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PERSPECTIVES

# Regional and Global Responses to the Asian Crisis

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**Regional and global responses to the Asian crisis**

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## Introduction

The Asian Crisis of 1997-8 left an imprint on the countries involved – in some cases deep scars, in others a balance of pluses and minuses. For Indonesia, the scars are long-lasting[1], whereas in Korea the crisis was of short duration and it could be argued that it provided the catalyst for beneficial reform. While the focus here is on economics, the changes and responses were not just economic – there were changes of government in each of the countries most affected (Indonesia, Thailand and Korea).

This paper looks beyond the experience of the individual countries, to see what the response of the region was, and the global response. While these responses will be the main focus, we can't make sense of these unless they are in the context of what went wrong. So Section I looks briefly at the causes of the crisis and the immediate response. Section II looks at what the countries of the region, collectively, have done, and to what extent their common paradigm or approach to economic policy has changed. Section III examines the global response – principally its effect on the International Monetary Fund, both operationally and in its understanding of how the world works.

Sometimes a "response" can take the form of an easily identifiable change in rules or institutions. But the more important response may take the form of a change in the *way of thinking* about a policy issue – the paradigm. In attempting to identify responses, it will often be difficult to isolate changes which came about as a direct consequence of the crisis and those more evolutionary changes which occurred because the economic environment has changed for other reasons: not every change that has occurred in the last decade can be attributed to the crisis. For the regional economy, the rise of China (with its profound

[1] Williamson (2005)(Table 2.3) reports three different measures of lost GDP, suggesting that all the crisis countries lost significantly, with Indonesia losing perhaps the equivalent of around a year of GDP. If the hypothetical non-crisis level of GDP has not been regained, the losses are ongoing.

implications for economic rivalry and complementarity) would have occurred even without the crisis and some of the changes in structure of the crisis countries would have happened anyway. To give one example: even without the crisis, China would have received an increasing flow of foreign investment. But at least some of this redirection of the flows came about as a result of the less attractive investment climate in the aftermath of the crisis.

"Responses" may be negative as well as positive: "the dog that didn't bark in the night". Two of these "non-responses" seem quite remarkable: none of the countries introduced trade restrictions (e.g. import controls) in an attempt to soften the adjustment; and the crisis countries remained (and remain) very open to capital flows, with capital controls only lightly used and quickly removed. The general principle that creditors should be repaid (as opposed to unilateral rescheduling, as occurred in Argentina in 2002) was maintained (although of course quite a few individual debtors did not repay). At a more general level, it is remarkable how little the broad macroeconomic approach has changed – implementation and execution are seen as the main issues requiring reform, but something along the lines of the Washington Consensus is still the prevailing policy paradigm.

**I. What were the problems/lessons?**

There was no shortage of explanations offered for the crisis, including crony capitalism, corruption, lack of free-market orthodoxy (having an exchange rate which was neither a firm fix nor a completely free float), absence of democracy, governance deficiencies, moral hazard and lack of transparency. Most of these explanations seem unsatisfying, if only because these circumstances had existed during three decades of extraordinary growth. For an economist, the key problems might be identified as excessive foreign capital inflows in the five years or so before the crisis, which fed a local asset boom and created the potential for volatile outflows (Mexican-style "sudden-stop" capital crisis), combined with weak banking systems. This might be contrasted with earlier crisis experience, particularly in Latin America during the first half of the 1980s, where the capital reversals were symptomatic of other serious domestic macro-imbalances. For Asia, good macro policies (balanced budgets, modest current account deficits[2] and tolerably low inflation) were not enough. The problems were not foreseen, and even as the crisis unfolded, its true dimensions were not recognised. With the nature and extent of the problem misdiagnosed and the centrality of the capital flow issues unacknowledged, the immediate policy responses left much to be desired: "When in doubt, tighten policy". Tightening of fiscal policy was inappropriate, and the interest rate increases

[2] With the possible exception of Thailand, although the current account deficit was still much smaller than the capital inflow.

did little to counter the capital reversals. The lender-of-last resort facilities – both domestic and foreign (via the IMF) were clumsy, with tranching of urgently needed foreign funds and distracting conditionality, and both bank restructuring and private debt resolution were tardy[3]. It was not until the Korean crisis late in 1997 that an effective response to capital flight and private debt rescheduling was developed or rediscovered. For a useful account of the crisis (although less critical of the IMF than this author), see IMF Independent Evaluation Office (2003).

## II. The regional response

Here our focus will not be on the detail of what happened during the crisis, but on the longer term response to make the region less vulnerable. We will look at two aspects. First, what were the changes to the general policymaking paradigm (the "best practice" model, common to all the countries of the region). Secondly, how regional co-operative arrangements changed in response to the crisis.

### 1. The "consensus paradigm"

(a) Capital flows

Prior to the crisis, most of the affected countries were relatively open to capital flows, as is demonstrated by the large inflows that characterised the five years or so leading up to the crisis[4]. There can be little doubt that the full dangers of the capital flows were not fully appreciated before the crisis. While officials worried about the size of the flows (there were detailed discussions in EMEAP meetings in 1995 and at the BIS in 1996) and some academics noted the size of the foreign debt with concern (Radalet (1995)), it was not until *after* the crisis that there was a full recognition of the consequences of large capital reversals, including the negative balance sheet effect of the consequent large exchange rate depreciation. The oft-quoted analysis of "twin crises" – Kaminsky and Reinhart (1999) post-dates the crisis.

[3] On Indonesia, the IMF Independent Evaluation Office (2003) says: "The single greatest cause of the failure of the 1997 program was the lack of a comprehensive bank restructuring strategy."

