than a live body? Asians might reply that transparent, audited accounts are yet another manifestation of "marketism", just like litigation or due diligence. Perhaps that is the case, but trust investors to take it seriously if only because their clients on the other side are now asking hard questions.

The other obstacle to an early and enthusiastic return of investors is politics. We have to see just how well Asian politics takes to IMF programs. In Korea the uproar is underway—the IMF program is called a US attempt to buy up Korea at bargain prices. In Indonesia it is expected to bring down Suharto, though not the system. Dr Mahathir is busily blaming speculators to try and extricate his own dubious commitment to a world of mega projects. The more politics is in the street and noisy, with IMF programs in question or even suspended, the more reason to stay away.

But politics is also a factor in deciding who pays the adjustment burden left after this crisis. Are bank owners bailed out and not only depositors, do Suharto's children get to keep their toys? Will the Japanese bureaucrats pay for the damaged banks and make them good investments or do bankers get hair cuts? With these questions unanswered, investors will spend a quiet Christmas at home, celebrating their profits and preparing to take a fresh view of Asia right after New Year. They say they are interested, but they admit it may be premature.

Long Run Prospects

In a pre-crisis survey of Asia, the World Bank predicted an outstandingly favorable view of Asia's per capita GDP growth prospects. The 4 Tigers become like more nearly the industrialized countries, Chile keeps going strong but at about half the speed of the last decade. South East Asia experiences a moderate deceleration as a byproduct of economic success. South Asia gets going big time. Does all of that remain plausible?

Table 2: Selected Asian Economies and Regions: Per Capita GDP Growth (Percent per Year)

	1965-95	1996-2025	1996-2025*
Four Tigers	6.6	2.8	1.7
China	3.9	6.0	4.5
S.E. Asia	5.6	4.5	3.5
South Asia	1.9	4.0	3.0

Source: World Bank Emerging Asia and author's estimates denoted by an *

Of course, the World Bank outlook studies the next 25 years, not the 5 years immediately ahead. Thus even assuming that it is basically right, two adjustments are to be made. First, the current crisis will take 5 years to be worked off and thus will take some toll. Second, the Krugman effect needs to be incorporated to make allowance for inefficient investment and declining motivation to save. To some extent the Krug-

man effect is already embodied in the deceleration, but a bit more is necessary just to offset World Bank fascination with Asia.

In the immediate future growth prospects in the region are sharply down. There are basically two scenarios—the two-thirds scenario and the one-third one. In the favorable scenario, average growth over the next 5 years will be reduced by something like one-third. The reduction will be much sharper at the front and then growth will pick up as normalization gets underway, but the average is surely down. Asia will not go back to a situation of yesterday, as if nothing had happened. The growth reduction surely differs across countries: it will be more severe in Thailand and Korea and much less in Malaysia or the Philippines.

The two-thirds scenario is optimistic in that it just recognizes a work out phase but assumes that politics will not be a big issue and that financial clean up will get underway promptly and completely. It also assumes that the world economic environment remains outright supportive for an export-led reconstruction of prosperity.

The pessimistic scenario brings in three critical negatives: First, politics just does not work so well. Throughout the region IMF programs will cause confrontation, long-established rulers will be toppled, macro discipline in the budget and on the inflation front gets somewhat less tight. All of that complicates reconstruction and a return to creditworthiness. Second, the world economy may become a complication via trade restrictions in the face of an Asian export onslaught. Third, Japan may just go, as seems now the case, into protracted near-recession or worse. As a result it becomes a weight on Asian performance rather than a locomotive. If more pessimism is needed, Chinese

banking and privatization problems might slow down that economy and pose much wider questions for prosperity in the region. Even the one-third scenario still has growth. Asia saves and invests and that, mechanically, produces some growth in output. But, of course, that is a far cry from the miracle performance in the past.

The Asian Economic Model and Lessons from the Recent Asian Financial Turmoil

Bill Emmott

Others on this panel are far more technically expert and economically sophisticated than me, and I therefore will rely on them for such expert analysis. As a simple journalist, I will confine myself to some simple observations.

In order to understand the recent turbulent events in many East and South-East Asian financial markets, and especially in order to identify the policy options arising from those events, it is necessary first to dispose of, or at least downgrade the importance of, two widespread views about what one might call the current excitement.

The first of these views is that the recent turbulence is a sign that something called "the Asian economic model" has outlived its usefulness; that that model is somehow responsible for the crisis; and that the model needs to be rethought and reformed.

This view needs to be disposed of both because in my opinion it is wrong, and because it risks leading people's thinking towards the wrong policy conclusions. It is wrong because I don't think there has ever been anything that could usefully be defined as an Asian model. If you compare the economies of Thailand, the Philippines, Indonesia, Malaysia, South Korea and Japan, to name merely those in the financial front-line, it does not seem to me that the similarities outweigh the differences, either in number or in significance. The role of foreign investment, the sequence and degree of liberalisation, the role of

government-directed capital allocation, the level of industrial concentration: all these factors, which are often cited as key indicators of the Asian model, differ widely between these economies.

I do not think that in structural terms or policy terms these economies in reality have had any more in common than might be said, for example, of France, Britain, Holland and Italy in Europe. These European economies differ widely, even though certain characteristics cross certain borders, and even though they form part of the world's most advanced arena for policy integration. The picture in Asia is, in my opinion, similar, albeit that in Asia policy integration has barely begun.

What the European economies have in common is geography, a high degree of intra-regional trade and investment flows, and thus a high degree of macroeconomic interdependence and policy interaction. This has, for 50 years, given the European economies a highly synchronised business cycle and an increasing recognition that events in one country will inevitably affect events in others.

