Mr Stals talks about the international economic environment

Address by the Governor of the South African Reserve Bank, Dr Chris Stals, at the Convention of the Institute of Life and Pension Advisers (ILPA) in Johannesburg on April 12, 1999.

1. The international financial crises of 1997/98

The past eighteen months witnessed disrupting turbulences in world financial markets that led to the collapse in financial structures in many countries, and to a serious decline in economic growth in the world at large.

A chronic weakness in the Japanese economy over a prolonged period of time should perhaps be regarded as the major cause of the financial crisis, which is generally linked to the collapse of the economies of a number of countries in East Asia. These included Thailand, Korea, the Philippines, Indonesia and Malaysia -- countries that managed their economies with great success for many years. What went wrong in these countries is now part of history, and some consensus has been found on an ex post basis of the reasons for the collapse in the economies of what used to be referred to as the East Asian Tigers. In general, the following can be offered as a summary of mistakes that were made in the economic management of the afflicted countries:

* Governments failed to react timeously to overheating economies. This was manifested in unsustainable high levels of economic growth, inflated property and share prices, as well as large deficits on the current account of the balance of payments.

* Prolonged pegging of currencies to the United States dollar at unsustainable levels, making monetary policy less effective and making the exchange value of domestic currency appear to be guaranteed. This encouraged huge external borrowing, leading to excessive exposure to foreign exchange risks for borrowers in the public and in the private sectors.

* Insufficient supervision of financial institutions and poor enforcement of prudential rules, reinforced by cronyism.

* Lack of sufficient and accurate data to enable market players to make a correct assessment of economic fundamentals.

* In the situation, international investors under-estimated risks as they searched for higher income yields. In particular, investors failed to grasp inevitable links between market (liquidity) risks and credit risks.

* The expanding world financial market and lax controls over multi-national financial institutions encouraged excessive leveraging based on a relatively small capital base for hedge funds and certain banking institutions.

* A herd-like reaction by international investors, once the bubble burst, that led to an almost panic-withdrawal of funds from economies that could not in a short period of time absorb the shock of the turnaround in the sentiment of international investors.

The adverse developments in East Asia almost immediately affected emerging markets all around the world. Initially, that is from the middle of 1997 up to the second quarter of 1998, most of the other emerging markets succeeded in keeping afloat and there was still a chance to keep the crisis restricted to the East Asian region. The situation was exacerbated, however, by the complete collapse of the situation in Indonesia, and by the early signs of an emerging second crisis in

Russia. The effective devaluation of the rouble and unilateral restructuring announced by Russia in August 1998, triggered a further series of sharp market corrections, indicating a generalised increase in perceived risk or risk aversion.

A third threat to a major collapse of the global financial system came towards the end of last year with the deterioration of the financial situation in Brazil, mainly because of chronic fiscal imbalances and large-scale speculative attacks on what markets perceived to be an overvalued currency.

In general, the immediate effect of a loss of confidence of investors in any specific economy was reflected in a decline in the inflow of foreign capital or, in many cases, a large withdrawal by non-residents of previously invested funds from the country.

The widespread flight to quality and liquidity gave rise to a severe tightening of credit conditions in the affected countries: equity prices fell sharply; yields on bonds rose to extremely high levels, followed by soaring interest rates in general, and exchange market pressures intensified as exchange rates went in an uncontrollable tumble. As a by-product of these developments, many international investors and banks suffered substantial losses, especially on highly leveraged investment positions.

Gradually, the worsening conditions in the financial markets also affected real economic activity. The International Monetary Fund (IMF) revised its outlook for world economic growth in 1998, first from 3 to 2½ per cent (in August 1998), and then to 2 per cent (in October 1998). For 1999, the projection was similarly reduced from 3¾ per cent to 2¼ per cent at this stage.

2. The contagion effect of the financial crisis

A special feature of the financial crisis of the past two years has been the contagion effect, or the spill-over of the economic problems of a few important emerging market economies to other countries, and eventually to the world economy.

The transmission mechanism, or the conduit followed in the contagion process, was not the same for all countries. Initially, with countries in East Asia, perceptions played an important part in the process. Once the Thai baht came under pressure in the middle of 1997, it did not take long before international investors discovered many similarities in the economies of Korea, the Philippines, Indonesia and Malaysia.

