

Ms. Rivlin remarks on lessons drawn from the Asian financial crisis Remarks by the Vice-Chair of the US Federal Reserve System, Ms. Alice M. Rivlin, before the Hyman P. Minsky Conference on Financial Structure at The Levy Institute in Annandale-on-Hudson, New York on 23/4/98.

Toward A Better Class of Financial Crises: Some Lessons from Asia

Drawing lessons from the Asian financial crisis has become a minor industry, partially offsetting the impact of the crisis on developed economies -- at least for economists. It contributes to conference budgets, airline revenues, bar tabs, and the length of academic resumes. The opining classes can turn almost any bad news into an excuse for more meetings in beautiful settings like Bard College.

Some of the talk has been devoted to the blame game. Was the crisis (or rather the rolling set of interrelated crises) home-grown, that is, brought on by ill-conceived investment, over-leveraged companies, lax banking supervision and crony capitalism in the borrowing countries? Was it the greed, inattention, or herd instinct of the lenders? Or was it the inherent instability of international capital flows? Did the IMF step in just in time to avert total meltdown or did it fail to provide early enough warning? Did the conditions imposed on borrowers help restore investor confidence or further undermine it?

The quick answer is that all of the alleged culprits bear part of the responsibility. International flows of capital can be unstable -- what flows in can quickly flow out -- and fast. The enormous escalation in the volume of private capital flows, coupled with the advent of simultaneous communication in all the world's markets, has greatly increased the exposure of economies to rapid turnarounds in cross-border flows. Decades of rapid growth and apparently unending capital inflow had made the Asian emerging markets, until recently known as "tigers", believe they were immune from the reversals of investor confidence that beset other parts of the world and produced an incaution that led to over investment in some sectors, inflated equity and real estate prices, and some ill-thought-out projects, public and private. Close relations between companies, banks and governments created false senses of security, as well as uneconomic "policy" loans and investments. Weak supervision of financial institutions and markets, on top of traditions of secrecy in business and governmental transactions, aggravated the crises when things turned down. At the same time, foreign investors and creditors asked too few questions, were hesitant to reign in the galloping goose that had laid so many golden eggs, and reinforced each other's reluctance to be the first to pull back. As tensions were developing, the IMF pointed to some of the dangers without getting much response, and missed some others, as did the much-vaunted market gurus and rating agencies. When the crises hit, the IMF quickly crafted rescue packages that imposed serious structural reform as conditions of aid, inevitably making some mistakes in the process, but arresting the spreading downward spiral and restoring enough confidence to allow the countries to get their policies in shape to support the climb back to economic health. No one thinks the climb will be easy, but the best bet is that the worst is over.

Now the talk has shifted to the more difficult subject of what the international community can do to prevent, mitigate and manage financial crises in the future. The stakes are high, for industrial and emerging market countries alike. When international capital markets function well, they help achieve rising standards of living for both creditor and debtor countries. When the markets crash, they bring incredible hardship to ordinary workers and their families -- often people who have been pulled out of their traditional occupations and communities by economic change and may have nothing to fall back on.

Two sets of prescriptions are relatively uncontroversial, albeit deceptively hard to achieve. First, the world's capital markets and the machinery designed to stabilize them would function better with more complete, accessible and timely information flows. Investors can make better decisions and lenders can exercise more discipline over borrower behavior if they have more accurate and more complete information and have it sooner. Both international and domestic officials can monitor, supervise and warn of impending danger only if they know the facts. Improving transparency should apply not only to businesses and banks, but to official bodies, both national and international. It's important to know what a country's budget deficit really is (on budget and off budget) and what its exchange reserves really are, including any operations in the forward markets. The Asian crisis was certainly exacerbated by lack of information of many sorts, including accurate data on reserves.

There is currently a great flurry of activity in various international fora to raise standards of accounting and reporting on business, banking and governmental activity and balance sheets. Progress will be made. But one should not expect too much. Although post mortems on financial crises, especially reviews of investor decisions that went sour, feature a great deal of if-only-we-had-known rhetoric, in actual fact a great deal of information usually turns out to have been available which no one ever looked at or effectively analyzed. For transparency to be useful, people need to actually want to look -- and too often those who are making high profits would rather not hear bad news.