[4] An interesting partial exception is Korea, where there were restrictions which encouraged short-term flows and discouraged equity flows, which in the light of experience, might be judged to be the wrong priorities, at least from a stability viewpoint. See Yoon-Je Cho and Robert N. McCauley, Liberalising the capital account without losing balance: lessons from Korea, in China's capital account liberalisation: international perspectives, *BIS Papers* 15, April 2003, pp 75-92.

Despite the central role of capital flow volatility in the crisis, the response was *not* to restrict flows. Malaysia imposed some outward capital controls, but these were eased within a year or so, and no other country attempted to control capital outflows, even during the most fraught part of the crisis[5]. Other countries copied Singapore's (successful) strategy of limiting the degree to which foreigners could borrow in the domestic market, thus making it more difficult for foreigners to "short" the currency. But no crisis country, for example, took the lesson that China had been protected by its capital controls. Remarkably enough, there was no general negative reaction to capital flows[6], but rather a more positive response on how better to use these flows, to make them safer, but at the same time implicitly *widening rather than narrowing* the opportunities for foreign capital. Table 1 shows that the total flows quickly recovered, with FDI continuing unabated throughout the period. The biggest change is in the addendum item to this table, showing the current account deficits of the pre-crisis period replaced by sustained current account surpluses.

Table 1: Private capital flows to Asia $US billion

| | 1990-97 | 1998-2003 | 2003 | 2004 | 2005 |
|---|---|---|---|---|---|
| TOTAL FLOWS | 55 | -1 | 64 | 120 | 54 |
| Direct investment | 36 | 58 | 68 | 60 | 72 |
| Portfolio investment | 15 | -5 | 4 | 4 | -31 |
| Other | 4 | -54 | -9 | 56 | 13 |
| [Current Account] | -10 | 104 | 166 | 184 | 241 |

Source: BIS Annual Report 2006

Nor was there a general attitude of reneging on the debt (c.f. Argentina), although much of it had to be rescheduled in various ways. While there was a general acknowledgement that "for every imprudent borrower there had been an imprudent lender", there were few arguments that this might justify writing off all or some of the debt[7].

[5] Although Korea limited foreign exchange sales and there was a "standstill" on bank debt while rescheduling was negotiated.

[6] Williamson (2005) shows that it would have been easy to blame the opening up of capital markets as the key, and those countries which were less open were less vulnerable. "These figurers suggest that countries with free markets were more, not less likely to get overwhelmed by the crisis".

[7] Of course there were some cases where the debtor claimed that the initial flow had faults which justified renegotiation of debts, especially in Indonesia.

It is interesting to speculate why this was so. As far as the possibility of reneging on the debt, the creditor pressure was clearly great, with the IMF acting as principal enforcer: to renege on debt would have put the IMF support funds at risk[8]. In some cases the debt was linked to further assistance (c.f. Japanese aid programs in Indonesia and debt resolution on large commercial projects which had Japanese involvement). In other cases the individual debtor took low-profile effective action to avoid paying by making the debt enforcement very difficult or impossible.

Whatever the reason, this difficult issue was finessed, and attention turned to the ways to continue to accept capital flows but to make them less volatile, and to find better ways of handling repayment failure in the future. In fact little progress was made on the latter. This leaves the issue to be resolved largely in terms of improving the domestic institutions (in the Douglass North (North (1990)) sense of rules. The response here might be seen in the other reforms discussed below: more flexibility ("floating") of exchange rates; improving the health of the banking system through better prudential supervision; deepening the financial sector; holding larger reserves; and changing the characteristics of the capital flow (particularly its currency denomination) to make the flows less volatile or their reversal less damaging.

With the new focus on the vulnerability of foreign capital flows, efforts were made to identify the characteristics that created vulnerability. The first was given the catchy title of "original sin" – that countries are inherently vulnerable if their overseas borrowing is denominated in foreign currency rather than their own (Eichengreen, Haussmann and Panizza (2006)). Others (notably Goldstein and Turner (2004)) have argued that the vulnerability comes from *currency mismatches* rather than the denomination of currency. It's not clear that either of these points has been incorporated in the post-crisis paradigm: own-currency borrowing has increased (see Battellino (2005)), but this may be an accident of capital flow composition rather than a conscious policy element.

A greater emphasis on equity flows would address the issue of "original sin". In the immediate aftermath of the crisis, equity flows replaced borrowing to some extent, as debt-for-equity swaps were used to resolve some debts. More fundamentally, Korea is an example of a country which eased earlier constraints on foreign capital ownership. Indonesia and Thailand, also, eased the constraints on foreign ownership in the banking sector.

[8] Although this would, at the same time, have reduced the need for support.

None of this has been put to the test under adverse conditions, largely because the post-crisis period has been characterised by current account *surpluses* in the region, and net capital flows from the emerging economies to the mature economies (see McCauley(2003)).

(b) Floating exchange rates

It is still a moot point whether the "fixed" exchange rates were an important part of the cause of the Asian crisis. Just as unclear is whether the current exchange rate regimes are significantly more flexible than the pre-crisis regimes. Certainly, there is a degree of flexibility (but so too was there before, especially if the focus is wider than the $US bilateral rate), but there has also been significant reserve build-up (for a discussion of this flexibility, see McCauley (2001)). Nor has the principle of the system yet been tested – will these countries be prepared to see their competitiveness seriously eroded by exchange rate appreciation? Despite the strong arguments by the Fund for "corner solutions" (either a rigidly immutable fixed rate or a completely free float – see Fischer (2001)), there still seems to be a high degree of "fear of floating" and the success of the Singaporean regime (but without using the exchange rate as an instrument of monetary policy) might be the implicit model for the crisis countries. This may not be very different from Williamson's (1999) BBC (basket, band, crawl) suggestion, but used on an individual country basis rather than as a common currency for East Asia. In both cases, there is exchange rate flexibility, with the intention and capacity for heavy intervention at times.