The serious collapse of the Russian financial system, and particularly the action taken by the Russian Government in the unilateral restructuring of its sovereign debt, gave rise to an indiscriminatory withdrawal of funds previously invested in sovereign debt of other emerging market governments. It was also noted at the time that the IMF, the World Bank, and Governments of other countries were rather reluctant to provide the massive amount of assistance needed for propping up the Russian balance of payments problem. The following quotation from a recent IMF publication summarises the Russian events of mid-1998:

"More important was the role of Russia's default as a defining event that challenged widely held views about the default risks associated with all emerging market investments, and the willingness and ability of the international community to provide assistance to countries in difficulty."

(World Economic Outlook and International Capital Markets, December 1998)

The flight to high quality assets and, at a later stage, a major "de-leveraging" process of multinational investment institutions, reduced international capital flows in general, and therefore provided a second conduit for contagion. It is estimated at this stage that net private capital flows from the industrial countries to the developing and emerging markets, including countries in central and Eastern Europe "in transition", declined from US $118 billion in 1997 to $70 billion in 1998. In the case of the Asian countries, it changed from an $100 billion net inflow in 1996 to an $18 billion outflow in 1998.

A third obvious conduit for the transfer of the economic ills of the East Asian economies to other countries, and particularly countries with vulnerable balance of payments positions, is the deterioration of current account positions caused by the generally depressed world economic environment. The negative effects of this development are only now beginning to filter through to some of the poorer, developing countries in the world that do not have developed financial markets but are nevertheless dependent on the exports of basic commodities, metals and minerals. Examples in Southern Africa can be found in Botswana (diamonds), and Zambia (copper).

Finally, the weakening or full collapse of the banking systems in a number of the afflicted economies has had a major impact on the global banking sector. Not even financial institutions in the major industrial countries have been immune to this problem. The near-collapse of the Long Term Capital Management Fund in New York towards the end of September 1998, provided a stern warning to the world that the East Asian crisis had indeed become a worldwide financial problem. Quick action by the American Federal Reserve and the major New York banks prevented serious problems for other financial institutions, including many multinational banking institutions with similar over-leveraged positions.

3. Policy reactions to the global financial crisis

The initial "fire-fighting" reactions of countries in the midst of the crisis obviously differed from country to country. Led by initiatives from the IMF, however, a relatively standard policy procedure was adopted that required of countries, firstly, to adjust important macroeconomic fundamentals to new levels as dictated by market forces; secondly, to restore some stability to financial markets, and thirdly, to introduce structural and other remedial adjustments that will regain the confidence of international investors.

In the process, the countries directly afflicted by the crisis had to accept:

* a sharp depreciation in the external value of their currencies;
* a substantial tightening of liquidity conditions in domestic financial markets;
* a tightening in fiscal policy, mainly through significant reductions in government expenditure.

In some countries, inflation also increased to higher levels and necessitated even more restrictive monetary policies.

These developments obviously depressed real economic growth, and led to increased unemployment in the affected economies. It is estimated, for example, that the rate of economic growth in the ASEAN Countries (Indonesia, Malaysia, Philippines and Thailand) changed from positive growth of more than 7 per cent in 1996, to negative "growth" of more than 10 per cent in 1998.

In the case of two important countries also afflicted by the crisis, a different approach was followed with macroeconomic policies to address the problem. In the case of Malaysia, the Government preferred a route of self-protection by the reintroduction of exchange controls on international capital flows. The wisdom of this policy was severely criticised at the time, but history will eventually provide a final verdict on the issue. There is general belief, however, that international investors will in future be much more reluctant to invest again in Malaysia than, for example, in the other East Asian countries that were more prepared to bite the bullet with extremely painful and costly macroeconomic adjustment processes.

The second country to follow a different route, Russia, perhaps had no alternative but to introduce an almost complete moratorium on the repayment of its foreign debt. Private market investors have more or less written off their Russian exposures as a complete loss. It will take major adjustments before these bitten investors will ever return to Russia.

4. Promising signs of a reversal in the financial markets

It would seem as if the global financial crisis reached a lower turning point in about October last year and, although still very fragile, there are encouraging signs of a return of greater stability in the global financial markets. In retrospect, the demise of the Long Term Capital Management Fund of New York at that time may have triggered the required concerted international action, also from the major industrial countries, to help restoring a measure of calm to financial markets. Actions taken since October 1998 included:

* The easing of interest rates by central banks in most industrial countries, including the United States, United Kingdom, and the newly-established European Central Bank.

* In Japan, new policy measures to address banking sector problems and announcements of further fiscal actions to stimulate demand. The Japanese Government indeed provided ¥60 trillion (about US $500 billion) to restructure the banking sector.

