Timothy F Geithner: Asia, the world economy and the international financial system

Remarks by Mr Timothy F Geithner, President and Chief Executive Officer of the Federal Reserve Bank of New York, at the Economic Society of Singapore 2007 Annual Dinner, Singapore, 13 June 2007.

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Good evening. I am pleased to be able to join you tonight. The past decade has been one of remarkable achievement in Asia. This is a testament to the resilience and dynamism of this region, and yet the memories of the financial crises remain vivid and still exert a powerful influence on policy today. Tonight, I want to reflect on what policymakers learned from the crises, to review the extent of the progress since and to examine some of the challenges ahead.

The Asian financial crises of the late 1990s were exceptional in many respects. Described at the time by some as the first crises of the 21st century, they were commonly regarded as without precedent and fundamentally different from previous emerging market financial crises. Here were countries with a remarkable record of rapid economic growth over several decades, substantial rates of investment, with low inflation and relatively strong fiscal positions. Most conventional indicators of economic performance and financial strength did not suggest acute underlying vulnerability.

Yet the crises erupted with remarkable speed and force. The sudden collapse of confidence led to a sharp reversal of capital flows to the region. On the eve of the crises, net capital inflows to the Asian crisis countries were equal to almost 6 percent of their GDP. Over the next two years, the flow of capital more than fully reversed. Income and output contracted abruptly: in the worst affected countries, GDP shrank by more than 10 percentage points from peak to trough and in one case, the contraction was closer to 15 percent. By any standards, these financial crises were unusually severe. The crises marked a sudden and dramatic break with the past, and brought a new sense of vulnerability to economies perceived as strong and successful.

Yet though some of the characteristics of the Asian crises distinguished them from other episodes of financial turmoil, they shared several important features in common with crises in countries with modern, market-oriented financial systems. They were largely unanticipated. A rise in borrowing created vulnerability to a shift in asset prices. Uncertainty about the scale and nature of the underlying vulnerability magnified the problem. Contagion spread rapidly. Markets overshot.

The fundamental economic and financial weaknesses that were the source of vulnerability were the consequence of the interaction between weak domestic financial systems, selective liberalization of controls on capital flows and fixed exchange rate regimes.

Banking systems combined relatively weak supervision with broad government guarantees, some explicit, but more commonly implicit, reflecting a tradition of public sector intervention to protect troubled companies and banks from failure. Tax and regulatory incentives promoted short-term borrowing in foreign currency through the banking system. Capital inflows, largely through the banking system, helped finance a boom in investment and real estate. Distortions in the financial system led to a misallocation of resources so that high rates of private investment did not generate substantial improvements in productivity. Exchange rate regimes where the domestic currency was fixed to the dollar generated false expectations of stability, and the resulting increase in unhedged borrowing generated large exposures to changes in the exchange rate or interest rates.

By 1997, the short-term external debt of the private sector had risen substantially, relative to GDP and to reserves, and this created conditions similar to a classic bank run, when the crises hit.

The initial spark for the loss of confidence is still not fully clear, as is often the case in financial crises. And although the particular dynamics differed across the countries in the region, the basic pattern was common, with a rapid and sustained effort by domestic and foreign investors to reduce their exposure to further losses. The initial effects of this behavior made the exchange rate commitments untenable, and when those commitments were broken and currencies fell, the panic became self-reinforcing.

Uncertainty and lack of information fed the run. Market participants were unable to judge whether deteriorating developments reflected temporary liquidity problems or deeper solvency issues. They

reacted by assuming the worst. These shifts in market sentiment risked becoming self-validating, with liquidity problems transformed into solvency problems with broader risk of default.

The capacity of policymakers to restore stability was constrained by the depth of the balance sheet problems. In some cases, where the scale of external borrowing was less acute, policymakers had more room to act. But in most cases, policy options were very limited. Initially, governments were reluctant to let exchange rates move too far, because of fears that this would force banks and companies that had borrowed in dollars or yen into default on a scale that could further damage growth. At the same time, the authorities were reluctant to tighten monetary policy as a way to help stabilize the exchange rate because of concern it would hurt growth and perhaps exacerbate the flight from domestic assets.

This dilemma made the initial policy response in the crisis countries look halting and tentative. And, uncertainty about the strength and continuity of political leadership further hampered government efforts to recover credibility. In the countries hit hardest by the crisis, looming issues of succession and elections compounded the problem of confidence.

