I. Introduction: distinguishing symptoms from causes

It is understandable that the recent Asian crisis has attracted enormous attention. Although some difficulties had been foreseen, the suddenness with which the crisis began, the relentless process of contagion across countries and the magnitude of the collapse in exchange rates and asset prices were all unexpected and unprecedented in recent times. And the shock was all the greater in view of the emerging consensus that Asia was the model for the future. Nor is it totally clear that the worst is over. While financial markets have stabilised somewhat, the full impact on domestic companies and the institutions that have lent to them remains to be seen, as do the full social costs. The domestic sources of the crisis are, with hindsight, all too obvious. They might and should have been avoided. Excessive credit growth and associated over-expansion of the capital stock, inadequately supervised banking systems, asset price bubbles and excessively rigid exchange rate regimes played roles of varying importance in all of the countries affected. Nevertheless, it would be a mistake to conclude that all the difficulties could have been easily avoided if only domestic policies had been somehow better. These events have occurred against a backdrop of international macroeconomic imbalances which contributed materially to developments in Asia and may yet have further manifestations.

An important external influence has been the divergence of the cyclical positions of the major industrial countries, which has lasted much longer than anticipated. Strong domestic demand in the United States has contrasted sharply with stagnant and falling domestic spending in Germany and Japan respectively (see Chapter II). In large part, the recent strength of the dollar against the Deutsche mark and the yen could be seen as simply a normal reflection of these cyclical divergences. Yet such divergences are themselves the result of unusual domestic circumstances. In the United States, unexpectedly weak domestic inflation has allowed the upswing to continue with only the mildest response from monetary policy. In Japan, continuing headwinds arising from difficulties within the financial sector have contributed to unprecedentedly low interest rates and a marked expansion of liquidity in the banking system. And in a number of European countries, rates have also remained near historically low levels.

Against this background, it is not surprising that capital inflows into other parts of Asia surged, with associated upward pressures on real exchange rates and growing trade deficits (see Chapter III). The strong rebound of the dollar from its 1995 lows, together with the strong competitive position of a resurgent China, exacerbated such pressures given the policy decision by many Asian countries to link their currencies to the dollar. In the end, markets responded by forcing large nominal depreciations, which were then compounded as domestic weaknesses became increasingly evident. In some respects, this process seems reminiscent of the ERM crises of the early 1990s when cyclical divergences, between a US economy facing difficulties in the financial sector and a Germany embarking upon reunification, led to currencies linked to the strengthening Deutsche mark being attacked one after the other.

At the same time as the cyclical positions of the major industrial countries have diverged, measured inflation has tended to converge at a relatively low level. In part this is because exchange rate movements have acted to shift demand away from countries facing stronger inflationary pressures to those with higher levels of excess capacity. However, this convergence also reflects deeper forces: in particular, a more resolute policy commitment to low inflation (discussed in Chapter IV), fiscal restraint in Europe and North America, the greater contestability of markets that are increasingly integrated internationally, and the cumulative effects of heavy investment in computer-based technologies and related industries. The Asian crisis, and its impact on world prices for electronic products, oil and other commodities, will reinforce these disinflationary trends even if the crisis spreads no further.

Whatever the source of these disinflationary pressures, financial markets worldwide have reacted to them, the Asian crisis apart, extremely favourably. Even the Asian crisis, which did precipitate a generalised flight to quality late last year, has more recently been viewed as having beneficial disinflationary side-effects for some industrial countries. Accordingly, prime-quality bond rates declined through much of last year, and particularly sharply in the first few months of 1998. Credit risk spreads, which also narrowed during 1997, widened as the Asian crisis unfolded but by April 1998 had reversed a large part of the increase. Indeed, international capital has again begun to flow back into a number of the countries that succeeded in rebuffing speculative attacks at the time of the Asian turmoil. And finally, after a setback in October, stock markets in most industrial countries recovered briskly to record levels (see Chapter V), indicating that the effects of lower inflation and interest rates still outweighed any investor concerns about potential risk exposure or a possible slowing of earnings growth in the future.