My contention is that the thread that connects the currently troubled Asian economies is of an essentially similar nature. The cliché of Asia's flying geese, with Japan as the lead goose, is wrong if it is taken to imply identity or even similarity of policy. However it is appropriate if it is taken to imply merely that in the past two decades rapid economic growth within Asia became mutually reinforcing, as intra-regional trade and investment grew to substantially outweigh trade with other regions, as the economies of the region became more open to one another as well as to global flows, and thus as the countries' business cycles became more synchronised.

Up to a point, then, the East and South-East Asian economies have become so inter-related that major events in one or two countries do affect the others, to a greater or lesser extent. This point leads on, however, to the second of the two widespread views that I believe needs to be disposed of or downgraded: the idea that this is a crisis of contagion.

This idea depends on a metaphor of disease: that contagious diseases are passed on from sick people to others who were previously healthy, innocent bystanders, and that this is what is happening in Asia, and more widely in emerging markets.

Contagion is a highly misleading and dangerous view, even though it contains a grain of truth. It is misleading because the bystanders who have caught the disease first contracted by Thailand were neither innocent nor healthy. It is dangerous because it tends to divert attention to the symptoms of the sickness, namely capital flows, rather than to the true underlying causes. But it does contain a grain of truth.

That grain begins with the economic and financial interdependence already remarked upon. It continues with the inevitable effect in such circumstances on one country of a currency devaluation in another. And it is reinforced, unavoidably, by the often-observed tendency of investors to move in herds, running one way at one moment, but then panicking at another.

This grain of truth in the contagion thesis does lead, I think, to some policy conclusions, but not policies of a primary or short-term sort, and certainly not policies that seek to restrain in any significant way the free flow of capital around the region.

To arrive at primary, or short-term policy implications, you must, I think, put the contagion thesis to one side, and replace it with a broader perspective. Crudely put, this is that there is nothing new in the world of financial crises, and certainly nothing uniquely Asian about the ones we are seeing now. And the fact that several are being seen at the same time has more to do with correlation than contagion or mutual causation.

The banking collapses in South Korea, Thailand and to a lesser extent Malaysia are of a nature perfectly familiar to financial historians around the globe. Similar collapses have happened before in the United States, Western Europe and elsewhere, and similar collapses will doubtless happen again. The homilies of hindsight that can be applied to these collapses in developing Asia are the same as those applied to the bursting of Japan's bubble in 1990-92: that a long period of growth can breed hubris, as well as slack discipline in investment, lending and accounting habits; that such growth, particularly when associated with stock and property market frenzies, encourages corruption and other criminality; that long periods of growth eventually lure in new sources of capital, be they retail investors or overseas investors, that for a time provide easy pickings for unscrupulous insiders. And finally that partial deregulation of financial systems can lead to unforeseen consequences, as happened in both Britain and the United States in the 1980s.

When the economic and financial tide eventually turns, it exposes all sorts of wreckage underneath. As these Asian economies shared tidal patterns, so they have some correlated banking ills, and so their wreckages are being exposed at similar moments.

But the point of this correlation thesis is that the problems we are seeing are essentially national problems, which require national solutions. They are not primarily regional, nor, as I have already argued, do they reflect a shared intellectual crisis. Last week, Alan Greenspan spoke in New York about the ills caused by government-directed investment and lending in Asian countries. While I would share his critique of such practices, I do not think he was right to identify this as a unifying theme across the region. His remarks perfectly capture the problems of South Korea. They may well apply to China's next crisis. But they are irrelevant for Thailand, and somewhat misleading for Malaysia and Indonesia, where although public direction of resources is part of the problem, it is so largely because of misguided affirmative action in Malaysia, combined with some governmental hubris about prestige projects; and in Indonesia it reflects a political problem of the power concentration in the Suharto family, not a question of misguided economic philosophy.

The solutions will differ substantially from country to country, because the nature of the structural problems differ. In dealing with those domestic problems, there are simply three general homilies that can be invoked to apply to all involved.

Homily number one is that all the troubled East and South-East Asian countries need to learn from the lesson of Japan: that if you fail to deal properly with a banking crisis, then it is likely to get far worse, and far more dangerous, as time goes on. In Japan's case, it is now eight years since the crisis began, and reform so far has been tentative at best. The reasons for this are understandable, but the result is now highly dangerous.

Homily number two is that there is no reason in economics why current events should cause more than a temporary pause in East Asia's long-term growth. The fundamentals still look favourable.

But homily number three is that economics will not play the decisive role in determining the duration of this pause. That role will be played by politics and by policy choices. In any crisis of this sort, there is the potential for political change which ends up thwarting structural reform, or reversing liberalisation, or leading countries in a new direction. It is even conceivable, in a region such as East Asia in which there are so many territorial disputes and points of friction, that diplomatic and military conflicts could arise which begin to have an important economic impact. On an international basis, there is also the all too real possibility that Asia's currency devaluations could re-fuel protectionism in the United States, a force that has already been gathering strength in Congress and the country at large; which could, in principle at least, in turn trigger retaliatory reactions in East Asian countries. So while optimism is both reasonable and advisable, it ought not to blind one to less happy possibilities.

But a further question remains which is of great interest to this forum: even if the primary response must be national, what role is there for regional responses or broader international efforts?

As usual, my view is fairly simple.

First, I take a highly orthodox, and thus highly critical, view of the notion of an Asian currency fund. At best it is likely to be a sideshow. At worst, it could become part of the problem.

One of the abiding characteristics of the inter-action at a political and policy level between East and South-East Asian countries, whether inside ASEAN, APEC or other bodies, is an unwillingness to criticise each other. Yet stabilisation funds and mutual support agreements only work when they involve real conditionality: a commitment to and enforcement of the idea that the breathing space provided by the funds will be used to make necessary structural reforms. In current circumstances in East Asia, such conditionality can only be imposed by the IMF. Without such conditionality, currency funds are likely to increase moral hazard or to damage the confidence of investors by simply pooring good money after bad.