(c) Larger FX reserves

This has not been articulated as a conscious strategy, but is generally acknowledged as one of the responses to the crisis. With the perceived failure of the IMF to provide enough lender-of-last-resort funding, countries of the region have looked to become more self-reliant, either from their own resources or through reserve pooling arrangements (see regional response, below).

Table 2: Emerging Asia, FX reserves ($US billion)

| | 2000 | April 2006 |
|---|---|---|
| China | 166 | 875 |
| Other Asia | 529 | 1060 |

Source: BIS Annual Report 2006

Of course this is one of the factors in creating an unusual, unsustainable and undesirable flow of funds from the emerging countries running current account surpluses to the larges mature economy – the USA – running a very substantial deficit.

(d) Improving the banking system

This has always been accepted as desirable in its generality, even before the crisis: the issue is in the detail of implementation. The post-crisis paradigm seems to have the following elements:

- Stronger prudential supervision, with an articulated commitment to "prompt intervention" to resolve banking problems.
- Some plans and peer pressures to move towards a unitary supervisor (although implementation is lagging on many cases)[9].
- Explicit deposit insurance.
- Acknowledgement that State-owned banks (SoBs) are intrinsically vulnerable (not only to crisis, but to the inefficiency and compromised incentives with credit standards), but so far only modest progress in privatising the SoBs

Most observers see improvements in the banking systems since the crisis (see BIS (2006)). While the government still owns about the same percentage of the banking sector that it did before the crisis, the share in foreign ownership has increased, which probably makes the sector safer. But the current rankings by rating agencies demonstrate that there is still a long way to go in many of these countries.

[9] Among the developed-market economies of the region, Japan and Australia have unitary supervisors. Singapore has always had these functions within MAS. Among the crisis countries, Thailand and Indonesia are considering setting up stand-alone universal supervisors.

Table 3: Bank Strength Index

| Moody's Weighted Average Bank Financial Strength Index 1/ | | | |
|---|---|---|---|
| | Dec. 2002 | Dec. 2003 | Dec. 2004 |
| China | 10.0 | 10.0 | 10.0 |
| Hong Kong SAR | 62.3 | 62.3 | 62.3 |
| India | 27.5 | 27.5 | 24.2 |
| Indonesia | 3.0 | 3.0 | 7.3 |
| Korea | 16.7 | 18.3 | 18.3 |
| Malaysia | 31.7 | 33.3 | 35.2 |
| Philippines | 20.4 | 20.4 | 19.2 |
| Singapore | 74.7 | 74.7 | 74.7 |
| Thailand | 15.8 | 15.8 | 15.8 |

Source: Moody's Investor Service.
1/ Constructed according to a numerical scale assigned to Moody's weighted average bank ratings by country. "0" indicates the lowest posible average rating and "100" indicates the highest possible average rating.

Another common characteristic of the countries involved in the Asian crisis is that they universally protected the depositors of the banking system against loss. During the crisis many observers gave "moral hazard' a central role in the crisis (see, e.g. Dooley (1999) and McKinnon and Pill (1996)) and many others have implicitly or explicitly advocated this approach. The alternative is to avoid the moral hazard that comes from doing this by allowing the depositors to "take the hit", or at least undergo a substantial haircut. The current approach, in fact, often implicitly supports it: while the new or prospective deposit insurance schemes will protect the smallest depositors, larger depositors have very partial protection, and their funds typically make up around three-quarters of total deposits[10]. In evaluating these different strategies, we might note that the policy of bailing out the depositors, for all its expense and moral hazard, did create the possibility that the banking system could quickly return to its customary size and – more importantly – its role as principal financial intermediary. There are no examples of the counterfactual in Asia, but Argentina provides an example of the other approach, which has left a banking system in which bank credit is, today, 10 percent of GDP, in contrast to the typical figure of around 100 percent in Asia (with Thailand and Indonesia,

[10] Of course this is yet to be tested in practice – governments will always be able to bail out all depositors on an ad hoc basis, and non-protected depositors may be relying on this.

whose banking systems suffered most, still recording credit-to-GDP ratio of 80 percent and 40 percent respectively)[11].

(e) Deeper financial markets

Former Fed chairman Greenspan has talked of the need for a "spare tire" (Greenspan (1999)), with the notion that when the banking system came under pressure, there would be alternative sources of funding. There were implications for foreign funding as well: the heavy weight of bank finance meant that much of the foreign capital flow was short term. So there seemed to be a good case, across the whole region, for institutional development of equity and bond markets. Equity markets had some clearly desirable attributes. Investors tended to be more "sticky"; they "took the hit" directly in bad times and (in relation to foreign capital flow) equity had the advantage of being denominated in local currency, so a big fall in the exchange rate didn't cause balance sheet problems for the institution receiving the funds. But equity markets were relatively undeveloped in many of the countries (but not all: c.f. Malaysia, as well as Singapore and Hong Kong). Much the same can be said of bond markets: these were less developed than would be expected, given their stage of development (Battellino (2005)), with bonds providing only 20 percent of funding compared with banks 80 percent. As with equity, there was a belief that bond funding might be more long-term and "sticky" in the face of a crisis (although foreign bond holders can short their foreign-currency exposure). While the issues were common to most of the countries of the region and each country made some progress since the crisis in developing their domestic bond and equity markets, the most interesting initiative was a regional one: the efforts to develop the Asian Bond Market (examined in the regional response, below).