Part of this financial optimism rests on a certain set of beliefs which may or may not prove justified: that a "new era" of productivity and profit growth can already be discerned in recent US economic statistics; that a wave of restructuring in Europe will lead to the same result; and that rates of return in many emerging economies will continue to be high enough to compensate for associated risks. However, the strong price performance of financial assets may also reflect some underlying and potentially more worrisome developments. The first is a marked expansion in global liquidity, manifest in the recent acceleration of monetary growth in many countries and the atypically low level of interest rates referred to above. The second is the effects of ongoing change in the pattern of international financial intermediation. The financial services industry has clearly entered a period of sharply increased competition and some banks may have been tempted to engage in unusually risky business in an attempt to offset declining rates of return on intermediation. A related consideration is the continued growth in the size and international presence of non-bank institutional investors such as insurance companies, pension funds, mutual funds and the like.

The downward trend of nominal interest rates on high-quality assets may have predisposed both the owners and the managers of such funds to seek to maintain yields without adequate regard to the increased risks involved.

The Asian crisis, like the Mexican and Nordic crises before it, has underlined again the complementarity between macroeconomic stability and financial stability. Alone, neither is sufficient. Moreover, temporising with either greatly increases the risks of undermining the other as well, threatening potentially large multiplicative effects. It is true that the policy commitment to both fiscal restraint and price stability has received growing public support over the last two decades. Such objectives are now the norm in most industrial countries and are increasingly being accepted in developing economies as well. Yet a recognition of the need to strengthen banking and financial systems has emerged only more recently, and indeed still seems to be subject to strong political resistance in some countries, reflecting both nationalist sentiments and entrenched interests.

Over the last few years, the various committees of national experts which are supported by the BIS have focused increasing attention on issues having implications for the stability of the international financial system. In recognition of the globalisation of financial markets, representatives of emerging markets are playing a role of growing importance in bodies recommending international standards and practices. While implementation will certainly be made easier if those affected also have a part in drawing up the rules, no one should be under any illusions as to the magnitude of the problems still to be faced and the potential difficulties along the way. If the Asian crisis has given impetus to bringing forward these necessary initiatives for financial reform worldwide, then its heavy costs will have had at least one important offsetting benefit.

Contagion processes and policy responses

After the initial depreciation of the Thai baht in July 1997, a wave of speculative pressure engulfed a host of currencies and countries in the region. Again with hindsight, a dynamic of this kind should not have been unexpected once some trigger had set the process in motion. Many of the countries affected had a similar mix of exports to that of other countries in the region (see Chapters III and VI), and their prices (especially for electronic products) had recently been weakening. This implied a significant vulnerability to competitive depreciation. Many had recently received large inflows of short-term foreign capital. Moreover, many of these countries were suspected to have weak financial institutions, even if an almost universal lack of transparency made firm conclusions impossible.

In such an uncertain environment, it was all too easy for investors to lose confidence in the Asian region as a whole, and this tendency was reinforced by inadequate policy responses to the crises in those countries which were hardest hit (see Chapter VII). A particularly important factor was the large exposure of domestic residents to short-term foreign currency liabilities, perhaps to be expected after a decade of currency stability, and their increasingly frantic attempts to hedge their positions as the spreading crisis made losses look more probable. In the end, with even trade credit drying up in some cases, the events took on the character of a liquidity crisis or "bank run" of classic dimensions.

Broadly speaking, the severity of the damage done to date by higher interest rates and lower exchange rates has reflected the strength or weakness of the underlying fundamentals, in particular the relative strength of domestic banking systems. Indonesia has suffered the most and Singapore, Taiwan and Hong Kong the least. In the last case, the authorities managed to preserve the currency board link with the US dollar, albeit at the expense of sharply higher interest rates for some time and lower asset prices. The Hong Kong authorities, and many others, were aided materially by the repeated statements by the Chinese authorities that the renminbi would not be devalued. Such a development would have added a further vicious twist to the process of contagion both within and outside the region.

As it was, other parts of the world were already being affected to varying degrees. In Eastern Europe, the Czech koruna had to be devalued and an austerity package imposed around the time of the Thai crisis. The Russian rouble was also subject to speculation, and was successfully defended only through brutally high interest rates. The Brazilian currency and stock market also came under heavy pressure in the autumn of 1997, but recovered in response to sharp fiscal and monetary tightening. And many other countries, including Poland, Greece, Estonia and South Africa, experienced similar strains at one time or another. Subsequently, markets in Asia seemed to regain some stability; exchange rates strengthened in some cases and interest rates generally came down somewhat in consequence. It is, of course, too early to conclude that the crisis is over, particularly for countries with weak financial systems or whose real exchange rates have risen sharply in recent years.