Second, however, I do think that the grain of truth in the contagion thesis is likely to have some impact on the institutional structures in Asia. The fact that currency devaluations have rippled from country to country, and that recent events have underlined the degree of inter-dependence between countries in this vast region, will, and probably should, give some impetus to Asian integration in the same way as similar concerns have driven integration in Europe. Currency baskets that were primarily directed at the dollar are likely in future to have more of a regional flavour. The old 1980s notion of the yen block, with a sort of loose Asian monetary system surrounding the yen in the same way as Europe's system surrounds the Deutschmark is quite likely to raise its head again. Given the weak institutional links, the diversity of the region, and the reluctance to criticize each other, this is unlikely to arise rapidly. But it will evolve, and serve to entrench the existing ties between Asian central banks.

Third, though, I return to the key role of the IMF. In circumstances such as those in South Korea and elsewhere, it is necessary to have

someone to hate. That is and must be the IMF's role, in being awkward and reluctant to offer a rescue, in finally providing ample funds when funds are required but also providing the necessary discipline to bring about painful structural change. That role could not sensibly be played by the United States, nor by Japan, nor by the European Union.

I do not envy Mr. Sugisaki and Mr. Camdessus in having to play this role. But I am very glad that they are there to play it.

The Causes of the Asian Currency Crises and the Role of the IMF

Takatoshi Ito

What is happening to Asian currencies? Since the floating of the Thai baht in July we have seen depreciation of several other currencies. Five months have passed since then, and these depreciations have become much deeper. By the end of August, the IMF had put together a support package for Thailand. Notwithstanding the IMF package, the depreciation continued. It was also contagious, spreading to Indonesia, and then to Korea: and we are not certain whether we have yet reached the bottom or not. Some people argue that the size and the content of the packages were not sufficient. I will come back to these points later to give you some concrete propositions.

What was cause? Mr. Sugisaki and Professor Dornbusch covered this, so I will be very brief. We should look at the peso crisis of 1994 because when the Mexican crisis happened, it was quite possible to foresee the eventual rise of the Asian crisis. Mexico had a current account deficit of 8 percent of GDP but capital inflows exceeded this until February 1994, thus increasing official foreign reserves. The currency was in effect pegged to the US dollar. As a result, it became overvalued by the degree of the differential between the two countries' inflation. Then the presidential candidate, Mr. Colosio, was assassinated and that triggered the reduction of capital inflows. In the meantime the central government did not disclose this new trend, or maybe I should say there was a big time lag before this was revealed. Therefore, in December when foreign reserves reached rock bottom, the market was not fully aware of by how much foreign reserves had, in

fact, fallen. On December 20, all-of-a-sudden, the government announced a devaluation of 15 percent to correct the current account deficit. This seemed like the right measure at the time. However, it triggered another major outflow of capital. Foreign investors started to sell Mexican assets. Given the paucity of its reserves, the Mexican government was unable to defend the exchange rate and they therefore had to move to a floating system. After a month or so, the United States and the IMF put together a support package of approximately US $50 billion. So the Mexican peso crisis was the basic root of the problem, and the lessons are as follow: First, there is a potential risk for any currency that pegs to the dollar. Second, for any currency with a pegged rate, it is difficult to determine the best timing of the exit from the peg. Third, Mexico had issued short-term treasuries denominated in foreign exchange. Since these short-term government bonds were indexed to the dollar, once the peso devalued, the government's debt grew and people lost confidence in the government's ability to repay—again leading to the currency crisis. With the currency pegged to the US dollar, the more investors believed the peg would be maintained, the more they wanted to have dollar-based assets in Mexico with higher interest rates. Once the devaluation took place, it was found that the banking sector had a tremendous amount of dollar-based assets. So the currency crisis transformed itself into a banking system crisis. These are lessons from the Mexican experience.

In putting together the support package, there was a debate within the IMF about the lending limit to a country, and about the function of a quota for a country. At the time of the Mexican crisis, the limit was 300 percent of quota, which would mean simply US $7.8 billion for Mexico. The Fund applied various exemptions, and added around an extra US $10 billion, so it became US $ 17.8 billion but it was still

short of what Mexico needed at the time. The United States therefore offered to supplement the package. Altogether Mexico received a package of around US $50 billion. So already, at the time of the Mexican crisis, we recognized that there is a limit to the lending capability of the IMF. If developing countries suffered currency crises, the IMF alone would not be able to provide sufficient financial support. We knew this problem right after the Mexican crisis. There were many discussions on allowing increases in access to the Fund's resources but no concrete solution was reached until the Thai crisis.

The IMF recognized that there is a lack of information disclosure in the Mexican crisis. The level of foreign exchange reserves is a very important piece of information, and yet market participants did not know what the true level was. So market discipline could not work. If the market had received more appropriate information it could have issued warnings, but in the absence of information it could not do so. Of course—and Mr. Sugisaki referred to this—the Special Data Dissemination Standard has existed for some time. Even so, this painful experience was repeated in Thailand and in Korea. In other words we did not learn from experience.

Also, the peso crisis was known to have a "tequila effect". In other words, once Mexico suffered from this crisis, it spread to Argentina, triggering their currency crisis. However, in March 1995, Argentina received support from the IMF and it saved Argentina from having to devalue. So the IMF packages to Mexico and Argentina worked to limit the scope of contagion. However, in the case of the Asian crisis, contagion has continued for longer and spread wider.