Second, a major sustained international effort is needed to strengthen the structure, functioning and supervision of financial systems in emerging market countries. A clear lesson of recent economic history (and not just in emerging market countries) is the crucial importance of strong banks and other financial institutions, adequately capitalized and able to manage risk, overseen by serious prudential supervision and an independent well managed central bank. Industrial countries can ill-afford to be sanctimonious on this score -- many of us have experienced the adverse effects of poor prudential supervision or lack of political will to close failing financial institutions -- but good management and strong supervision of financial institutions is clearly a key to withstanding economic shocks.

Here, too, consensus is strong and serious activity is underway under the aegis of a variety of international bodies, perhaps too many, to evolve clear rules for financial supervision and help countries implement them. The task will require time, patience and resources. It is not just bank examiners, but bankers who need training in how to do their jobs in modern, fast moving internationally exposed economies. Strengthening financial systems, including improving corporate governance, goes hand in hand with efforts to improve transparency and information flows -- to investors, shareholders, supervisors and international agencies -- and both will require sustained effort and run into significant resistance.

The first two prescriptions are preventive, designed to reduce the frequency and amplitude of financial crises. But no one with a sense of history -- or reality -- believes that crises can be eliminated. Hence, a third prescription also appears on everybody's list, albeit with far less agreement on what it means, namely, private creditors should take on a greater portion of the burden of resolving future international financial crises. Sharing the burden is a far more difficult issue to come to grips with conceptually than either the need for greater transparency or the need for stronger, better supervised financial systems. Not much intellectual structure yet exists for thinking about burden-sharing in international financial crises. Moreover, cross-border financing is growing so rapidly and market instruments are morphing so fast that designing ways of sharing the burden is like changing the tires on a moving car -- pretty exciting and not obviously doable.

The task cannot be set aside, however, for at least two reasons. First, the cost of resolving international financial crises is outrunning the likely resources available for that purpose. The volume of cross-border flows has grown precipitously and the cost of breakdown has escalated with it. High speed traffic on a six lane freeway moves a lot of people to their destinations fast, but the pile-up in a wreck is a lot more expensive than on a winding two lane road. If recent trends continue, managing the next crisis will call for more resources than taxpayers in the United States and other developed countries are likely to feel comfortable turning over to the IMF and other international organizations, even if they are reasonably confident that the borrowing countries will pay the loans back, as experience indicates they will.

Second, and far more important, the perception that official resources can be counted on to bail out creditors (directly or indirectly) arguably generates moral hazard. It could lead to excessive risk-taking by lenders and funding of less economically defensible projects. It may also channel financing into less stable forms whose overuse makes crises more likely to occur. In recent episodes, direct investors and holders of equity and long-term debt have taken serious losses, but short-term lenders, especially interbank lenders, have been largely protected. While a country in trouble has understandable reasons for not wanting to cut itself off from short-term bank credit and for using its scarce international resources to keep this lifeline attached, the result may be to reinforce excessive dependence on debt rather than equity and on short, rather than longer-term financing.

Both reasons combine to create an urgent need for serious and creative thought on the part of the international community about how to “bail in” private sector financiers, in order to reduce the impact on the financial resources of official institutions like the IMF, the World Bank and the regional development banks, to reduce moral hazard leading to excessive risk-taking, especially short-term inter-bank borrowing, and to improve risk assessment.

Designing mechanisms for appropriate burden sharing among private sector investor/creditors is inherently hard because it runs into some very sticky and fundamental dilemmas. The basic principle from which all borrowing and lending must proceed is that people who use other people’s money have a firm obligation to pay it back. Hence, a suspension of payments or a work-out arrangement must be clearly rare and exceptional, resorted to only in extreme situations. Raising fears that suspensions are likely or work-outs normal could unnecessarily increase the cost of capital, cause drastic reductions in cross-border flows and diminish future incomes of debtors and creditors alike. Yet having no known or understood process for dealing with default can, as has been seen in Asia, lead to inequitable burden sharing, high official cost and potential future moral hazard.

A related basic dilemma involves the timing of a suspension of payments. Authorities have to hold off long enough to be sure there is no other choice, but not wait so long that creditors are running for the doors and irreversible damage is already done.

The problem is, of course, not entirely new. International borrowers have gotten into trouble before, and precedents for workouts have been developed -- Paris Club procedures for resolving sovereign debts to public creditors; London Club for resolving sovereign debts to private banks. But each crisis is different from the last. A critical element in the Mexican crisis of 1994-95 was the threat of default on dollar-indexed Mexican short-term bonds (*tesebonos*¹) for which no work-out process existed. Dealing with bond holders (who are likely to be numerous and scattered) is more complex than dealing with lending governments or a relatively small (and known) group of

¹ Tesebonos were technically denominated in pesos.

international banks. The recent Asian crises posed still another problem. The borrowers were not governments, but private banks and corporations, a situation that may be typical of future crises, and one that adds greatly to the legal and organizational complexities of sharing the burden of financial distress.

