IX. Conclusion: identifying risks and preventive measures

In spite of the traumatic events in Asia, the economic prospects for the rest of the world are still thought to look generally positive. The long-running expansion of the economies of the United States and the United Kingdom is projected to continue. European economic and monetary union is to be introduced on schedule with a broad membership, amid emerging signs of strengthening growth and confidence. Not only have serious contagion effects thus far been avoided elsewhere outside the Asian region, but some have argued that the worst may be over in Asia itself given that financial markets there have stabilised to some degree. In most of the industrial countries, asset markets have reached record highs, accompanied by an extraordinary flurry of mergers and acquisitions and associated financing. At a more fundamental level, the events in Asia have even been interpreted positively by some as a confirmation of the dominance of the market-driven model of economic growth that has become increasingly fashionable since the 1970s.

Like fashion, however, economic circumstances can change quite quickly and all economic projections and judgements should be approached with a proper sense of humility. One good reason for this, illustrated clearly by the Asian crisis, is that the economic and financial world is a highly uncertain place in which perceptions of liquidity risk, market risk and credit risk can interact to produce multiplicative effects and unpredictable outcomes. And if economic developments have social and political ramifications, the results can be more uncertain still. A second reason for humility is that success seems all too frequently to contain within it the seeds of failure. Over-optimism, in a word, has commonly affected the judgement of markets and policy-makers alike.

Mexico, for example, was widely praised and rewarded by the markets in the early 1990s for its deregulation and fiscal austerity, as were many Asian countries (including Japan) for their very high rates of saving and investment. However, these countries were nevertheless subjected subsequently to very rapid shifts in market sentiment. In Mexico it was realised that deregulation, particularly in the financial sector, had led to a consumption boom and an unsustainable current account position. In the case of a number of Asian countries, the markets came to understand that high savings were not an unmitigated advantage if they were associated with unprofitable investments that were likely to depress asset prices for years.

In both these cases, and many others, the process of boom and bust seemed to follow a very similar dynamic. Good domestic "fundamentals" were followed by spending excesses fuelled by domestic credit. In such an environment, profit opportunities first attracted the attention of more thoughtful foreign lenders, whose activities in turn attracted the money of the less thoughtful. Structural

change in financial systems worldwide gave further impetus to these developments. Domestic deregulation in emerging markets frequently made credit more easily available, while heightened competitive pressures in industrial countries led many financial institutions to turn to new markets in the confident expectation of compensating for shrinking rates of return at home. In the end, the unwinding of this excessive optimism on the part of both borrowers and lenders was sudden, brutal and costly for all concerned.

Over-optimism of a related sort can also affect policy decisions. Whether in emerging or industrial economies, it is always difficult to change policies incrementally so as to avoid crises, and it is even more difficult when the public is strongly of the view that economic prospects remain excellent. Even the broad success of policy-makers in reducing consumer price inflation may have attendant dangers if this success inadvertently encourages the development of asset price bubbles, while at the same time reducing the policy scope to resist them. When nominal and even real interest rates decline as inflationary pressures recede, investors may well search for higher returns elsewhere. Unfortunately, whether in domestic equities or in foreign investments, higher returns come only with commensurately higher risks.

Policy-makers who focus primarily on traditional measures of inflation commonly argue that higher asset prices can generally be ignored, unless their effects on consumer price inflation can be confirmed. While true, this argument should also be complemented by concern about the effects on the health of financial systems if intermediated credit is being used to fuel an asset price bubble which will subsequently burst. The policy-makers' hard choice in such a situation may then be to raise interest rates to resist the bubble, and undershoot inflation targets a little, or to desist and eventually undershoot them a lot. This may be a particular risk if, as the Japanese experience seems to bear out, reflating the economy may prove especially difficult at low rates of inflation that leave little room for reductions in real interest rates. While the increase in property prices which has accompanied the rise in securities markets in most western industrial countries has been nowhere near as great as that seen in Asia, the recent acceleration of monetary growth in the industrial countries nonetheless merits attention.

Obviously, the intended message here is not that economic growth, deregulation and low inflation should be avoided because they might have attendant risks. Rather, three more sensible conclusions seem warranted. The first is that, by better understanding the dynamics of macroeconomic processes, we may be able to head off problems before they become too disruptive. The second is that market liberalisation must be pursued vigorously but prudently. And the third is that efforts must be made to strengthen the health of financial systems everywhere to ensure resilience in the face of the larger shocks likely to be faced in freer markets.