The industrial countries have thus far been affected less by these events than some initially feared. In part this is because exports from Asia have not yet responded to lower exchange rates, but it must also be due to lower commodity prices and increased spending associated with the generally easier conditions prevailing in world financial markets over the last year or so. An important and worrying exception may be Japan, whose considerable domestic problems are already being exacerbated by the difficulties elsewhere in Asia and are contributing to them in turn.

After a promising start to 1997, Japanese domestic demand fell steeply following the sharp tightening of fiscal policy in April. Consumer and business confidence has been further eroded by a series of shocks: rising unemployment and fears of prospective industrial restructuring, the Asian crisis and a resulting decline in exports to the region, and the fragile state of the Japanese financial system. Credit rationing, particularly for smaller enterprises which commonly have no alternative source of funds, is already hampering the economy and the substantial exposure of Japanese banks to doubtful Asian debtors can only amplify such effects. The Japanese authorities have responded with two more stimulative economic packages, supplementing many other such efforts. However, in view of the earlier consensus on the national need to save more to deal with demographic pressures, and the temporary nature of the tax cuts made so far, the ultimate effects on spending remain to be seen. Liquidity in the banking system has also been increased in response to widening credit premia, particularly for Japanese financial institutions. After many years of delay, due to public antipathy to the use of public funds to support the financial sector, the authorities have finally begun to address this fundamental problem. In March 1998, ¥13 trillion was committed to the recapitalisation of banks and another ¥17 trillion to improving the deposit insurance system. The efficacy of the first of these measures remains unclear in that it is not yet known how "good" and "bad" banks are to be distinguished and how the latter are to be dealt with definitively.

In continental Europe, the repercussions of the Asian crisis are appreciably more difficult to identify. While a significant proportion of external European trade is done with Asia, export orders have not yet begun clearly to falter and effects related to foreign direct investment (Asian into Europe and European into Asia) thus far seem small. The fact that the exposure of European banks to Asia is almost as great as that of Japanese banks could be a source of concern, although this is somewhat mitigated by the better health of the former. Yet this shock does come at an inauspicious time for some countries at least. There may still be a lingering degree of vulnerability in France, although domestic demand has recently begun to replace exports as the primary source of growth. In Germany, there are still few signs of a similar process beginning, even though unemployment in the western part of the country has fallen more than had been predicted. Moreover, throughout Europe there has been persistent and significant fiscal tightening associated, in part at least, with efforts to meet the Maastricht criteria. And uncertainties about other government policies – the planned 35-hour working week in France and Italy, and social security and tax reform in Germany – continue to play a role.

Nevertheless, as the acceleration of growth during 1997 in continental Europe attests, there have also been some powerful forces for continued expansion. Not only have longer-term interest rates declined and stock markets risen, but European currencies have weakened against those of countries further ahead in the economic cycle. Indeed, as financial markets became increasingly convinced that the euro would be introduced on time and in a broad group of countries, the effect of convergence on asset prices in peripheral countries was little short of phenomenal. In some of these countries, the primary concern now is excessively easy financial conditions and the potential for more generalised inflationary pressures. Paradoxically, the Asian crisis may have served to heighten such fears if the Bundesbank's decision to eschew further monetary tightening was due, in part at least, to concerns about how these Asian developments might affect a still sluggish German economy.

The macroeconomic implications of the Asian crisis, both for the United States and for the United Kingdom, could on balance be interpreted as not unwelcome, especially given the more limited exposure of their domestic banks to affected countries. In both economies, strong growth of domestic demand has pushed output to, and potentially beyond, levels previously thought incompatible with non-accelerating inflation. To date there have been fewer than expected overt signs of inflation, perhaps owing partly to productivity increases, but some easing of external demand in the wake of the Asian crisis could be considered as insurance against such an eventuality. It is also the case in both economies that the rise in the external value of their currencies has played a significant role in keeping down measured inflation. Safe-haven considerations, linked to both

Asian and euro-related developments, may have given further impetus to these currency movements.