Professor Dornbusch has argued that the Mexican and Asian crises are similar. I would challenge that: is it really true? Thailand, like Mexico, had a very large current account deficit at around 8 percent of GDP. And of course the Thai baht was linked to the US dollar, as was the case of Mexico, and it was also overvalued to the extent of inflation. What aggravated the problem was that, unlike Mexico, Thailand was very dependent on its trade relationship with Japan. With the depreciation of the yen, Thai export competitiveness was lost. Therefore the weakening of the yen from 80 to 130 yen to a dollar, from April 1995 to the late 1996, created competitiveness problems for both Korea and Thailand. Since both currencies were linked to the dollar, their effective exchange rates went up.

In the early part of 1997, there were speculative sellings of Thai baht. As Professor Dornbusch said, the central bank became the counterparties to those speculative transactions in the futures market. Of course this was only revealed afterwards. The IMF's Data Dissemination Standards focused only on the balance sheets of the central bank not on the futures markets. That off-balance sheet information was not revealed to the markets. In the end, the Thai authorities had lost almost all their foreign exchange reserves in either the cash or futures market so they had no choice but to abandon the peg and go to a floating system. Now, while there was speculative selling, the financial system was also at considerable risk. The bubble in the property market had burst somewhat earlier, just like in Japan, and there were many non-performing assets and loans held by financial institutions in Thailand. The so-called "finance companies"—the non banks which correspond to the "jusen" housing loan companies in Japan—those finance companies had very high non-performing assets. The central government tried to assist, but the help they gave was insufficient. Foreign institutions were also lending to the finance companies but

eventually they too withdrew their funds, thus creating the financial crisis.

So on July 2 the baht was devalued. Many foreign investors and financial institutions decided not to roll over their loans to Thai enterprises. That deepened the crisis, thus forcing the Thai government to seek support from the IMF.

There are indeed many similarities between the Thai and Mexican experiences, as Professor Dornbusch has explained. First, both currencies were pegged to the dollar and both had weak financial systems. Thailand, in particular, had high levels of non-performing loans and bad assets. Thailand also had a lot of short-term foreign currency -denominated debt. Immediately after the devaluation, Thailand was saying; "We are not like Mexico" because in Mexico the issue was government-issued debt whereas in Thailand, they said, it is private sector debt. It does not have anything to do with confidence in the government, they argued. Well, it may have been the private sector that incurred much of the debt in Thailand, but the private financial sector had, in turn, borrowed money from the government sector. Given that relationship, whether or not there was a solvent debt did not really matter. It led to whether you could have confidence in the government or not. I do not think there is enough time to cover Indonesia and Korea, but I would like to draw a few conclusions from the lessons we have learnt.

First, pegging to the dollar is very dangerous or risky because currencies tend to become overvalued. So the question is—at what point should currencies move to a floating system. Again, we do not have a clear-cut solution to this.

Second, short-term foreign currency-denominated external debt is a very risky undertaking. Thailand had considerable amounts of short-term bank borrowings. The fact that they also had a lot of non -performing loans soon became a very serious issue. This is something that needs to be watched very closely. As I have said, both Thailand and Mexico had net inflows of capital until several months before their crises. What they did when there were net inflows of capital is really important, because, once they reversed, it was too late. One must be prudent in making sure to take full advantage of capital inflows without increasing too much risk.

Third, once you are in a crisis, what do you do? What happened in Thailand? They tried to impose austerity policies, but maybe that kind of traditional approach is not efficient under current circumstances. Professor Dornbusch implied that it was the right thing to do, but again, I am not too sure whether the traditional approach would have been enough. The magnitude of the non-performing loans was a warning that the authorities' power to avoid a crisis was severely constrained. Earlier this morning there was an announcement about the Thai finance companies which hold the key to this issue. I think, belatedly, the Thai government has started to be very serious about this finance company issue. So today (December 8, 1997) may be a milestone for Thailand in the sense that the government has belatedly become very serious about the finance companies.

Lastly, on the role of the IMF, I thought Professor Dornbusch would be very critical of the Fund, so I was planning to be ready to defend the Fund. But since he was so supportive of the IMF's role, I would like by contrast to make a few critical remarks of the IMF.

We know that the dollar peg is a problem, but the IMF has not yet demonstrated what exactly is a safe path to the exit from a peg. The IMF sometimes recommends a peg in cases of hyper-inflation, or to stabilize inflation in an economy, but it does not say when it is best to exit from that peg. The IMF sometimes recommends flexibility on the currency to avoid a one-way bet, but it was precisely when Indonesia made the currency more flexible that the speculation overpowered the central bank.

The second challenge is that of over-borrowing in foreign currencies. This is one of the inevitable results of financial liberalization. The IMF, as Mr. Sugisaki mentioned, is moving towards greater capital account liberalization as its mandate. But will the IMF recommend gradual liberalization? Will it put some conditions on capital flows? Does the IMF recommend certain steps as precautions to manage capital inflow efficiently?

The third challenge is a simple question. Why couldn't the IMF stop the Asian contagion when they largely succeeded in stopping contagion in Latin America?

Fourth, is the prescription for the Asian countries right? Professor Dornbusch commended the traditional austerity plan or tight fiscal and monetary policies. It works well for a country suffering hyper-inflation with large fiscal deficits, which are largely monetized. However, the fundamentals, as Mr. Emmott said, were fine in Asian countries. It was the banking sectors that had the problems. So Asian countries need to clean up their banks' balance sheets and actually stimulate economic growth to boost confidence of investors. I think the IMF, the World Bank, and the Asian Development Bank and other involved

parties have to allow the experts on banking systems, banking supervision and financial sector restructuring to help these Asian counties. Unfortunately, Japan is not setting a good model for its neighbors.

Last, the fifth challenge for the IMF, I think, is that, as Professor Dornbusch pointed out, and I agree with him, that over-borrowing is a problem. But over-borrowing also means over-lending. Who are those lenders? How can we hold these lenders responsible?