Macroeconomic perspectives and policy lessons

The prolonged divergence in the cyclical positions of the major industrial countries has given rise to certain tensions. In particular, the relative strength of

demand in the United States (and also in the United Kingdom) has led to sharp currency appreciation and an associated deterioration of the current account balance. This has been matched by growing surpluses in Japan and continental Europe. Moreover, forecasts by the IMF and the OECD indicate that the United States will provide most of the offset to the anticipated improvement in Asian trade deficits, pushing the current account deficit as a proportion of GDP to near-record levels.

The dangers in this are twofold. The first is that the markets will lose patience with the accumulation of US external debt and drive the dollar sharply lower. Such a movement would reverse the beneficial and significant disinflationary effects of the appreciating dollar and raise further the probability of monetary tightening in the face of emerging capacity constraints in the United States. Were this to happen, an associated reduction in asset prices might also be expected, with substantial knock-on effects on US consumer spending and confidence given the increased importance of financial assets in household portfolios. The second danger inherent in the strong dollar is the possibility of a resort to protectionist policies in the United States. While the robust economy has kept such sentiments below the surface, a marked slowing of growth could easily change this situation.

Any threat to continuing, non-inflationary growth in the United States might also have broader implications. While the recent strengthening of demand in Europe could make those economies more resilient to an appreciation of their currencies, the same cannot be said for Japan. Moreover, a general rise in interest rates, whether initiated in the United States or in Europe, might provide the incentive for a further withdrawal of funds from emerging market economies as well as an overdue reassessment of credit risk in all markets. It is not clear what the full implications of this latter possibility would be in a world where the growth of international interbank deposits increased almost fourfold to over $700 billion last year, and where international securities issues have recently hit all-time record highs.

It should be clear that this is a scenario rather than a forecast. A forecast would rightly be more benign with respect to the US current account problem, pointing out that the ratio of net external debt to GDP, while rising, remains low (and debt service lower still) and that, for the moment, the dollar's unrivalled position as the world reserve currency will help protect its value. But it is through identifying risks that attention is directed to the policies that might avoid them. In principle, this would seem to come down to encouraging more demand in slower-growing industrial economies and the opposite elsewhere. Yet there are obstacles in many countries to the practical implementation of such policies. Relying on fiscal policy to stimulate demand, for example, might in some countries conflict with medium-term goals for fiscal consolidation, while relying on monetary easing would run the risk of further fuelling asset prices.

In the emerging economies of Asia, prompt, and above all politically committed, responses to the prescriptions of the International Monetary Fund would do more to revive growth prospects than anything else in countries where such commitment is still lacking. This would help restore confidence, allowing interest rates to decline and exchange rates to rise from excessively low levels.

As the burden of both domestic and external debt service became more bearable, credit spreads would be expected to narrow and the availability of foreign credit to increase again. Clearly, the likelihood of securing such political commitment would rise if the scope of the Fund's recommendations were to narrow towards the re-establishment of financial stability and traditional measures required to ensure balance-of-payments equilibrium.

A further necessary step towards the reliquification of many of the Asian economies would be an early, transparent and politically neutral restructuring of domestic banking systems. While there has not thus far been credit rationing on the scale seen in Mexico, except in Indonesia, the potential for such an outcome elsewhere in Asia must be reduced. While some might argue that restructuring will itself contribute to credit rationing, history would seem to teach just the opposite. Closing the weakest banks and definitively recapitalising the others need not cause problems, although it is admittedly a delicate task. Rather, credit rationing arises most frequently when the authorities allow uncertainty about the good health of the banks to continue, particularly when this interacts with the banks' own uncertainty about the soundness of their customers. Finally, it must be recognised that optimal policies cannot be counted on in the first place and will take time to work in any event. Assuming an interim and perhaps prolonged period of slow growth, the World Bank and others have been quite right to emphasise the need to cushion the plight of the poorest who are bearing the heaviest burden of the Asian crisis.

Rekindling growth in Japan will not be easy after almost a decade of temporising with underlying problems which bear some similarity to those which have only recently emerged elsewhere in Asia. In the meantime, consumer confidence and the financial situation of both the corporate and banking sectors have greatly deteriorated. Indeed, the Japanese experience ought to be an object lesson in the need for decisive action to re-establish stability quickly after a bubble bursts. Nevertheless, it is still not too late to restructure the banking system, broadly as suggested above, and to stimulate the economy further through permanent tax cuts directed at those thought most likely to spend the extra income in the current environment. This is all the more necessary since monetary easing seems increasingly constrained by a sharp rise in domestic liquidity preference (partially related to concerns about the health of banks) and by fears that a lower yen will aggravate trade tensions with the United States. This latter concern may well be inappropriate, in that the US current account deficit is essentially the home-grown product of a fully employed economy and a relatively low national saving rate, but it seems nonetheless to be a political reality.