The crises prompted a searching reassessment of the conventional economic wisdom and a new appreciation of the challenges that come with financial integration. The classic measures of macroeconomic stability and policy prudence, in fiscal positions and measured inflation rates, could mask substantial structural weaknesses, and these same structural weaknesses could ultimately undermine the achievements of otherwise reasonably conservative macroeconomic policy management. Partial capital account liberalization, which encouraged the accumulation of short-term debt obligations, brought substantial risk, magnifying weaknesses in domestic financial systems. Exchange rate commitments provided less stability than had been assumed. The rise in capital mobility increased exposure to shifts in sentiment. Markets could now adjust much faster than policy could typically react.

These judgments precipitated major changes in policies and a sustained investment in improvements to the institutional framework of domestic financial systems across the region. And these changes in turn laid the foundation for recovery and for the very substantial improvements in economic and financial strength now evident across the region.

Achievements since the crises

Although it took some time for policy to begin to restore confidence, recovery was stronger and more rapid than had been typical in other emerging market financial crises. Barely 18 months after the crisis, for example, Korean GDP had returned to pre-crisis levels, and this was true for all the Asian crisis countries by 2003. Growth has been relatively strong and stable since, though at a pace somewhat below the unsustainable rates of the decade prior to the crises.

The balance sheets of the region have been transformed from weakness into strength. Current account balances are generally in surplus. External debt of the banking and corporate sector has fallen. Banking systems are now much less exposed to liabilities in foreign currencies; and the currency mismatches that made economies so vulnerable as the crises erupted have been greatly reduced. Official reserves have risen to levels without precedent in modern financial history.

Fiscal positions have strengthened. After rising initially with the substantial costs associated with bank recapitalization programs, in recent years public debt ratios have generally been declining as a share of GDP.

Monetary policy regimes have become more mature, with some progress toward greater de facto independence for central banks, with clearer mandates for price stability.

Exchange rate regimes in the crisis countries have become somewhat more flexible, providing greater scope for monetary policy to sustain the domestic conditions for price stability.

Financial systems are substantially stronger. Bank capital ratios now provide a significantly larger cushion against potential losses – though capital ratios in Asian banking sectors are still generally lower than those in other emerging economies. The quality of bank assets has improved. Non-performing loans, estimated to have peaked at between one-quarter and three-quarters of total loans in the crisis countries, are now under 10 percent of total loans. Financial institutions that required government intervention have largely been restored to private ownership. Domestic capital markets

are an increasingly important channel of intermediation in financial systems that had historically been dominated by banks.

These are impressive achievements by any measure. And the changes that have taken place provide a strong foundation for future growth and they make it much less likely that these economies will be vulnerable to the type of crises of a decade ago. This progress is reflected in a broad range of financial market indicators of risk. Risk premia in domestic interest rates markets are low. Spreads on remaining dollar-denominated debt have fallen to levels that reflect little concern about future financial stress.

It is important to bear in mind that some of the most dramatic changes in the performance of Asian and other emerging market economies have taken place in an unusually benign economic environment. The past four years have marked the strongest sustained period of growth for several decades. Global interest rates have been relatively low. Asset prices in many markets have been rising for a sustained period of time. Volatility in equity, interest rate and foreign exchange markets has fallen to unusually low levels, and although we've seen the occasional sharp correction in some markets, recovery has typically been quick.

These favorable conditions make everything look somewhat better than it otherwise would. But the improvements in Asia are real, and they will make the region more resilient in the face of future challenges.

The challenges ahead

Even with the relative prosperity of the recent past, policy in much of the region reflects substantial ambivalence about the risks that come with financial openness. The memory of the trauma of the crisis explains much of this ambivalence. The difficulties in managing this more recent period of substantial capital inflows provides an additional source of unease. Policy regimes across the region are to a significant degree directed at providing some insulation for the domestic economy from what is considered a volatile global financial environment.

This impulse reflects itself in many different ways. It is manifested in exchange rate regimes that still permit relatively limited variability against the dollar. It is manifested in the extent of reserve accumulation, in part the consequence of resistance to exchange rate appreciation. And it is manifested in the remaining controls on capital movements and the occasional experimentation with the introduction of new controls.

