Prasarn Trairatvorakul: Post-crisis recovery – Asian lessons for Europe

Speech by Dr Prasarn Trairatvorakul, Governor of the Bank of Thailand, at the OMFIF Golden Series Lecture, London, 12 September 2012.

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Distinguished guests,

Ladies and Gentlemen,

I am honored and delighted to be part of the Golden Series Lecture and would like to thank OMFIF for the kind invitation. Events such as these provide an opportunity for us to exchange views on topical issues that are at the center of international finance and I am keen to learn from the perspective of our audience.

Fifteen years ago the Asian crisis forced us to go through painful adjustments and far reaching economic and financial reforms. We had to embrace legal, regulatory and governance reforms, while our business sector had to deleverage and our bankers became much more prudent and risk conscious. Today, the world is witnessing another crisis not dissimilar to ours and I have been asked to share with you some lessons from the Asian financial crisis. This is somewhat ironic as we in Asia look to Europe as a role model and a benchmark in our integration efforts. Individually we are all small states and find it difficult to compete for foreign investment without the attraction of size and economy of scale. So my talk today will be a modest contribution to the current debate on the challenge of post crisis recovery.

I will start with a brief recap of the Asian crisis, drawing some lessons and comparison with the European debt crisis. I would briefly discuss the economic setting and policy reform that brought Asia out of the crisis and end with some thoughts and reflections on the post crisis recovery period.

Ladies and gentlemen,

As a well-known American author, Mark Twain puts it, “history doesn’t repeat itself, but it does rhyme”. So despite the differences in the context and details of both the Asian and the European crises, the underlying root causes are not dissimilar.

First, both crises, like most others in the recent economic history of the world, are often associated with the mispricing of risk and distorted incentives structures.

In the case of Asia, our problem was both a currency and a banking crisis. We had to abandon the pegged exchange rate system which led to massive devaluation of our currency. With the corporate sector largely overleveraged and loaded with foreign debt, the sharp depreciation of the currency technically bankrupted firms overnight. Banks NPLs shot up and brought on with it the banking crisis. It was clear that the region’s “original sin” was well beyond redemption. We borrowed in foreign currencies and used it to finance projects that did not generate foreign exchange earning to service such a debt.

In the case of Thailand, the amount of private external debt was over three times the level of international reserves. Given the healthy public finances in Thailand (with 9 years of fiscal surplus prior to 1997), the expanding foreign private sector debt was interpreted as a sign of euphoria and confidence in the emergence of a new tiger of Asia.

In Europe, a similar story of mispricing occurred when some peripheral nations were able to access financing at a much cheaper rate than the country’s underlying credit rating would have allowed them to do so - and this was made possible out of sheer membership of the Euro zone. A single currency and a convergence in risk rating, like our fixed exchange rate, gave the market a false sense of security that encouraged borrowing beyond our means and without proper risk management.

Second, both crises occurred as a result of a failure to fulfill the necessary "pre-conditions". In Asia, they were preconditions for liberalization, and in Europe they were preconditions for integration.

A number of Asian countries embarked on ambitious liberalization programs with insufficient safeguards, appropriate infrastructure and policy tools. Liberalizing capital flows while still maintaining a fixed exchange rate system eventually ran up against the impossible trinity. The country must give up control over monetary policy. Recourse to macroprudential policies to stem the excessive bank credit expansion and asset price inflation, was not well-known then.

Along the same line, the currency union proceeded without the necessary preconditions for integration. Countries entered the union with large diversities both in terms of economic development and competitiveness, and in the absence of fiscal, and banking union.

On the whole, these countries were victims of their own success. The "reckless optimism" prior to both episodes of crisis had ultimately led the countries to face similar consequences of severe market stress and capital flight, albeit with different symptoms: for Asia, losses incurred in the private sector's balance sheet, for Europe, public sector balance sheet was impaired.

Ladies and gentlemen,

Let's now look at how Asia got out of the crisis and whether such conditions are available for Europe.

At the onset of the Asian crisis, Indonesia, Korea, and Thailand built up large private short term external debt while high private credit growth fueled the bubble in the stock and property markets. Once the crisis hit, these countries faced sharp capital reversal of up to 10% and 12.5%[1] of GDP in 1998 for Korea and Thailand respectively and a massive devaluation of the currency soon followed. Some of us were forced to seek international assistance (IMF) or, in the case of Malaysia[2], to undertake rigorous self-reform and an eventual unorthodox measure on exchange and capital flows.

Notwithstanding the different approaches, these steps were all painful yet critical for economic recovery. By 1998, the current account balance of the four countries became positive, helping to improve the national account and restore consumer confidence. GDP growth subsequently returned to positive territory by the second quarter of 1999.

Two differences stand out between Asia and Europe.

The first is policy flexibility. The devaluation of the exchange rate helped restore export competitiveness of the Asian economies. However, this freedom of flexibility might not be practical for Europe given its single currency setting and political complexities.

The second is the supportive global economy, which provided the necessary market for Asia and allowed Asia to export our way out of the crisis. Global GDP registered a 4.7% growth in 2000 with advanced economies, the world's largest consumer, growing at 4.1%. In contrast, the global setting of the current European sovereign debt crisis is not

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1 BOT's staff computation from CEIC data.