When the debt in question is sovereign debt, whether to banks or other lenders, it may not be hard to re-establish stability and confidence in the sovereign. The IMF can lend enough to solve the borrowing government's immediate liquidity problem while the government works out a debt restructuring with its creditors. IMF rules permit "lending into arrears" in these circumstances.

If the creditors are bondholders, as they were in Mexico, the situation is more difficult. IMF rules do not at present permit a government borrowing from the IMF when it is unable to pay its bondholders. Even a small minority of the bondholders can use their bargaining power to obstruct a resolution of the crisis in hopes of getting a better deal. After the Mexican crisis had been resolved with the help of significant new official lending to Mexico, the international community focused on how to improve the bargaining position of the debtor government with its bondholders if such a crisis should arise in the future.

The "Rey Report" on Sovereign Liquidity Crises (named for its author, Jean-Jacques Rey of the Central Bank of Belgium) was a major effort by the G-10 countries to learn the lessons of Mexico. It recommended two new steps:

- First, the IMF should expand its willingness to lend into arrears to cover the situation in which a sovereign was making a good faith effort to work out a debt restructuring with its bondholders.
- Second, it recommended that bonds issued in international markets contain clauses that would facilitate debt restructuring if it became necessary. Clauses could be added to provide for debt-holder representation in negotiations with the sovereign or qualified majority voting on changes in terms. Such clauses would make it harder for minority creditors to block restructuring or exact a higher price than necessary to satisfy the majority.

Neither of these recommendations received much official attention until the Asian crisis hit. Although the recommendations were not actually germane to the situation in Asia, the IMF reviewed the recommendations at its Interim Committee meeting in April 1998 and action in the near future seems more likely than a year ago. Perhaps the official community will always be one crisis late.

Unlike the sovereign debt crises in Latin America, the situation in Asia involved private debts (of banks in Korea, corporations in Indonesia, and some of each in Thailand) to private creditors, mostly banks. Hence, it was inherently harder, as currency values plummeted and reserves all but disappeared, to design ways either to restore stability or to organize work-outs.

An additional complication was the fact that, although the debts were private, some of them involved varying types of implied government guarantees. In Korea, the Finance Minister ill-advisedly volunteered that the Korean government would honor foreign debts of Korean banks. When the Korean banks experienced difficulty rolling over their international bank loans, the Bank of Korea provided the reserves they needed to repay the loans, in effect delivering on the guarantee, but rapidly depleting the central bank's reserves in the process. Guarantees of this sort clearly create moral hazard. Pre-crisis, they result in more bank lending than would otherwise have taken place, and when trouble begins they may accelerate a bank run. But much less explicit guarantees can be

trouble as well. Where governments are heavily intertwined with banks and companies, as has been normal throughout much of Asia, foreign lenders and investors may well assume that the government will not allow favored operations to fail. One of the challenges of mitigating and managing future crises, therefore, is finding ways to discourage emerging market governments from guaranteeing private debts or being so closely involved with private enterprises that these enterprises are seen as immune from market forces.

The expectation that future borrowers in international markets will be mostly private enterprises, greatly increases the importance of the first two prescriptions -- increasing transparency and strengthening financial system surveillance -- not just to prevent and mitigate crises, but to manage them when they happen.

In an economy that tolerates secrecy in business and financial dealings and where information disclosures are limited, firms with fairly shaky fundamentals may be able to borrow easily in a boom. They will be carried along by the general optimism, since everyone wants to believe the best and there is no tradition of asking hard questions anyway. But in a crisis, market participants tend to believe the worst. To contain the crisis and restore confidence, it is necessary both for managers and public authorities to be able to deliver the bad news and be believed by the markets. If there is no tradition of accurate, high quality information that can be relied on, market participants and bank depositors are likely to believe that things are substantially worse than they really are and proceed to prove it by their actions. A culture of transparency and timely, accurate information can serve as an economic stabilizer in both directions. It can restrain the boom by enabling investors to assess risk more accurately, and it can cushion over-reaction once a downward slide begins. But such a culture cannot be built quickly, and even where it exists, has to be assiduously maintained.