(f) Macro-policy

On macro-policy, the broad elements of the Washington Consensus still seem to be in place. The desirability of price stability has been reinforced by the wide-spread introduction of inflation targets. Fiscal policy is still in good shape, not much changed from the pre-crisis situation of balanced or near-balanced budgets. More controversially, without articulating this too openly, these countries still believe that export-led growth is a powerful dynamic element and that this is helped by a competitive exchange rate. This is less readily accepted by some

[11] This was not the only factor differentiating Argentina – the long inflation history isn't conducive to large bank deposits.

of the countries on the receiving end of these exports (particularly in relation to China). But it still seems like a viable strategy.

(g) Evaluation of the post-crisis paradigm

Many of these elements seem improvements which make the countries less vulnerable. More transparency and better governance are buzzwords which, if given operational content, might be important. Stronger prudential supervision is a more clearly defined element. Less clear is whether universal supervision and deposit insurance are positive steps. While the case for universal supervision may be strong in advanced financial sectors where full integration of banks with non-bank financial intermediaries is already a *fait accompli*, to the extent that some institutional separation and differentiation still seems possible in emerging financial markets, there seems a powerful case for maintaining this separation, at least for the moment (see Grenville (2006)). These institutions have very different risk profiles and management ethos, and the task of effective prudential supervision of the integrated entities is not only extremely complex (stretching bureaucracies which are far less well resourced than in mature financial markets), but it also spreads the implicit protection of supervision over the whole of the financial intermediation sector, rather than encouraging the idea of conscious and overt risk differentiation. The widespread introduction of explicit deposit insurance may also be a mistake, as these institutions are underfunded and under-resourced to handle systemic problems, and will add another level of bureaucratic delay should such systemic problems occur.

The exchange rate regime still represents "unfinished business". Table 3 suggests that, with the possible exception of Korea, exchange rates have been as stable as before the crisis (and the reserve build-up confirms this, even for Korea). There is a general acceptance that flexibility is desirable, but in practice the accepted model is closer to Williamson's BBC model or the Singapore float (with heavy management if the rate moves outside the comfort zone). This stands in opposition to the Fund-endorsed corner solutions[12], and the unresolved status of this debate seems to be a potential source for tensions and debate with the Fund. Meanwhile a very different (presumably much longer-term) debate concerns an Asian Currency Unit (see regional arrangements, below.)

[12] Some argue that the Fund advocates free float rather than corner solutions.

Table 3: Exchange rates (/USD)

| | 2000 | 2005 |
|---|---|---|
| Korea | 1265 | 1010 |
| Indonesia | 9675 | 9830 |
| Malaysia | 3.8 | 3.78 |
| Philippines | 50 | 53.1 |
| Thailand | 43.3 | 41 |
| China | 8.3 | 8.1 |

Source IMF GFSR April 2006

The debate on "original sin" and currency mismatch hasn't had much impact on the paradigm in practice, partly because it hasn't been refined to meet practical needs. There is still considerable room for disagreement with these concepts. While "original sin" is too simple, the currency mismatch measures seem to ignore the basic fact that if a country runs large current account deficits, one party (either the domestic borrower or the foreign lender) has currency exposure. While hedging can shift this exposure to another party, the overall macro exposure remains. It is, perhaps, unhelpful to the case that the strongest countries (Hong Kong and Singapore) have by far the most adverse mismatch ratios (see the ADB web-site quoted in footnote 15).What *does* seem to be important is to risk-proof the banks from balance sheet revaluation problems as far as possible, which would require prudential supervisors to limit banks provision of foreign-currency denominated loans and to monitor indirect exposures – lending to clients which have a large foreign-currency exposure.

## 2. Regional co-operative arrangements

Henning (2006) sees regionalism as "a defining feature of contemporary global politics and economics". Closer regional arrangements occurred in regions which didn't have a crisis, and would have happened anyway in East Asia. But there is little doubt that the Asian crisis provided a catalyst for regional financial arrangements and affected the particular nature of the regionalism that developed. At the same time, there is a consciousness that the regional arrangements that *did* exist at the time of the crisis were largely ineffectual, and indeed largely irrelevant to the crisis.

Four issues resulting from the crisis were taken up at a regional level: pooling foreign exchange reserves; a common currency; deeper financial markets (specifically, development of bond markets); and surveillance.

(a) Pooling reserves

This has been the main focus of regional attention. Even before the crisis there was a swap arrangement among ASEAN countries, but its amount was small and it was not used in the crisis (and hasn't been used since 1992). As well, there were FX repurchase arrangements under an EMEAP framework. Again, these were not used during the crisis (although there were bilateral swap arrangements done to supplement the Thai assistance package, and as "second-line" defence for Korea and Indonesia).

The Chiang Mai initiative – a series of bilateral currency swaps – is much more substantial in amount. Beyond a modest drawing, it involves IMF conditionality. This might be surprising, because one of the commonly held views in the region during the crisis (and still today) is that the Fund conditionality had been inappropriately applied. The risk of use of the funds would lie with the borrower (unlike some of the old EU arrangements, which attempted to spread the burden of defence of currency parities among the whole group[13]).