One recent development, related to the Asian crisis, will help support demand in Japan and many other countries. The recent fall in oil and other commodity prices amounts to a positive terms-of-trade shock for all the larger industrial countries, and many emerging economies as well, helping to raise disposable incomes. Moreover, it will contribute to reducing the absolute US trade deficit even if it further increases the Japanese and European surpluses. The downside to this development is that the costs will be borne by a limited number of countries, particularly the main oil exporters, which may not find it easy to adjust. In both Mexico and Russia, oil exports still account for about one-third

of all government revenues, and fiscal restraint will thus imply sharp decreases in government expenditures. Saudi Arabia, Venezuela, Nigeria and Indonesia will face similar problems. On balance, given that those who lose are forced to adjust, while those who gain need not, the decline in commodity prices is likely to slow global demand overall.

With monetary union well on the way to completion, the prospects for non-inflationary economic growth in Europe, and the implications for monetary policy, must increasingly be assessed on an aggregate basis. If German and French interest rates are currently set at levels appropriate for those two countries taken alone, rates appropriate for the whole EMU area might be somewhat higher given the more advanced cyclical position of some other member countries. This conclusion is, however, subject to three important caveats. First, ongoing fiscal consolidation and structural adjustment in Europe would mitigate the need for such monetary tightening. Secondly, should the dollar fall against the European currencies, there would be further disinflationary effects. And finally, the full impact on Europe of the Asian crisis still needs to be assessed. Perhaps the only thing that is completely clear is that the European Central Bank will have to monitor the conjunctural situation with great care both prior to 1st January 1999 and subsequently.

In both the United States and the United Kingdom, a combination of tightening labour markets, worsening trade balances and booming prices for financial assets would indicate that inflationary risks are on the upside. Further monetary tightening might then seem to be recommended, even if there are also other risks. Higher interest rates, particularly in the United States, would complicate the problem faced by highly indebted emerging economies and could have effects of unpredictable magnitude on domestic equity prices as well as exchange rates. In the circumstances, an additional degree of fiscal restraint would contribute to meeting both short-term cyclical requirements and longer-run concerns about fiscal sustainability. In neither country, however, can it be said that the likelihood of this happening is very great.

Financial liberalisation and structural change

As if the conduct of macroeconomic policy were not difficult enough, policy-makers must increasingly make their judgements against the backdrop of continuing liberalisation and structural change in financial markets. Three important developments can be identified. First, there is increasing competition worldwide in the provision of financial services, with traditional banking firms already coming under particular pressure. This could well have implications for the monetary policy transmission mechanism. Secondly, swings in international capital flows to emerging markets have severely complicated the formulation of their domestic policies. Thirdly, the introduction of EMU will provide a new context for the conduct of macroeconomic policy in Europe. All of these developments also have implications for prudential policies, as is discussed further below.

Non-bank financial intermediaries are receiving a growing proportion of the savings of the industrial world. Moreover, with the recognition that unfunded

pension schemes in Europe and elsewhere are not likely to be adequate to meet future needs, this trend looks likely to accelerate. It can plausibly be argued that the behaviour of those allocating such funds will be different from, although not necessarily better or worse than, the behaviour of traditional bankers. For example, the increasing tendency of private savers to choose equity funds as a vehicle for longer-term savings may have contributed to the recent strength of stock markets worldwide. Nor is it easy to predict what the same savers might do in the face of a sharp correction in equity prices.

It is also the case that traditional banking intermediation is increasingly under threat from securities markets and that, as a defensive manoeuvre, banks are becoming increasingly involved in the securities business. Narrowing margins everywhere, only temporarily reversed by the Asian crisis, indicate the extent of these competitive pressures and help explain why credit growth has been faster in some countries than might otherwise have been expected. Furthermore, the effective demise of Glass-Steagall restrictions in the United States, the advent of the "Big Bang" in Japan from 1st April this year, and the spur to international competition likely to be provided by the euro indicate that this process of structural change and heightened competition is likely to intensify further.