Similarly, prudential supervision of financial institutions may be thought of as primarily valuable for crisis prevention -- useful for ensuring that financial institutions are adequately capitalized, don't take unacceptable risks with other people's money, and that the weak ones are required to shape up or go under. Once a crisis hits, however, it is important to be able to distinguish strong from weak institutions, those that ought to be rescued from those that ought to be closed. Unless supervision has been effective on an ongoing basis, however, the supervisors will not be able to tell strong from weak and will not be able to find out fast enough to prevent a rout. Good institutions then go down with the bad. It is actually in the long-run interest of financial institutions that aspire to be the survivors of a shake-out to insist that supervisors are well informed and applying a high standard.

Another lesson of recent events in Asia has been the importance of clear, enforceable bankruptcy laws in dealing with a crisis, as well as helping to prevent one. Bankruptcy provides an opportunity, not only for closing down truly insolvent enterprises in an orderly way, but for rescuing troubled ones by allowing them to cut a deal with their creditors, restructure their obligations, and go on operating on a sounder basis. But bankruptcy procedures cannot be rapidly invented or first tested in a crisis. For bankruptcy procedures to mitigate crises effectively and help to get survivors on their feet, there has to be a "culture of bankruptcy" which operates in good times as well as bad. Debtors, creditors, lawyers and courts have to be used in the process, know what to do, be able, because they have done it before, to cut the deals that will minimize the damage and keep potentially profitable enterprises afloat. Asian countries, most obviously Indonesia, found that since their modern market experience had been primarily one of boom and growth, they had inadequate bankruptcy laws and little "culture of bankruptcy" to help manage a sudden negative turn of events.

Improving transparency, supervision and bankruptcy procedures will help emerging market economies grow more sustainably (albeit perhaps slower) and manage downturns better

when they happen. But the conceptually hard questions involve international collective action and how it can manage major crises more effectively.

Once a crisis hits one country, especially a country of significant size and linkage with others, the whole international community has a strong interest in rapid action to isolate markets and prevent the contagion from spreading and engulfing others. At this moment, the community looks to the IMF to act quickly, provide liquidity and restore confidence, especially the confidence that the crisis has bottomed out and will not be part of a continuing downward spiral. Asia in 1997 was a demonstration of how fast the dominoes could fall.

When the root cause of the problem is inappropriate macro-economic policy, especially big budget deficits and easy money combined with a pegged exchange rate, it may not be difficult for the IMF to restore confidence by injecting enough liquidity to pay short-term claims in foreign currency in return for rapid changes in policy. When macro policy is not obviously the chief culprit, restoring confidence may be harder and more expensive.

Injecting new money in exchange for reforms may still be the primary answer, but the patience of taxpayers wears thin as amounts escalate and it is perceived that some classes of creditors are being bailed out with official international resources -- creditors who should have calculated the risks more accurately and should bear the cost of not having done so, so they won't do it again.

Some have asked whether official resources could be saved and moral hazard reduced by designing an automatic international bankruptcy-like process, known in advance, by which a standstill could be triggered, followed by a set procedure for sharing the burden among all the relevant creditors. Serious thought is being devoted to this issue. It is not hard to imagine such an approach, but all crises are different and applying a cookie cutter solution could well do more harm than good.

The next few years will be a testing time for what I think of as the "cross-border community", meaning the organizations, public and private, dedicated to making the cross-border relationships (especially business and financial ones) work better. The "cross-border community" includes mega firms that produce goods and deliver financial services on a worldwide scale, and associations of accountants, lawyers, bankers, securities dealers, insurance underwriters and various kinds of financial regulators as well as general international financial institutions (the IMF and the World Bank) and more specialized ones such as the Bank for International Settlements, and the regional development banks -- to mention only a few of the more obvious members of a burgeoning species.

The benefits of cross-border trade and capital flows for raising the world standard of living are clear, but so are some of the costs -- especially the costs to ordinary people of being caught in the backwash when there is a crisis. If these costs are not taken seriously and methods designed to mitigate and manage financial crises better, a wave of political backlash against capitalism, foreigners and what we all think is "progress" could result. One lesson of recent crises is that factories, banks, shiny buildings, and eager investors do not by themselves create the underpinnings of modern economic society able to withstand shocks with minimal damage. That takes -- in addition to good fiscal, monetary and other public policies -- an infrastructure of laws and traditions and expectations that cannot be built overnight or imposed from the outside. The challenge for the cross-border community will be to work closely with emerging market economies to help them build this infrastructure in ways that work for them. Wading in and saying, "do it our way" won't work. The process will involve continuous interaction and adaptation and may well result in better functioning economies in the so-called developed world, as well.