* Commitments and actions by Brazil to address its chronic fiscal imbalances, and the large-scale support of the international community, agreed in mid-November, for a strong programme of assistance that would forestall a financial crisis in that country.

* Continued progress with stabilisation and reform in the Asian crisis countries implementing policy programmes supported by the IMF. With current account balances having moved into surplus and financial market confidence having begun to recover, the strengthening of exchange rates has allowed monetary policy to be eased, which in turn has helped to boost equity markets.

* Recent increases in IMF quotas and other measures taken to replenish the funds of the IMF improved the international community’s ability to assist countries in the resolution of financial crises.

It would seem as if the first objective of macro-economic policy has therefore been achieved in the major crisis centres (with the exception of Russia). Some stability has now been restored in the financial markets. The attention of the world debate has now been shifted, firstly, to what is needed and prudent to re-stimulate the world economy and, secondly, what structural adjustments to national and global economic structures will be necessary to avoid a recurrence of the East Asian crisis and its contagion effects in future.

5. The lessons learned from the experience of the past two years

The analyses of the reasons for the financial markets' disaster of 1997/98 are still continuing and the dissection of the major casualties is continuing. Some consensus may be developing, however, that both at the macroeconomic and at the microeconomic level, important adjustments are necessary to strengthen the fibre of financial systems and markets in order to meet the challenges of the irreversible process of globalisation. These structural adjustments must include:

* An improvement and standardisation of accepted institutional arrangements covering aspects of property protection, bankruptcy procedures and accounting standards.

* Bank and other financial institution supervision and regulation must be upgraded, and new standards of adequate risk management must be introduced.

* The architecture, role and policies of the multilateral institutions such as the World Bank and the IMF, not only on an ex post basis but also in the prevention of a crisis, must be reviewed.

* Policy makers must follow sound and credible economic and financial policies. The experience in a number of countries, for example, warned against a policy of excessive short-term borrowing by governments and by countries to finance chronic fiscal or balance of payments deficits. Credibility comes from monetary policies aimed at achieving price stability. Macro-economic policies that are judged by investors to be responsible are those that allow free markets to work with undue intervention from governmental authorities.

* The international exchange rate regime of floating exchange rates and its contribution to the increasing volatility of the global financial markets has come under the spotlight.

* The need for greater transparency at the level of multinational institutions, governments and public sector institutions and, very importantly, also from private sector participants in global markets has been identified.

* The ability of countries to attract long-term foreign capital, e.g. direct foreign investment, should be improved. This once again leads to the conclusion that exchange controls and/or excessive protectionist policies should be avoided by developing and emerging market countries that want to remain competitive in the global market environment.

6. Prospects for the world economy

Although there are still a number of downside risks in the global economy, there is growing optimism that some recovery will take place in most of the more seriously affected economies of the East Asian crisis. The main priorities in these countries are now to end the decline of economic activity, limit the adverse impact of the crisis on the welfare of the most vulnerable members of the community, promote the resumption of sustainable growth, and accelerating the restructuring of financial and corporate sectors. In Korea, Thailand, and more recently, Indonesia and the Philippines, the tightening of monetary policies that occurred in the wake of the crises has achieved considerable success in re-establishing financial stability. A strengthening of exchange rates has indeed allowed interest rates to be lowered significantly.

In Brazil, a determined and sustained implementation of a front-loaded fiscal adjustment effort, accompanied by appropriately tight monetary policies and wide-ranging structural reforms is making an essential contribution to sustaining the improvement in global financial market sentiment.

Russia continues to lack macroeconomic policies that would help to restore the confidence of investors and establish the preconditions for sustainable growth. Once again, however, the financial markets of the world have marginalised the Russian situation, and seems to have discounted it as, for the time being, a lost cause.

In Japan, the critical challenge for the authorities remains to find a quick and forceful restructuring, including a recapitalisation, that will restore the financial health and profitability of the banking system. It remains a problem to re-stimulate demand in the highly saving-conscious community of Japan.

For the other industrial countries, although there have been widespread downward revisions to growth projections for 1999, the outlook in most cases is still fairly good. Continuing low inflation provides scope for monetary easing, if warranted, to support demand and out-put growth, and also to help stabilise financial markets.

There is, therefore, cautious optimism in general that the painful macroeconomic adjustments of the past year have succeeded in restoring financial stability in most parts of the world, and that a basis has been laid now for some recovery in real economic activity in the depressed economies that suffered most from the East Asian crisis of the past two years.

Note:

Information used in this presentation has been taken mainly from: World Economic Outlook and International Capital Markets - Interim Assessment, December 1998; published by the International Monetary Fund.