2 Malaysia's policy mix started out with an initial fiscal and monetary tightening, a conventional IMF-like measure, followed by a reversed loosening of macroeconomic policies. The insufficiency of these policies to restore confidence led the country to resort to exchange and capital control which yielded positive result.

as favorable. Global and advanced economies growth turned to a negative territory of 0.6% and 3.4% respectively in 2009. Emerging and developing economies, increasingly feeling the pinch of the global slowdown, witnessed the continued slowdown of their GDP growth from 8.7% in 2007 to just 2.8% in 2009.

I believe that there may be other success factors for the European story. But, we have to bear in mind that some of the success factors are not without costs that remain to be addressed. In the case of Asia, the sharp devaluation and swift recovery in exports led the Asian economies to become addicted to large volume of export at low prices. And, in the case of Thailand, with little incentive to invest in research and development to raise the products' value and enhance human capital, the average growth of labor productivity[3] had trended down from the 1990s to 2000s.

Ladies and gentlemen,

This brings me to my third part on the lessons from the Asian financial crisis. I would like to offer three reflections that may not necessarily pertain to Europe but may provide food for thought for policymakers.

First, conventional policy prescriptions may not be appropriate for unusual circumstances and there is no one-size-fits-all solution. Asia was a case in point of ill-timed austerity measures. Public sector debt in Thailand then was less than 15% of GDP; yet the policy prescription for Thailand was to tighten fiscal policy and maintain tight monetary policy, resulting in (interbank) interest rate rising from 10% at the beginning of 1997 to over 20% at the end of 1997. With large private external debt beyond the ability of the country to service, a way out should have been debt restructuring with international creditors to give the country a breathing space and avoid the painful shock from the sharp reversal in capital. This was made possible only in the case of Korea which has helped the country recover from the crisis and was able to bring down interest rate much faster than other crisis countries.

The case of Indonesia further led the IMF to reform towards more careful and focused policy prescription. The abrupt close-down of Indonesian commercial banks under the IMF program added to a sense of panic, which led to a broad-based bank run. Moreover, the conditionalities did not focus on the more critical macroeconomic adjustments which were directly related to the problems of the crisis but also included unrelated changes such as requirement to abolish import restrictions on all new and used ships.

Secondly, policymakers must be ready to take away the punch bowl. In the past we used to talk about monetary policy being on the alert to take away the punch bowl. This crisis has proven that public policy in general need to observe this principle as well. Fiscal policy must guard against falling into the populist trap. Financial supervisors also need to be vigilant and watch out for signs of excessive credit creation, and act pre-emptively for the cost of cleaning up the crisis far outweigh the brief euphoria and exuberance of the moment. Central bank must maintain independence and credibility in order to voice and conduct appropriate policies that may not be favored politically. Going forward, I view that there is a need for international institution that oversees all finance-related conducts to ensure strict compliance of rule, implementation of ethical codes and avoid double standard across nations.

Lastly, continuous and collective reforms are vital. Crisis is a recurring phenomenon and no lessons from previous crisis will ever fully prevent the next one. But through the process of reform after each crisis, the market grows and becomes more efficient. Crises provide a window or "political feasibility" to undertake needed structural changes that

3 International Labor Organization (ILO).

may be hard to sell to the public in normal circumstances, so one should not waste a good crisis. I am pleased to see numerous improvements in key areas of finance and supervision such as the use of macroprudential measures to complement traditional monetary policy tools. It is also more acceptable to require banks to provision in good times against losses in bad times, for after all most bad loans are made in good times.

In addition to structural reforms, change in "mindset" is probably the most important. In order to keep up with the dynamic global environment, we may need to challenge and correct some of our old beliefs. Let me name a few – 1) sovereign is no longer risk-free, 2) we are taught to value economies of scale but are now confronted with the too-big-to-exist problem and 3) banks should no longer be only international in life but also in death as crises are more and more systemic given the growing interconnectedness. Spillover and contagion were witnessed in 1997 where the turbulence spread from Thailand to South East Asia and to Russia, China and Brazil, as it was a decade later in 2007 where the crisis widened from US and EU to the rest of the world. Imagine the pace of the spread of crisis in the next 10 years in 2017 – where crises would grow in size and speed beyond the management capacity of a single nation, real collective action is called for.

Most importantly, we have to be forward-looking and well prepared. As crises are prone to occur more frequently with larger spillover, reform must be continued during normal times. It is imperative that the public is on board and support the reform effort to raise the competitiveness of the country, and minimize vulnerabilities or imbalances that may be triggered by external factors through no fault of their own.

Ladies and gentlemen,

Let me conclude by offering an observation that in 2002, five years after 1997 crisis, Asian economies had fully recovered, in particular, Thailand was able to repay the IMF package some two years ahead of the schedule. Today, four years after the Lehman crisis, more work remains ahead of us. At this critical juncture, it might come down to policy action, which entails clarity, commitment and credibility, to progress onwards.

Indeed, there are always benefits from looking back to the do's and don'ts in the rear mirror but it is of greater importance to be looking forward in the windshield. As such, for Asia and other non- crisis country, in this era of growing uncertainties, complacency is a luxury we can ill afford.

Thank you.