They are half of the problem. If borrowing is a problem, lending is a problem. How can the IMF ask lenders to bear their fair share of the pain of adjustment in this mess? We do not have the answer to this over-lending problem. This is a challenge for the IMF, and I think for us, the academics and policy-makers as well.

Managing Capital Flows and Market Volatility —Some Issues in the Framework for Financial Markets Stabilization—

Virabongsa Ramangkura

Since the flotation of the Thai baht in July, the region's financial markets have been beset by continuous pressures that have led to almost a synchronized sharp devaluation of the region's key currencies, a marked adjustment in the region's equity and other asset prices, as well as a deflationary impact on the real economies and the region's banking sectors. The speed as well as the extent of the so-called "contagion effect" that has affected so many countries in this region and beyond have caught many of us by surprise. Although the crisis seems to have peaked, the near-term outlook for financial markets stability still remains unsettled. But, most importantly, the turmoil so far experienced has led to a rethinking about the rationale behind free capital movements in general, and about the policy response to manage the excessive market volatility in particular. Being an economist, I tend to embrace the longer-term benefits of a free, open, and liberal market system. To me, the key challenge for policy is how best to live with capital flows: by learning to better manage the risk of capital flows as well as by strengthening the international policy and regulatory framework so as to allow countries to better cope with excessive market volatility.

The focus of my remarks today will be the framework for financial markets stabilization. The question is whether the international policy framework and institutions that we have today to safeguard

the risk of cross-border capital flows is adequate. I will not surprise you by saying "NO", definitely more can be done. In making this argument, I will touch on several issues about international capital movements and the existing policy framework. And finally, drawing on my experience with the Thai problem, I would like to offer some views about ways to further strengthen the existing framework, mainly as food for thought.

As we all know, cross-border capital flows have been the cornerstone of the region's economic growth and prosperity over the last ten years. Between 1990-96, according to the IMF, Asia received more than US $60 billion a year in capital inflows, and a total of US $107 billion alone in 1996. Thailand, in particular, benefited from the recent capital inflows receiving more than US $13.6 billion a year in 1990-96, and a total of US $19.5 billion in 1996. This large influx of international capital was in response to the higher rates of return in the recipient countries, supported by sound conduct of macro-economic policies in the environment of liberalized financial markets. Over the years, the benefits of capital flows to Asia is evidenced by the region's high rates of investment, the strong economic growth, the high employment levels, as well as the longer-term benefits associated with a more efficient resource allocation and the more expansive financial sector. I would say that the Asian economies, on the whole, have benefited considerably from the recent capital inflows. The annual growth rate of Asian developing countries rose to an average of 8.3 percent between 1990-96, from an average of about 6.8 percent between 1979-88, the period prior to the inflows.

The issue confronting Asian policy makers today is not about the benefits of international capital flows, but rather management of the

risks of capital flows. We have seen from the recent turmoil that these risks are real and can be very potent. The major risks are:

(1) Macroeconomic stability risks associated with the widening of the current account deficit, the rise in domestic prices including asset prices, and a sharp rise in the country's external liabilities relative to its stock of financial assets,

(2) Financial sector risk precipitated by excessive lendings, increased credit and foreign exchange risks, as well as the increased liquidity risk due to maturity-mismatch between bank assets and liabilities, and

(3) Liquidity or balance of payment risk brought on by a sharp and sudden reversal of capital flows as a result of an abrupt change in market sentiment and investor confidence.

We can assume that policy makers in Asia have been well aware of these risks. This issue has been widely debated and discussed. To contain them, the existing policy framework has focused on the prevention of the risks translating into a crisis through an early identification of the problem as well as an early adjustment of policies. As for the macro-stability risk, the existing framework—typically proposed by the Fund—is to combine cautious demand management policies with greater exchange rate flexibility aimed at reducing external deficits and pressure on prices. As for banking sector risk, countries are advised to strengthen the regulatory framework, to improve supervision procedures and to ensure an adequate level of capital. And to maintain market confidence, the existing policy framework focuses on market liberalization, greater transparency of the policy process as well as a quick and credible dissemination of market data and information.

Under this broad policy framework, I believe countries in Asia have managed the macroeconomic implications and the risks of large capital inflows reasonably well. This is evidenced by the fact that the regional economies have been able to sustain the persistently large influx of foreign capital for over quite a long period, without a major imbalance, up to the Thai difficulties. While individual country responses may differ, they broadly adhere to the policy framework noted above: that is, combining early domestic demand adjustment with greater exchange rate flexibility and measures to strengthen the financial sector. Particularly for Thailand and Malaysia, economic adjustment to reduce the current account deficits and to strengthen the banking system had been well underway prior to the onset of the crisis.

But what turned economic adjustment into a full-blown financial crisis had been the sharp swing in market sentiment precipitated by lack of confidence in the countries' macroeconomic policies. This is very much the case for Thailand in which macroeconomic adjustment was complicated by a sustained and concentrated speculative attack on the currency. Even with a strong adjustment program backed by the IMF, market confidence in economic policies has not fully returned. My point is that while we believe that market opinion can exert a disciplining influence on the country's macroeconomic policies, market reactions can also be excessive. Such overreactions may be due to incomplete information about ongoing government policies, or perhaps due to an inaccurate appraisal of the underlying economic situation, or even a result of herd instinct. Whatever the cause may be, market overreaction is a key factor that makes a financial crisis a self-fulfilling prophecy.

Once a crisis occurs, what can the existing policy framework of-

fer as a way to deal with it? To answer this question, we have to look at the existing international policy framework for financial crisis management. Since the Mexican peso crisis, the international community has sought ways to prevent and minimize the contagion effect of a financial crisis. The International Monetary Fund, in particular, has strengthened its approach to handling financial crises by increasing its role in market surveillance, by making available vast sums of financial support at short notice, and by streamlining the dissemination of data by member countries through its SDDS or Special Data Dissemination Standard.