The broader issue here is the case for an Asian Monetary Fund. This was, of course, proposed in the early stages of the crisis by Japan, but received (perhaps unfortunately, with hindsight) no support from those countries which might have supplied funds. The initial lack of support reflected strong opposition from the Fund (hardly surprising) and the USA, and to a lesser extent China. It may seem curious that no similar proposal has emerged in the post-crisis period, given the widespread feeling in the region that the Fund did not perform well in the crisis, particularly in relation to Indonesia. All countries which received IMF support repaid just as quickly as they could, with an almost audible sigh of relief to be out from the Fund's strictures. Yet the closest substitute for the Fund as lender-of-last-resort – the CMI – has made Fund conditionality a central part of the arrangements.

(b) A common exchange rate

Again, there were pre-crisis precedents for this, with Japan encouraging the idea that the yen might become the anchor for the region, replacing the US dollar. These ideas didn't gain much momentum, as most countries recognised that the yen was not a logical anchor for those countries which still had substantial potential productivity gains as they moved to the technological frontier[14], and that the production/export mix in, say, Indonesia was

[13] But then the objective within the EMS was different – to keep the bilateral parities within the group, whereas Asia seems concerned to keep stability against the US dollar.
[14] So stability against the yen would imply too much inflation.

diametrically opposed to that in Japan (one a commodity producer, the other an industry-specialised exporter), so the "optimal currency area" case for a common currency, (whether based on an existing currency such as the yen or a common currency basket) was never convincing (de Brouwer (2001). But for a counter-argument, see Williamson (2001).

The crisis brought new interest in this debate: if the crisis had come about because domestic currencies were vulnerable to speculation and changes of sentiment, could this be avoided by having a unified currency? The success of the Euro may have lent weight to this, although the Euro and its "snake" antecedents had a different motivation – to maintain parity among the members, while the East Asian countries are more interested in keeping stability *vis-à-vis* major world currencies. But in practice the economic case against a unified currency (i.e. the non-applicability of the optimal currency area arguments) remains powerful: whatever likelihood there is that countries would become more alike over time if they were linked by a common currency is outweighed by the prospect of very different productivity performances over the medium term. The current debate seems to have narrowed to the possibility of an agreed currency basket becoming a *benchmark for analysis*, currently under consideration at the Asian Development Bank.

(c) Developing the regional financial infrastructure

Such was the enthusiasm for fostering bond markets, that three separate regional institutions have done substantial work in this field – APEC, ASEAN+3 and EMEAP. There is some division of labour, with APEC promoting securitisation and credit guarantee markets, ASEAN+3 encouraging the issuance of local currency bonds by international institutions, and EMEAP working at the operational level, facilitating the creation of two bond funds – one comprising US dollar instruments and the other holding a mix of local currency bonds (see Stevens (2005))[15]. This has led to other forms of regional co-operation – for example an Association of Credit Rating Agencies in Asia has been formed. These initiatives, taken together, seem a very valuable step in the longer term, particularly to facilitate, through joint endeavor, the development of the complex institutions that surround bonds markets. If these markets are to grow in importance and attract foreign funding, they will require extensive infrastructure, including well developed accounting, legal and regulatory systems, payments and trading platforms, derivative markets, settlements systems, ratings agencies, and networks of brokers to sell bonds. The importance and urgency of the task is emphasised by the huge need for infrastructure finance.

[15] The ADB has a comprehensive web-site on these activities: www.asianbondsonline.adb.org ). See also EMEAP Working Group (2006).

Having come into the crisis with small bond markets, these are now substantial by comparison with Latin America and Eastern Europe (see Battellino (2005)). Bond issuance is now around 50 percent of the GDP of the relevant countries and particularly large in Malaysia, Hong Kong, Singapore and Taiwan. It would have to be said, however, that a good proportion of the issuance of new government debt in the three crisis countries was to recapitalise failed banking systems, and that much of the private bond issuance is illiquid: the *sine qua non* of a deep and liquid market – reliable commercial information – is still scarce in a number of these countries.

(d) Surveillance

Once again this pre-dates the crisis, and surveillance is on the agenda in ASEAN and APEC, as well as the IMF. There is so much overlap that one group set up specifically for this purpose – the Manila Framework Group – has been wound up.

The case for active and meaningful surveillance is strong. The peer pressure it brings can be a powerful dynamic encouraging reform; the need for co-operation and even co-ordination rises as integration becomes deeper; and donors will be looking to surveillance to ensure effective use of funds. But surveillance is only a powerful instrument for reform if it is used in a frank way and countries feel really pressured by it for operational change. So far the discussions have been too subtle, polite and oblique (too "Javanese", some would say) to be of much effect.

## III. The global response

It would have to be observed that the Asian Crisis impinged rather lightly on the world stage[16]. To paraphrase a comment made in an earlier era, it was seen by many as "a small problem in a distant region about which we know little" and described by the American President as "a few glitches in the road". This is not to argue that there were no changes to global infrastructure in the years after the crisis, but rather to suggest that many of these changes (particularly to governance) were motivated by other crises closer to home in the USA, such as LTCM and the clutch of commercial crises – Tyco, WorldCom and Enron. There was considerable progress in building an internationally consistent infrastructure to strength financial systems – especially through the Bank for International Settlements (with the Basle Committee introducing hugely complex changes to bank supervision rules, whose

[16] As evidence of this, we might compare the response to the Mexican crisis (with nearly $50 billion of funding made available) with Thailand three years later.

implementation is still pending) and the creation of the Financial Stability Forum (which has specified 12 international standards and codes for strengthening financial systems). But it is hard to see much direct connection between these developments and the Asian crisis.

