<u>Mr. George gives a central banker's response to the Asian crisis</u> Speech by the Governor of the Bank of England, Mr. E.A.J. George, at the Foreign and Colonial Emerging Markets Conference, in London, on 28/5/98.

Thank you, Mr Chairman. I'm delighted to participate in this Emerging Markets Conference, sharing the platform with such distinguished company. I am particularly pleased to be joined in this session by Guillermo Ortiz - my colleague from the Bank of Mexico.

The particular examination question which you set me is: "How did an OECD central banker respond to the Asian crisis?". I have to confess that it's a somewhat embarrassing question. If I'm brutally honest I have to acknowledge that I didn't see it coming; I played a modest role in helping to contain its immediate impact on global financial stability; and I'm still struggling to understand its implications, in terms both of its economic after-effects, and of the lessons we must all learn to reduce the risks in the future. I would only plead in mitigation, your honour, that I was by no means alone in all of that; and I beg leave to join in my defence all my central banking colleagues, governments and Finance Ministry officials, in Asia and elsewhere, the international financial institutions, and the world's financial markets.

The storm last year in Asia struck essentially the ASEAN four - Thailand, the Philippines, Malaysia and Indonesia - spreading subsequently to South Korea and intermittently battering Hong Kong and elsewhere.

It is still not wholly clear - to me at least - quite why the storm struck suddenly when it did. Most crises of this sort have their origins in some evident macro-economic policy failure. At least in hindsight there are usually fairly clear tell-tale signs of expanding fiscal deficits and/or lax monetary policies, classically accompanied by evidence of imbalance in the form of accelerating inflation or a rapidly deteriorating balance of payments. There were such signs, perhaps most notably in Thailand; but they were not for the most part particularly pronounced in Asia. Some of you perhaps understand better than I do why the initial infection proved to be so contagious. It was after all your money!

In fact through the first half of the 1990's, and in some cases for much longer, the countries in question had been remarkably successful. They attracted, by their very success, huge inflows of capital from the rest of the world, where yields had fallen, in the hope of achieving higher returns.

There is no question that this capital inflow made a very big contribution to the remarkable economic expansion in Asia and hence to the global economy; but with the benefit of hindsight, the accelerating scale of the inflow, and particularly the forms that it took, became an important part of the problem. It was not all in the end productively employed. There was over-investment in some sectors; much went into ambitious property development; and much went into financial assets, including short-term foreign currency claims, rather than into real assets. The hoped-for higher returns could not be maintained.

Again with the benefit of hindsight, it is possible to identify a number of structural weaknesses in the mechanisms for financial resource allocation in the recipient countries. There was, for example, a general lack of reliable financial information, and a lack of transparency in relation to the financial position, of both public and private sectors. Complex and opaque links between government, financial institutions and non-financial companies made it difficult for outsiders to understand the real nature of their exposures. Financial markets were not well developed, leaving the system heavily dependent upon the banks. There was inadequate regulatory or supervisory oversight.

There was widespread, often informal, government influence over financial flows, which importantly also contributed to a perception that much of the borrowing was implicitly under-written by the government. The list could go on.

The problem was compounded by the absence of any real perception of exchange rate risk. Borrowers were evidently confident that governments would maintain their exchange rate pegs against the dollar, even when the dollar itself began to strengthen, so that unhedged foreign currency debt, much of it at short-term, appeared to be a cheap alternative to domestic currency borrowing. The result was a build-up of short-term foreign currency liabilities, by banks and non-banks, which was not fully appreciated, and which left the Asian economies especially vulnerable to a flight of capital in the event of a change in sentiment. The particular problem is that while national authorities can create their domestic currency, if they choose to do so, even if it leads to inflation, they cannot simply create foreign currencies in the same way.

So, once the run started, it was violent and contagious. For a time around the end of last year there was a significant possibility of a chain of default emanating from Asia that could have reverberated right through the global financial system. The immediate task was to contain that risk.

Essentially there are two broad options for dealing with a foreign currency crisis. One is simply to allow financial markets - exchange markets, interest rates, and stock and bond prices - to take the strain, and to seek to restore confidence, and to moderate the impact of market movements, by restrictive macro-economic policy adjustment in the affected country. The second is to try to limit the financial market impact and the extent of the associated macro-economic adjustment by providing or arranging alternative external financing. In practice these options are not, of course, mutually exclusive and the real question is the appropriate balance between them.