These initiatives, as we have seen, are positive steps towards the prevention and management of crises. Such an approach has worked well for the Thai case and has allowed the Fund—with the full cooperation of governments in the region—to respond rather speedily to the crisis, both in Thailand and Indonesia. Nonetheless, the fact that a crisis did happen and that the contagion effects have affected both the strong and the weak economies alike suggests that the existing policy framework may not be wholly adequate, particularly in dealing with the spillover effects of a crisis. More importantly, we have seen from the recent turmoil that markets tend not to differentiate the underlying economic situations of different countries, but tend to treat countries in the region as a group. These weaknesses, therefore, raise two important policy questions.

First, can the existing mechanism of market surveillance be improved so as to ensure adequate and timely policy adjustment, while enabling the market to have better information about the country's policy and economic situation.

Second, do we need an additional mechanism to enable countries with no serious macroeconomic problems to better manage market pressure and volatility at the time of the crisis?

I will not attempt to answer these questions directly, but will offer some views on ways to strengthen the existing policy framework.

First, for countries that have fundamental economic problems, it is most important for these countries to undertake the necessary policy changes. Although it is fair to say that the Fund's new surveillance procedure offers an improved approach to policy advice, in reality, it operates on the global level, and the advice is sometimes seen as too broad compared with the more practical guidelines that policy implementation requires. For example, the safe path for an exit policy from a dollar peg has been an important policy issue in Asia for some time. To fill this gap, I see benefit in additional policy consultation between regional governments involving a smaller group of countries. This additional mechanism would allow countries with similar experience in the region to exchange market information and policy implementation experience while, at the same time, becoming more familiar with each other's macroeconomic policies. This type of consultation can readily supplement the Fund's general policy advice and can be a conduit for exerting pressure for good policies. Some central banks in the region have already established this type of voluntary consultation on a bilateral basis, and I see benefits from this mechanism being expanded to cover more countries in the region.

Second, at the time of a crisis, it is important to ensure that countries that do not have fundamental problems can withstand the temporary excessive market pressure by having adequate financial re-

serves to do so. These resources need to be available readily so that the countries will not be forced by the market to undertake preemptive but unwarranted policy changes. What I am referring to here is a type of very short-term liquidity support that will allow the authorities to continue managing the exchange rate under severe market pressure. This type of arrangement has already been in place elsewhere, such as in the Organization for Economic Cooperation and Development (OECD), or in the European Union. I think Asia needs to be thinking of a similar arrangement, mainly as a facility to allow countries to cope better with shorter-term market pressure.

Third, as for the provision of market information, the recent crisis in Asia shows clearly that the soundness of the country's financial sector is a key determining factor in a crisis and better information on the banking sector is needed to enable the market to correctly evaluate the underlying financial position of the banking sector. Unfortunately, compared with economic and monetary data, there seems to be a lack of consensus on how these data should be provided. On this point, I believe there is additional room to establish an international data standard to improve the quality of information provided on the state of the financial sector. This standard can be developed in parallel with the Fund's existing Special Data Dissemination Standard. Institutions with a specialization in this area such as the BIS could be called upon to provide leadership in this matter.

My first two observations naturally raise the question of whether we would need a new institutionalized regional body to implement the additional mechanism. My personal view is that in the current era of financial market globalization, there is always a role to be played by cooperative efforts at the governmental level to stabilize financial

markets. After all, Asia's strong economic performance has been fostered by an environment of market and exchange rate stability. The key point is that regional cooperative efforts should be a supplement to, rather than a substitute for, the existing policy framework. Regional cooperative efforts can enhance our understanding of the market and the developments that are likely to affect regional economies as a group. More importantly, regional cooperative efforts also allow countries to share expertise and resources to better cope with unwarranted market volatility.

Characteristics of the Recent Asian Crisis and the Foreign Exchange Regime

Eisuke Sakakibara

I think holding this symposium sponsored jointly by IIMA and the IMF now is very timely. Indeed, I think it is regrettable that the symposium has been so timely. When the conference of countries providing support to Thailand met in Tokyo at the beginning of August, I didn't dream there would have been so many crises engulfing the region. Also, few people could have foreseen that South Korea would acquiesce to the IMF conditions two months ago. I think these crises have spread with a speed that makes it seem as if they are highly contagious.

I agree with IMF Managing Director Michel Camdessus when he terms the series of crises that extend from the problems in Mexico during 1994-1995 to that in South Korea as a 21st century type of crisis. Some observers are calling this an Asian crisis, but I disagree. While conditions in Mexico and South Korea differ, there are very close similarities in many instances. I think that if this can be termed a crisis, it is most likely a crisis of global capitalism.

This may become evident by comparing those crises of the 90s before the events that occurred in Mexico in 1994-1995, and the crises that have occurred since then. The former could be termed current account crises. Thus, countries were consuming in excess of their capacity. Trade deficits rose in tandem with imports, creating what the IMF calls a financing gap. The IMF moved in to correct the situation. These were the conditions that prevailed during current account crises.

Those crises subsequent to Mexico, however, have clearly been capital account crises. These occur when immense capital flows shift instantly from country to country in the global capital market. I believe that is how these crises occur.

Mexico's case was clearly a problem of government debt. Ultimately, the cause of the crisis was extremely rapid capital movement triggered by some factor. The Asian crisis is different because it is basically a problem of the private sector. The governments in this region have maintained relatively sound fiscal policy. The fiscal accounts in Thailand and other Asian countries are generally in surplus. In fact, these countries maintained fiscal accounts that may have been superior to that of any G7 country. Had there been currency unification, all the Asian countries in crisis would have satisfied the conditions enabling them to participate. It wasn't as if they were scraping by at 3%. In that sense, I think we can say that their conduct of fiscal policy was exceptionally sound.