There is, however, one global institution whose formation can be associated directly with the Asian crisis – the G20. This is potentially quite a significant grouping, bringing together the finance ministers and central bank governors of around 20 countries which account for two-thirds of world GDP. Its representation is wider that G7 (which reflects the power shares of the immediate WWII period) and yet is of manageable size and gives proper representation to emerging countries, including those in Asia. It provides a discussion forum far superior to the IMF, and one which holds out more hope of developing consensus on IMF governance reform than the IMF's own circumlocutory discussion. But it is a work in progress, which can only succeed if its members use it to carry out functions which are currently inadequately performed elsewhere (e.g. in the IMF).

Among the possible responses which did *not* occur is effective international policy co-ordination. There can be no doubt that the very low interest rates in Japan in the five years before the crisis was a factor in the flood of capital into the region, or that the large changes in major exchange rates (with the yen moving from 80/dollar to 148/dollar in 1995-7) played a role in the reassessments. But, ten years after the crisis, with huge international current account imbalances, the major nations show no interest in structured discussions, preferring to find single-cause explanations (mainly blaming the Chinese exchange rate) for complex problems. The IMF is currently attempting to establish a forum for discussion, but its efforts so far have been ineffectual.

So this leaves the main centre of interest the IMF: what responses can be identified there? The search might be subdivided into: its governance; its methods of operation; and, perhaps most interesting and important, its own "mindset", which we will call the Fund paradigm.

(a) Governance

At the time of the crisis the countries of the region were under-represented in the Fund (in quota access to assistance and in representation on the Executive Board), and that remains the case (see Parkinson and McKissack (2003) and Truman (2006)). Although the problem was

identified decades ago, it has proven incapable of resolution, and the crisis did not alter this[17]. Did it matter? Probably not much. The assistance which the Fund provided was only loosely related to the theoretical quotas. Fund commitments tended to rise during the crisis and have gone on rising further in more recent Latin American cases (most notably Uruguay, where the assistance was 12 percent of GDP). In short, IMF governance was not much affected by the crisis, but it probably doesn't matter. The region continues to be low-profile in the Fund debates, apparently by its own choice and the extra quotas given to China and Korea in September 2006 seem unlikely to change this much. Asia is a central element in the current issues on international imbalances, yet has articulated no regional view nor taken part in the debate (with the exception, of course, of China).

(b) Adequacy of Fund lending resources

Were the Fund's resources adequate, and if not, has this changed? If Bagehot provides the crisis criterion ("lend freely…') and Mexico the model, then the resources available in East Asia were manifestly inadequate. One measure of this is that supplementary and "second line" bilateral resources were needed (and, most clearly in the case of Indonesia, these were perceived by the market to be inadequate). Whether or not the current position is the same given the likely demands on the Fund is a matter for debate, but we could simply record that the Fund's overall lending resources are largely unchanged.

In the light of the experience with the Asian crisis, will these funds be disbursed differently? If experience with subsequent borrowers is any indication, the amounts will be substantially larger. Argentina received $22 billion and Brazil $35 billion in 2001-2, compared with Thailand's $4 billion in 1997. Uruguay (1999-2000) received IMF loans amounting to 12 percent of GDP, compared with Thailand's 2 percent[18]. There is likely to be less conditionality, and what there is will be focussed on macro issues rather than micro structural matters. But more radical plans (e.g., for a Contingent Credit Line, available for ready drawing by pre-qualified countries) did not become operational.

(c) Fund operations

As a direct result of the Asian Crisis, the Fund identified lack of transparency and inadequate institutions (including rules and regulations) as key causes of the crisis. While much of the

[17] Some marginal progress (with the promise of more to follow) may come out of the Singapore Annual Meeting of the Fund.
[18] For all these figures, see Goldstein (2005) Table 12.2.

response to these issues was in the hands of the countries themselves, the Fund (with the World Bank) has made real and tangible progress in both these areas using a variety of international codes and standards to put pressure on countries to raise their game. The Special Data Dissemination Standard (SDDS), Reports on Observance of Standards and Codes (ROSCs) and Financial Sector Assessment Program (FSAPs) have not only increased transparency (their principal goal), but peer pressure and the setting of "best practice" operational and regulatory rules seems to be exerting considerable pressure for improvement. These extra data seem to be feeding effectively into assessments of credit risk and, we can hope, investment decisions (see Cady and Pellechio (2006)). But it is worth noting that neither Indonesia nor Thailand have actually undergone FSAPs yet (although both are planning to do so).

Again coming from the Asian crisis experience, the Fund has put much store in transparency, particularly on matters such as net foreign exchange reserve position (c.f. Thailand in 1997). It's hard to argue against this in principle, but from time to time the Fund demonstrates, in its own actions, how uncomfortable full transparency can be – after all, confidential "side letters" were a standard part of the Fund's own operating procedures during the crisis.

It is hard to separate the Fund's efforts on transparency from the organic increase in available information which is part of technology and increasing globalisation. But there is little doubt that the volume of information available for monitoring these economies has increased substantially and that the standard of monitoring (e.g. from the credit rating agencies) is hugely improved. This has yet to be put to the test – during the crisis it was the dramatic revisions of ratings that suggested that earlier ratings had been grossly inadequate. There is still room for surprises (and sharp downward re-ratings, made tardily), but the volume of information and the effort put into understanding it have changed greatly.

It is difficult to asses just how the Fund would handle a repeat of the Asian crisis. Larger amounts of assistance, quicker restructuring of banks, perhaps a readiness to contemplate foreign loan rescheduling and more focussed (and reduced) conditionality would all seem to be likely elements, and we might look to the Brazil program of 2002 as the model.