Emerging markets may already have been affected by these trends and the resulting search for higher returns. Inflows of international capital, in large part in the form of short-term bank credit, rose from virtually zero in 1989 to a peak of almost $170 billion in 1996, to be followed most recently by major outflows. Coping with these swings has been enormously difficult, as they have generally fuelled existing spending booms on the way in and precipitated crisis on the way back out. While greater upward exchange rate flexibility would clearly have helped restrict such flows by opening up a two-way bet in exchange markets, the Mexican experience of the early 1990s teaches us that this is no panacea. In the light of recent developments in Asia, there has been a renewed debate about the merits of international capital controls, a debate given added vigour by a simultaneous proposal to amend the Articles of the International Monetary Fund to provide it with an explicit mandate to encourage capital account liberalisation.

Those proposing more controls point out that countries with high domestic saving rates often have problems in allocating even their own capital properly. They also emphasise the shorter-run problems of macroeconomic instability, and generally assume that international financial markets are prone to destabilising behaviour. In contrast, the Fund's approach is focused on the longer-run objective of microeconomic efficiency in the allocation of capital, allied with the belief that there are less distortive ways to deal with potential short-term macroeconomic problems. Insofar as these problems arise from herd-like behaviour on the part of banks, and indeed this does seem recently to have been the case, possible remedies are discussed below in the context of crisis prevention and management. There is clearly no single answer to this traditional problem, which involves a trade-off of longer-run efficiency against stability. Nevertheless, a consensus seems to be emerging that decontrol, while desirable, must be carried out extremely carefully and that capital inflows of longer maturity are preferable to shorter-term ones. Were the proposed amendment to the Fund's Articles to be accepted, it seems likely that the first fruits would be increased pressure on

emerging market countries to strengthen their financial systems as a necessary precondition for a subsequent liberalisation of capital flows. This would be no bad thing.

The third major structural change affecting financial markets, for which preparations are well under way, will be the introduction of the euro. The newly formed European Central Bank will initially have to take account of a number of transitional issues in the conduct of monetary policy. A full understanding of the transmission mechanism of monetary policy in the integrated market will take time to develop, and hoped-for increases in competitive forces may well prompt further changes in the underlying financial structure. This is particularly likely to affect the behaviour of monetary aggregates in the near term, suggesting the need to adopt a rather eclectic mix of monetary and inflation targeting for a period of time at least. As the ECB gains credibility, the associated effect on the process of wage and price formation will also change, albeit in a beneficial direction.

The longer-run conduct of macroeconomic policy in the euro area will obviously be affected by the introduction of the single currency. Countries whose wages and prices get out of line relative to competitors will no longer have recourse to exchange rate depreciation. The necessary adjustments will have to come from appropriate changes in domestic wages and prices if a rise in national unemployment rates is to be avoided. While the anchoring role played by a transparent inflation objective for the area as a whole will facilitate such an adjustment, much more far-reaching reforms in labour and product markets will also be needed. Unfortunately, while there has been significant progress in a few countries, the record of reform in Europe to date is very mixed in this regard. It is to be hoped that the introduction of the euro will also serve as a catalyst to spur needed structural changes across the broader European landscape.

Crisis prevention and crisis management

The Mexican and Asian crises were similar in that balance-of-payments difficulties interacted with weak domestic financial systems to calamitous effect. However, they differed in that the former was characterised by excessive consumption and the latter by excessive investment. Moreover, the Mexican crisis primarily involved a sovereign debtor and non-bank creditors while the Asian crisis has primarily involved private sector debtors and bank creditors. While the fact that no two crises are alike complicates the search for measures both to prevent and to resolve crises, some positive steps can still be recommended.

Crisis prevention demands, above all, healthy domestic financial systems. While the Basle Core Principles for Effective Banking Supervision provide a crucial building-block for improvements in this area, implementation will be a challenge. There is currently a great shortage of trained personnel among banks and supervisors alike, which will take a significant educational effort and require many years and considerable resources to rectify. Perhaps an even more difficult problem is political resistance to reform from those who have thus far benefited from the existing system. If market discipline, as well as peer pressure from supervisors and politicians in more progressive countries, do not suffice to

overcome such obstacles, the withdrawal of rights of establishment for banks from jurisdictions with inadequate prudential standards might eventually have to be contemplated.