These Asian countries also have an extremely high rate of personal savings. This extremely high personal savings rate prevented the capital influx from creating a condition of overconsumption. The capital influx was used for investment.

This means that the investments were poorly allocated, or there was a maturity mismatch—a currency mismatch. Thus, the problem was with the capital allocation after it entered the country—not that capital flows resulted in overconsumption. It has often been noted that the fundamentals of these Asian economies are strong. In that sense,

the fundamentals were in fact strong, and remain so today.

The capital influx was extremely large in the years 1993 and 1994, however. In Thailand's case, the Bangkok International Banking Facility was established in 1993. Roughly US $4 billion entered the country in the following three years. Of course, a capital influx of that magnitude will tend to boost a country's exchange rate. Also, the rate of consumer price increase was somewhat higher than advanced countries, so the real exchange rate climbed 30%-40% over the next three or four years. Therefore, since Thailand's export competitiveness substantially declined, the capital that entered the country was invested in the non-tradables export industry, rather than in tradables.

Investment was naturally directed toward land, real estate, or related non-tradables, so the country was not always able to allocate it toward enhancing export competitiveness.

An additional factor was maturity, or currency mismatch. The recent currency influx was primarily denominated in dollars, so the exchange rates in the region could be considered to have been set though a basket over the past three or four years. This basket was denominated mostly in American dollars, so the region's currencies were tied de facto to the dollar.

There is absolutely no risk in borrowing dollars when currency rates are fixed in such a manner. Therefore, a country's banks can assume an enormous amount of dollar-denominated debt on the assumption that the exchange rate will be maintained indefinitely. In Indonesia, commercial paper was issued, so the liability was assumed by companies in the country.

As it becomes apparent that the fixed rate cannot be maintained in this way, we see that the currency risk has mushroomed. This is termed excessive dollarization. When this excessive dollarization occurs in tandem with capital inflows, a country's private sector cannot manage risks in this process.

If the private sector does not have the capacity to manage risk, the central bank or the finance ministry must regulate the process. This prudential regulation did not exist, however. In fact, the private sector became liable for this enormous risk through the process of capital influx. The magnitude of the risk becomes apparent as it becomes evident that the exchange rate cannot be fixed.

For banks, this is currency risk for which they are liable. It also becomes credit risk in this situation if the bank's borrowers assume liability for this risk. Thus, financial sector problems have emerged. Rather than this being a case of distortions in the financial sector, I think risk management has been poorly handled over the past three or four years. This is particularly true for risk management of the capital influx.

Another factor in this process is that the crisis emerged suddenly. Of course, observers have frequently noted that people were well aware of the poor fundamentals. The same point also was noted during the Mexican crisis. And it also is frequently observed that the IMF issued a warning about Thailand one year before trouble emerged there.

This is partially true. In Thailand's case, the current account deficit had skyrocketed. Nevertheless, the crisis arose rather suddenly

when market traders were triggered by some factor to abruptly withdraw capital from the market. This trigger is often political in nature. In Thailand's case, the trigger was undoubtedly the resignation of the Minister of Finance.

One of the triggers in South Korea was the presidential election, but to determine what actually caused the crisis would involve an extremely subjective judgement. Whatever market traders and dealers consider to be the trigger, then that would become the trigger. In that sense, the market is extremely capricious and not very stable. Therefore, some believe the crisis was suddenly brought about by market traders. Capital markets today are clearly global in scope, so this is a capital market problem in which immense amounts of capital are shifted across national borders in this manner.

What occurs as a result is not a current account crisis, but rather a crisis in confidence. A country's confidence is suddenly dissipated by a trigger of some sort. The central bank usually has a role when a domestic crisis of confidence occurs. The central bank is the lender of last resort. There are discussions in Japan today regarding the use of public funds to ameliorate the crisis of confidence. A crisis of this sort demands a domestic lender of last resort.

Domestically, these lenders can provide unlimited liquidity in a crisis. This enables the crisis to be overcome and a new system to be created. Internationally, however, there is no lender of last resort. Of course, increasing dollarization makes the U.S. a logical choice to be the lender of last resort, but politically, this is not at all possible. Therefore, no one is assuming this role.

In the past, the IMF, the World Bank, and the Asian Development Bank created mechanisms to deal with a current account crisis. While these mechanisms were available, there was no international mechanism for dealing either with a crisis of confidence or a current account crisis.

We must strengthen our regional efforts within these various processes. Several suggestions have been floated, including the creation of an Asian Monetary Fund. Ultimately, what we have is that on which we agreed in Manila. This is called the Manila Framework. The agreement was reached because the IMF, and IMF participants such as ourselves, had to create a system to respond to this crisis. I think very highly of the Manila agreement. The IMF has started to make a major shift in that direction.

Agreement was reached in about four areas in Manila. These included agreements on regional surveillance, providing technical assistance to the financial system, and creating a preparatory cooperative finance arrangement for the second stage.

At the same time, the Manila conference participants reached agreement on building a new IMF facility. This was an agreement that a new mechanism should be created for short term financing. The IMF would procure a large amount of funds over an extremely short term to resolve a crisis of confidence, and lend the money for an extremely short period at close to prevailing market rates.

This plan was actually proposed by the U.S., and I welcomed it wholeheartedly. Previously, the function of the IMF was such that it was unable to deal with a capital account crisis or crisis of confidence

of this type. It is rather more important that the IMF or an international financial institution assume the role of lender of last resort. Thus, I think the essence of the problem is that until now, authorities have not been attentive to the globalization of the market.

Observers frequently bring up the issues of transparency and disclosure, and both of these issues are indeed important. We are actually liable for enormous risk in the immense global capital market, however. We must seriously consider how to manage this risk, or consider the problem of who will take the lead in managing a crisis when it arises.