### (d) Fund paradigm

How much did the Fund respond by modifying its own implicit model of how the world works? While the Fund has been reluctant to admit error on its part, some shifts in thinking can be identified. These don't involve the broad macro framework, so (like the countries of

the region) the Fund saw no need to depart from the tenets of the broadly defined Washington Consensus. There was a subtle shift in the endorsement of the market-based approach, to acknowledge more explicitly that markets require a complex set of rules and institutions, and that it might take time for these to reach maturity in emerging countries.

The emphasis was on the micro foundations of the financial sector, with particular emphasis on prudential supervision (not just of the banking sector, but the whole of the financial sector). Of course the Fund had been interested in this area before the crisis, and the changed view could not be immediately put into practice – in fact one of the beneficial responses was a greater recognition of just how long it takes to build institutions in general, and prudential expertise and experience in particular.

Given the central role of capital flows in the crisis, it is appropriate that this is the element of the Fund paradigm which has changed the most. The pre-crisis view was summarised by the IMF's Independent Evaluation Office this way: "The IMF's analysis prior to the mid 1990s tended to emphasise the benefits to developing countries of greater access to international capital flows and to pay comparatively less attention to the potential risks of capital flow volatility (IEO (2005) p3). "In the early 1990s, the IMF's multilateral surveillance work generally considered any measure that would promote capital flow to developing countries to be a favourable development" (IEO (2005) p29). To the extent that there was awareness of the risks, this was not operationalised: "Lacking the operational content, such talk of risks failed to mitigate the impact of the clear voice emanating from the IMF advocating capital account liberalisation (IEO (2005) p 29). The Mexican crisis of 1994 (identified by the Fund's Managing Director as the "first crisis of the 21st century") did not change this view, although it was the first in which capital reversals were the central element (see IEO p 34). But the Asian crisis did shift the Fund's view (see IEO (2005) p 35).

It is perhaps ironic that the high point of the Fund's enthusiasm for taking on the task of enforcing capital flow freedom came at the Hong Kong Annual Meeting in September 1997, when the Asian crisis was at its height. Before this time, the Fund saw the desirability of opening up capital markets in much the same way that it viewed trade liberalisation, and worked to introduce this presumption into the Articles of Agreement[19]. The IMF would "be endowed with a new purpose: to promote the liberalisation of capital flows… and the elimination of restriction on capital account transactions. …Second, the Fund was to assume jurisdiction over restrictions in the capital account" (IEO p19). Proposed amendments to the

[19] While there may have been warnings about vulnerabilities, there was a strong positive flavour; "Paradoxically, increased openness and greater integration may reduce vulnerability…: (IEO p25).

Articles would have given the Fund the presumption that free capital flows were the norm (one typical wording of the change was in terms of "Members shall not, without the approval of the Fund, impose restrictions of the making of payments and transfers for capital international transactions"). While this might seem to have been driven by the commercial interests of the largest shareholder, Abdelal (2006) quotes Larry Summers as saying "For the Fund it was less about sound economic policy and more about Fund turf". Whether or not these amendments would have passed in the absence of the Asian crisis is a moot point: with the crisis, it was clear that they would not and the effort was dropped. Abdelal's judgment on the Fund's actual performance is: "My reading of the evidence is that the Fund deserved much, but not all, of the criticism it received for embracing capital account liberalisation as a matter of doctrine". (p193)

In describing the change of view, there are three aspects worth separating: whether capital flows represent vulnerabilities; whether capital controls might be justified (either on inflows or outflows); and the role of the Fund in assisting creditor repayment and the resolution of debt.

First, the vulnerabilities are now clearly recognised, with the main response in terms of institutional strengthening and transparency (discussed above). "Following the East Asian crisis, however, "sequencing" emerged as an operational concept in the IMF's approach to capital account liberalisation." (IEO p22)[20]. The tone of commentary changed, to acknowledge the "feast or famine" dynamics in emerging debt markets and "boom and bust pattern and volatility of capital flows". At the same time the Fund "began to pay greater attention to the linkage between industrial country developments and their capital flow and risk implications for emerging market economies…how an underestimation of risks by international investors and low interest rates in industrial countries had contributed to large capital flows to emerging market economies. …. The 1998 WEO suggested that it would be wrong to attribute financial crises exclusively to policy shortcomings in the crisis countries" (IEO p25). This line of thinking was not operationalised in any way, even though the Executive Board "pointed to the need to improve regulatory oversight, on the supply side, of the highly-leveraged activities of financial institutions" (IEO p25). At the same time the Fund's contribution to the debate on this topic in the Financial Stability Forum was to broadly endorse the role of the hedge funds (see IMF (1998)). The problems were left with emerging countries to handle as best they could through institutional improvement, and through a floating exchange rate which would buffer this volatility.

[20] "Sequencing" involved specific measures of institution-building rather than the issues of ordering which had been central to the earlier academic debate.

Second, the Fund softened its attitude towards market-based controls on inflows (characterised as the Chilean taxes), but even here there was an implication that serious countries did not resort to such devices (see IEO quotes on p28) There was no attitudinal shift on capital outflow controls (c.f. the Fund's opposition to the limits which Thailand put on foreigners' baht borrowing (IEO p45-46): and Malaysia, see IEO p 28-29, p45-46), except when these were part of a standstill to facilitate rescheduling. It might seem surprising, given the key success of the Korean bank debt standstill at the end of 1997 that such measures did not become part of the Fund's standard toolkit, but forces worked to make sure this was seen as an aberration.