One implication of the associated good inflation performance is that interest rates in the United States, and to a lesser extent the United Kingdom, have been kept lower than would otherwise have been possible. A latent complication, however, is that widening trade deficits may eventually feed back to the exchange rate, implying that disinflationary gains from this source would also have to be surrendered. Indeed, the first indications of this might be seen when the dollar and pound sterling simply cease to rise. A further problem is that unusually low interest rates may help drive asset prices to levels which could prove unsustainable should inflationary pressures and interest rates eventually move upwards. Should either eventuality occur, even only with long lags, it would confirm what common sense would seem to suggest: the final effects of the Asian crisis will prove deleterious to all the parties involved, even if more harmful to some than to others. The obvious conclusion is that efforts directed to crisis prevention must continue to be a high priority for the public sector and the private sector alike.

Crisis prevention and crisis management

The fact that financial and exchange rate crises have continued to occur, and indeed have become more frequent in the 1990s, clearly indicates that preventive measures to date have been inadequate. Nevertheless, a great deal of work has been undertaken in recent years and considerable progress has been made in some areas. The Group of Seven summit communiqués from Halifax, Lyon and Denver gave significant impetus to such work, as have the documents issued after the Birmingham Summit.

If preventive action is to be taken to head off a crisis, market participants and regulatory authorities must first have adequate access to information likely to be useful in predicting such a crisis. Over the past year, an increasing number of countries have committed themselves to the IMF's Special Data Dissemination Standard. Moreover, agreement has already been reached on a number of useful changes (among them, broader country coverage, allocation according to ultimate risk and quarterly frequency) to the BIS semi-annual data recording the maturity, sectoral and nationality distribution of international bank lending. At the same time, it must be recognised that better information is a necessary, but in itself not sufficient, condition to prevent crisis. What is also needed is the vision to imagine crises and the will to act pre-emptively. The Asian experience makes this very clear. In spite of the ready availability of BIS data showing the increasing vulnerability of some of these countries to a sudden withdrawal of short-term international bank loans, the volume of these loans simply kept on rising (see Chapter VIII). Other evident problems, such as growing current account deficits and declining rates of return on investments, were similarly ignored. This illustrates that the use made of information is every bit as important as its mere availability.

A number of initiatives have already been taken to help prevent crises by strengthening financial systems, at both the national and the international level. A report on financial fragility in emerging markets, prepared jointly by representatives of emerging markets and the Group of Ten countries, set out a strategy for formulating sound principles and practices in this regard. Further, the report, which has been broadly endorsed by over 50 countries, made specific recommendations as to how the strategy might be implemented with the help of the international financial institutions and other bodies. Consistent with this, the Core Principles for Effective Banking Supervision, drawn up by the Basle Committee on Banking Supervision in conjunction with supervisors from a number of non-G-10 countries, were presented at the World Bank/IMF meetings in Hong Kong. The Core Principles have received wide acceptance from the international financial community and the Basle Committee is now working to promote effective implementation with the help of these two institutions among others. With a similar objective of strengthening the international financial system, the Committee on Payment and Settlement Systems and the Euro-currency Standing Committee, both of which meet at the BIS, published studies and recommendations covering a wide range of topics. These included foreign exchange settlement risk, settlement arrangements for securities and derivatives, market liquidity in times of stress and the Year 2000 problem among many others. The broad scope of these initiatives underlines the complexity of the issues being addressed, as well as the magnitude of the effort that will be required to reduce significantly current vulnerabilities in the international financial system.

The international community, led by the International Monetary Fund, sought to stabilise the situation in Asia with successively larger packages of liquidity support. These were combined not only with traditional demand-side conditionality and financial reform, but also with supply-side measures to support longer-term growth. In some cases, efforts were also made to encourage foreign banks to roll over or restructure the maturing liabilities of Asian borrowers. While some have questioned the appropriateness of certain of these policy initiatives, as well as the way in which they were to be implemented, the complexity and even novelty of the task being undertaken by the Fund should not be underestimated. Many of the countries affected did indeed have relatively sound fiscal policies but their exposure to a deterioration in market confidence on other grounds was nevertheless exceptionally great. Moreover, this was the first crisis in the postwar period featuring the combination of banks as the principal international creditors and private sector entities as the principal debtors. The principles of how to manage and resolve a crisis of this sort were not known in advance and, indeed, are still under discussion. In this area, as with crisis prevention, it will take some years before all the lessons have been understood and probably longer before they have all been accepted and applied. With this caveat clearly in mind, the Conclusion of this Annual Report nevertheless turns to some of the possible policy prescriptions suggested by the many surprising events of the period under review.