It may also be that international standards will be required in other areas if healthy financial systems are to be assured. Committees reporting to the Group of Ten Governors at the BIS are currently assessing the need for and the feasibility of developing such guidelines or principles in a number of areas. One obvious issue is the need for clear, internationally comparable and transparent accounting standards. Without clarity as to what corporate accounting numbers mean, it is impossible to assess the quality of credits or the health of the banks that have granted those credits. Confusion as to what the banks' own accounts might mean adds another unwelcome layer of opacity in many emerging market and even a few industrial countries. Both of these problems need to be urgently addressed. More broadly, there is a great need for more transparency and more disclosure about the financial activities of both the private and the public sectors in all countries.

Crisis prevention, however, goes beyond having a sound financial system at the outset. It also requires adequate indicators of any threat to macroeconomic stability, whether arising from new developments in the banking system or elsewhere, and a set of incentives to ensure that those who should act do so before the eruption of a crisis. However, the indicator problem is a thorny one for the reasons mentioned above. Dangerous excesses generally build upon good fundamentals, and knowing when the line has been crossed is not easy. While a number of empirical models have been developed for predicting both balance-of-payments crises and banking crises, their common shortcoming is the frequency with which they predict crises that never happen. Uncertainties of this sort may help explain the reticence of public authorities to make predictions in this regard and the unwillingness of rating agencies to respond promptly to early signs of trouble.

The issue of incentives to act pre-emptively is equally thorny. Consider the Mexican and Asian crises and the application of market discipline. In both cases money continued to flow in, even though widely available statistics made it clear that the stock of tesobonos and other short-term debt, in the former instance, and the level of short-term international bank lending, in the latter, had risen dramatically. These data were generally ignored, although in the Asian case there is also some evidence that non-bank financial institutions did withdraw funds before the crisis hit. Studies are urgently needed to understand the mechanisms which led banks to further increase their exposure to countries already subject to warning signals, including in some cases warnings emanating from within the banks themselves. One possible answer is that the sums involved were relatively small from the perspective of individual investors, even if of dangerous size from the perspective of the recipients. Should the existence of such externalities be proved, this would in itself provide an argument for some form of public policy intervention.

The public sector must also question whether its own incentive structures need improvement in at least three areas. One possible reason for the magnitude of international bank lending in Asia was the existence of public safety nets for

both debtors and creditors which seemed to attenuate virtually every form of risk. With most foreign loans being made to domestic banks, normal credit risk was reduced by the expectation of their governments' support. Concerns about liquidity risk may have been eased by the series of liquidity support measures which had been organised earlier by the international financial community, however necessary those measures were at the time. And finally, the fact that most such Asian loans were short-term and denominated in foreign currency lowered perceptions of market risk as well.

A second question for the public sector is whether the detailed specifications of regulatory capital ratios made short-term interbank lending look particularly attractive. If so, the various arguments for such specifications need to be reassessed. And finally, it may be asked whether the proper incentives are in place, in both lending and borrowing countries, for supervisors themselves to act expeditiously before a crisis erupts. Analogous to monetary authorities in the modern world, supervisors need a clear and consistent mandate, powers to act in pursuit of their objectives, and public accountability for their actions. In the absence of these conditions, and they are by no means present everywhere, supervisors too may be tempted to exercise forbearance.

Even though the Asian crisis is not yet definitively over, some issues pertinent to the problems of crisis management can already be identified. The first is the need for the private sector to take some responsibility for the ongoing provision of credit to customers to whom they had previously lent all too freely. This is not just to avoid moral hazard problems, but also to acknowledge a simple reality. Capital flows have now grown so large that public sector funds simply cannot fill all the potential gaps that might open up as capital inflows reverse. Thus, some better means of burden-sharing will be required. A second issue begins with the recognition that the threat of a unilateral stay on payments would help bring banks to the negotiating table earlier. Such a threat would be more credible if the international financial institutions were to announce in advance their willingness to provide further needed financing by "lending into arrears" to countries whose domestic policies were deemed acceptable. The Ministers and Governors of the Group of Ten have endorsed the suggestion that the IMF should reconsider its policies in this respect. Finally, after the Mexican crisis the G-10 Deputies made a number of recommendations designed to facilitate crisis management. None of these has so far been implemented, which raises the question of what could and should now be done in this regard.

Resolving issues pertaining to crisis management will continue to be important since measures for crisis prevention will never prove totally reliable. This is not a statement of despair but of realism. Hopefully, it will encourage policy-makers not only to redouble their efforts to promote price and financial stability, but also to plan their reactions in advance should events fail to unfold as they might desire. Given the troubling way in which economic, political and social factors can sometimes interact, it is simply not prudent to assume that everything will turn out for the best.