Third, in reflecting the creditor interests, the Fund has shifted little, with no recognition of the need for a generalised and ongoing framework for resolving private debt repayment failure (analogous to domestic bankruptcy rules). The nearest the Fund came to addressing these issues was to explore the possibility of a Sovereign Debt Restructuring Mechanism and Collective Action Clauses, but neither of these possibilities found favour with influential Fund members[21]. It is hard, even now, to distinguish between the Fund's position on these issues and that of the Institute for International Finance – the bankers' lobby group in New York. The interesting issue (yet to be fully played out) is how these attitudes will be modified in the face of Argentina's unilateral debt restructuring in 2002.

This evolution in thinking on capital flows still has some distance to go. Certainly, the rhetoric on the vulnerabilities that attend large capital flows and the inherent instabilities in financial markets has shifted noticeably. The influential papers by the current and previous Heads of the Fund's Research Department – Prasad, Rogoff *et al* (2004) and Rajan (2005) embody a very different tone about financial markets, with scepticism about the efficiency of these markets and recognition that even in the most sophisticated financial markets, risks are being mis-assessed and that this may have systemic threats[22]. There is even a recognition (in

[21] Although more contracts are now following the English model, which includes CACs.

[22] The point can be illustrated with specific quotes.

"International financial integration should, in principle, also help countries to reduce macroeconomic volatility. The available evidence suggests that developing countries have not fully attained this potential benefit. Indeed, the process of capital account liberalization appears to have been accompanied in some cases by increased vulnerability to crises. Globalization has heightened these risks since cross-country financial linkages amplify the effects of various shocks and transmit them more quickly across national borders." Prasard, Rogoff et al (2004)).

"The evidence presented in this paper suggests that financial integration should be approached cautiously, with good institutions and macroeconomic frameworks viewed as important. The review of the available evidence does not, however, provide a clear road map for the optimal pace and sequencing of integration. For instance, there is an unresolved tension between having good institutions in place before undertaking capital market liberalization and the notion that such liberalization can

Rajan (2006)) that the old "transfer problem" is still an issue – when countries receive substantial capital inflow, their exchange rates will rise to facilitate the real transfer (during the crisis overvalued exchange rates was put forward as one of the problems, without recognising that this was part and parcel of the capital flow issue. Whether this change of view at the analytical level in the Fund will be effectively operationalised remains to be seen.

## IV. Conclusion

How much has changed? The list of responses that *didn't* occur is quite significant:

- Trade restrictions were not imposed
- Capital restrictions were minor and quickly removed
- Debts were, at a general level, honoured
- The broad tenets of the Washington Consensus (notably its reliance on markets) were maintained
- Banking systems were supported and restructured, rather than being allowed to fail.
- The IMF remains as the principal international crisis manager.
- There is still no co-ordination of international economic policymaking

Of course there *were* changes during the past ten years, but it is tricky to know how much to attribute to the Asian crisis *per se*. As usual with history, the events in Asia were part of a larger picture. We noted, for example, how opinion changed during the 1990s on capital flows, recognising that, desirable as they are, they create vulnerabilities. These concerns were known before the Asian crisis (notably articulated by Diaz-Alesandro (1985) in "Goodbye Financial Regulation, Hello Financial Crisis"), and the role of capital reversal in the Mexican

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itself help import best practices and provide an impetus to improve domestic institutions". Prasad, Rogoff et al.

"There is little evidence that financial integration has helped developing countries to better stabilize fluctuations in consumption growth, notwithstanding the theoretically large benefits that could accrue to developing countries in this respect. In fact, new evidence presented in this paper suggests that low to moderate levels of financial integration may have made some countries subject to even greater volatility of consumption relative to that of output."

Rajan (2006 ) looks at how disintermediation, complex financial markets and risk-sharing have altered the potential for low-probability-high-cost crises, particularly in the emerging countries: "What is clear is that we are a long way from knowing all the answers on how to reduce the risks of financial instability. We have to steer between the Scylla of excessive intervention and the Charybdis of a belief that the market will always get it right."

This reappraisal is by no means confined to the Fund. At the BIS Bill White (2005), in particular, has drawn attention to the macro-prudential risks and the dangers that these will fall between the cracks of the regulatory overview.

crisis of 1994 was clearly identified. Following hard on the Asian crisis were the financial problems in the most sophisticated and developed market – in terms of Enron, WorldCom, Tyco and LTCM (the latter is particularly interesting, because it was seen as justifying official intervention, at least to organise the rescue). All these events, outside Asia, had their influence in shifting the financial markets paradigm in general, and had implications for how the events in Asia are now viewed.

The clearest example of a change in the paradigm was in relation to capital flows. But the wider market paradigm also shifted, if more subtly. The Asian crisis may have coincided with the high point of the belief that markets can sort out most problems, and the Asian crisis might have been one factor (among the others, mentioned above) in the partial retreat from the more dogmatic and proselytising versions of market efficiency. That said, the response is to make markets work better, not replace them with (e.g.) more government intervention. The general idea that markets can and should play a central role in efficient resource allocation remains widely accepted. As part of this process of reconciling the events in Asia with the earlier view that crises were caused by poor policymaking, a new ("third generation") crisis explanation was invented – the "self-fulfilling" crisis, with multiple equilibria.

Do crises help reform? For those who saw crisis as the catalyst for reform (c.f. Mancur Olson (1971)), the lesson might be that a modest crisis (Korea) leaves more reformist legacy than a major crisis (Indonesia). A deep crisis (as in Indonesia) is so disruptive that institutions – both good and bad – are swept away equally, and the task of rebuilding more or less from scratch is formidable (see Hill (2006), this conference).

We might conclude with a question. If the old paradigm is still largely in place, and the main lesson from the crisis is "try harder on implementation and institution-building", will progress on these difficult and time-consuming responses be swift and thorough enough to avoid a recurrence?

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