The search for durable insurance against future volatility is an understandable response to the searing experience of the crises of a decade ago. But there is risk in this as well. And the incomplete embrace of integration could contain the seeds of future vulnerability.

In this sense, the policy agenda needs to move from a focus on creating stronger defenses against crisis to building a greater ability to adapt to change. This requires strong institutions for the management of macroeconomic policy so that the monetary and fiscal policies are able to respond to shocks in a credible manner. It requires strong financial institutions with a substantial capacity to absorb losses and cope with volatility. It requires regulatory policies that encourage competition and innovation, with strong protections for property rights, low barriers to entry and effective financial supervision. And it requires investments in a nation's human capital, in education, healthcare and pension provision. This complement of policies improves the prospects for producing the mix of flexibility and resilience necessary for sustained growth in a more integrated world economy.

In emerging Asia, two key areas where there is the need and opportunity for further progress are in the financial system and in the monetary policy framework.

The financial sector plays an important role in the flexibility and adaptability of economies to change, in the resilience of economies and in the capacity of the monetary authorities to respond to adverse shocks to asset prices or demand. Although much has been achieved in Asia over the past decade, as the damage inflicted by the crises has been repaired, further reform will be important to the capacity of these economies to innovate and grow and to live more comfortably with openness to capital flows.

This requires stronger banks and more developed capital markets. Thus far, we have seen more progress on the former than the latter, but both are important and there remains considerable scope for broadening and deepening capital markets in emerging Asia. The extent of financial innovation in the industrial economies makes it possible for Asian countries to take advantage of huge

improvements in the efficiency of financial intermediation. Embrace of these reforms will help ensure that high levels of domestic savings are deployed more efficiently, that companies and financial institutions are able to manage risks more effectively and that the financial system is more resilient in the face of future stress.

Monetary policy regimes in much of Asia are burdened by two different types of constraints on independence. The first relates to the institutional relationship between the central bank and the government and the second to the multiple objectives assigned to the central banks.

All the evidence points to improved long-term inflation performance when monetary policymakers are freed from institutional constraints that hamper their freedom of maneuver and given full operational independence. Such independence is best achieved by enshrining it in an institutional framework that provides for legal independence from the government, with accountability for achieving a clearly defined mandate focused on price stability. Few Asian central banks yet enjoy full legal independence, though most now have greater de facto independence than they once had.

Fixed, or partially fixed exchange rate regimes, of course, also constrain the independence of monetary policy. As capital accounts become progressively more open, few countries can sustain over time a commitment to exchange rate stability without risking price stability. Eventually central banks will run up against limits on their capacity to sterilize the effects of exchange market intervention designed to limit the pace and extent of appreciation of the exchange rate. Although measured inflation in emerging Asian economies remains relatively low, the pace of credit growth and the behavior of asset prices provide some evidence of a growing tension among competing objectives. The longer this policy conflict persists, the greater the distortions building up in the economy, the greater the risk of future inflation and the greater the risk of a bumpy future.

Reserves in emerging Asia recently passed the $2.5 trillion mark, double their size at the end of 2003. Given the levels that have been reached in many countries, it may no longer be appropriate to view rising reserves as a source of increasing strength against future volatility. They are, increasingly, signs of the allocative distortions that result from the exchange rate regime. And they are in a sense too much of a good thing.

Conclusion

The economic and financial transformation of the crisis economies has been extraordinary. The policy reforms adopted in the wake of the crises have made those economies less vulnerable and more resilient. And these changes justify substantial confidence about Asia's economic future.

Asia's success fundamentally changes the international economic and financial system. It is no longer tenable to view the world as divided between a dominant core of mature industrial economies and a smaller periphery of emerging economies. Asia is now so closely integrated with the rest of the world, so large in relative terms, and growing so rapidly that the policy choices made in this region will have a much greater impact on the rest of the world. And it means that Asia will need to prepare for a future in which it relies more on the strength of growth at home rather than on the strength of growth in the rest of the world.

As Asia makes further progress in financial reform and toward more flexible exchange rate regimes, it will be in a better position both to deal with the inevitable challenges that come with economic and financial integration, and to make the necessary transition to stronger domestic demand led-growth, which will prove a more sustainable foundation for future improvements in living standards.

Thank you.