This is not merely an Asian problem. I think it is extremely likely that a similar crisis could occur in Latin America or Eastern Europe. Now that capital movement has become so liberalized, a similar problem could occur in any region of the world if some factor triggers the sudden withdrawal of capital.

Therefore, the issue is how the authorities will manage the exceptionally risky global financial market. I say manage rather than control. I think the way this risk will be managed is an extremely serious issue that has arisen.

We came up with a partial answer to this question in Manila. It is clearly a partial answer, but I believe the management of a globalized system without a lender of last resort is a critical issue.

One more factor that has become an extremely serious problem in this process is the problem of an exchange rate regime. Small- to medium-sized open economies such as those of Asian countries can

maintain a fixed exchange rate in the manner employed by Hong Kong. Hong Kong is a so-called special region, so the real sector there is highly adaptable. Hong Kong has special circumstances in which adjustments can be made in the real sector with exceptional adaptability. That means they can maintain a fixed rate regime or a currency board system.

I think the question of the type of exchange rate regime that would most benefit economies that lack Hong Kong's adaptability is an extremely difficult one. Is a flexible rate truly viable? Hong Kong is an extremely small market, so a small amount of leveraged funds would have a significant impact on the exchange rate.

Since the market will invariably overshoot, the problem becomes how to withstand an overshoot in an economy of that size. Further, an open economy with a reliance on exports will generate discussion about whether it can withstand an overshoot. Therefore, the critical issue in the future is how we consider the problem of the exchange rate regime. Some observers hold that flexibility will solve all problems. I am afraid that is not the case, however, and I suspect that a fixed regime is best for a small open economy.

In any event, I think Hong Kong is a special case. It is possible only in Hong Kong. Perhaps the real sector in Hong Kong can easily adjust through some form of pure capitalism. While I don't think adjustments will be easy, I do think there are special circumstances through which the real sector can adjust.

Another problem that has emerged in the Asian region through this process is how to respond to excessive dollarization. This is not

really a problem for a mature economy such as Japan. Dollarization seems to occur inevitably in countries still in the developing stage when foreign exchange transactions are completely deregulated. I think the question of how to respond is one issue we have been confronted with as a result of the recent crisis in Asia.

This speech has been rather long, so I will bring it to a close. I think this crisis is a major challenge not only for Asia, but also for the global market, and it is a challenge to which we must respond. The problems in Japan are not yet global problems. As Mr. Dornbusch noted, however, one extremely important factor for resolving the current crisis will be a strong recovery by Japan. Ultimately, I think we must create a base by which we can respond to this challenge both on an intellectual level and through policy.

(Original in Japanese)

Panel Discussion

In the panel discussion, debate ranged widely. Professor Dornbusch was asked about the role of the United States in the Asian crises. He agreed that the U.S. had a key role to play, including in supplementing the financing packages. At the same time, he stressed the need to avoid moral hazard and urged the Fund 'not to bail out too much'. He was nervous that protectionist pressures could build if the Asian crises led to a large rise in the U.S. current account deficit.

On the question of what exchange rate regime best suits Asian developing countries, the panelists agreed that, under current circumstances, there was no practical alternative to floating rates. Both Dr. Sakakibara and Dr. Virabongsa said that, under more normal circumstances, it would be worth considering some more fixed arrangement, perhaps pegging to an Asian basket of currencies. Dr. Virabongsa noted that Thailand's fixed rate system had served the country well for many years. The main danger he saw was that a fixed rate tends to become highly politicized.

Mr. Sugisaki mentioned that pegged exchange rates are generally most useful after periods of high inflation. In more normal times, some degree of flexibility should be considered. Hong Kong SAR and Argentina were, he said, special cases. If a country decides to peg to a basket of currencies, it should think carefully about the pattern of its trade with other countries in deciding the make-up of the basket.

Professor Ito pointed out the practical difficulty of moving off a peg when a country has been experiencing high capital inflows. He thought it important to look at the composition and allocation of those

flows in assessing which exchange rate regime would be most appropriate.

The question of an Asian monetary facility was raised. Mr. Emmott described it as a potentially very dangerous idea, feeling that it might exacerbate the moral hazard problem rather than provide a breathing space for genuine reforms to be put in place. The greatest potential he saw for enhancing stability was through more effective discussion of policies in the various regional fora. These may ultimately lead to a situation in which regional countries could target a basket of their trading partners' currencies, including, most importantly, the yen, but this was still some way off. The key, he suggested, was that any system chosen should give member countries both rights and obligations.

Dr. Sakakibara agreed that European-style unification was impossible in Asia, but pointed to the increasing importance of intra-regional trade in Asia. Much of this was still denominated in U.S. dollars. Exchange rate stability could be enhanced, he suggested, if a greater proportion of this trade were transacted in regional currencies.

The panel then turned to the role and financing of the IMF. Mr. Gyohten asked whether the package of assistance extended to Korea had created a precedent that could severely strain the IMF's liquidity were it to be applied in other countries.

In reply, Mr. Sugisaki assured the symposium that the IMF's resources were adequate for the programs it had underway. He was confident the IMF was adequately funded to support its member countries. He stressed the role of strict IMF conditionality in ensuring that borrowing members are able to repay the Fund. In the case of the East Asian crises, wide-ranging financial sector reforms had been a vital part of that conditionality.

On the lessons of the crises for Japan, Dr. Sakakibara said that Japan's major problem was a lack of domestic confidence in the economy. Gradual incremental steps would never succeed in turning confidence around. Dramatic actions were therefore required to solve the problem. He was confident however, that sufficient resources were available to achieve this. Professor Dornbusch argued strongly in favor of a substantial tax cut in Japan.

Mr. Gyohten and Mr. Saito thanked the panelists for their extremely interesting contributions.