Where a country has transparently been pursuing an unsustainable macro-economic policy, most people find it easy to accept that that country should bear the burden and adjust, painful though that may be. Many people find this harder to accept where, as in the present case, conventional macro-economic policies had, for the most part, been relatively responsible. There were certainly adjustments to macro-economic policy that needed to be made - a more flexible exchange rate regime in some cases, for example, or a somewhat tighter overall macro-economic stance, with perhaps some adjustment between fiscal and monetary policy. And, once the capital outflow had started, macro-economic adjustment had to be harsher than might otherwise have been necessary, in order to re-establish confidence. But there are real dangers in extreme market movements or in excessively severe macro-economic adjustment to contain them. The political and social consequences are all too apparent in parts of Asia; but even without that there is a danger of a vicious circle of domestic default and systemic financial weakness in the affected country. And that could have seriously adverse implications - in terms of both financial and economic knock-on-effects - for the global economy.

That, essentially, is why it may be in the self-interest of the international community to attempt to mitigate the market and macro-economic adjustment pressures by providing financial support. It is why the international community responded to the crisis in Asia by promptly offering very large amounts of official assistance - $17 billion in the case of Thailand, $43 billion for Indonesia and $57 billion for South Korea. This kind of official assistance of course is essentially for the international financial institutions and for governments - though central banks are often the channel for bilateral financing, as the Bank of England is, for example, in the case of the UK's contribution to the bilateral support for Korea.

But such official financial help cannot be unlimited and it cannot be provided without strings. It, too, has real dangers. If it were too readily forthcoming it could encourage "moral hazard", especially by encouraging commercial lenders - particularly foreign currency creditors - in the belief that they will be bailed out if things go wrong. That would be likely to add to the problem of potentially volatile capital inflows next time around. Not surprisingly, too, there is strong political resistance in many countries, including notably the United States, to the idea that public - taxpayers'- money should be used to bail out private creditors, especially foreign creditors.

External financing need not come solely from the public sector. Private finance would serve the same purpose, and in many situations market price adjustments may be sufficient to stem the capital outflow. But, given the extent of the loss of confidence in the Asian case, organising private financial support meant in practice persuading existing creditors that their assets would be better protected if they were prepared to leave them in place, especially if other major private creditors agreed to do the same, and if official support were made available in parallel. But in this case, too, difficult judgements have to be made. There is a danger that, if private creditors have in effect to be coerced into staying put, they will immediately cut their positions elsewhere, while they still could, thereby adding to the international contagion.

In fact, in the critically important case - because of its size - of Korea, the promise of massive official support failed to restore market confidence. And when it became apparent that the official bilateral financing was in practice available only as the very last resort we - again with the central banks as the immediate intermediaries - had to turn to the commercial bank lenders in the major creditor countries and persuade them to extend the maturity of their loans. Like most U-turns, it was a dangerous moment. But the banks' constructive response went a long way to stabilising the immediate situation in relation to Korea - and thereby to the region as a whole. The creditor banks are also now in negotiation with Indonesia's bank and commercial non-bank debtors.

I can't pretend that we are completely out of the wood in terms of the external financial crisis in Asia, but there is now at least a good deal more light between the trees.

International attention is now extending to managing the economic fall-out from last year's financial disturbances, against the background of the longer-standing financial and economic fragility in Japan - which is of course the largest economy in the Asian region. The concern relates in part to the implications for global economic activity; but it relates importantly, too, to the prospective external payments imbalances within the global economy which will need to be handled very carefully if they are not to lead to trade frictions and/or exchange rate volatility.

But attention has also turned to an intensive reappraisal, in all sorts of international fora, of more effective means of preventing, and managing, such situations in the future.

It would have been understandable in the light of the Asian experience if there had been some turning back from the path towards greater freedom of international capital movements, and there has been some suggestion of this. But on the whole the international debate - in which central banks as well as governments are actively involved - continues to recognise the long-term benefits of free capital movements and the contribution that they can make to global economic prosperity. The mood is to continue cautiously down that path, but to emphasise the need, not only for sound macro-economic policies, which everyone accepts as a *sine qua non*, but also for steps to accompany capital account liberalisation designed to reduce the risks of volatility.

These relate in part to the process of capital account liberalisation, where there is now a good deal more stress on 'sequencing' - that is on liberalising potentially more stable, longer-term, capital inflows initially, rather than short-term borrowing denominated in foreign currency.

But they relate particularly to three key conditions for living with free capital movements.

The first is "transparency". In a broad sense a need for greater transparency is recognised in relation to public policy, to the relationship between the public and private sectors, to corporate governance, accounting standards, and so on. In a narrower sense there is seen to be a need for more reliable, and greater and more timely disclosure of, financial information generally, at the level of individual borrowing entities, but especially also in relation to countries' true foreign exchange short-term asset and liability positions. This is especially important in relation to the foreign currency liquidity position of the monetary authorities and of the banking system. The general point is that we cannot reasonably expect markets to make a proper assessment of the risks of their investments, including particularly their short-term lending if they do not have adequate information in accessible form, so that we need to provide appropriate incentives for countries to provide such information. The corollary is that where they do have adequate information, financial market participants can be expected to accept the penalty if their judgements prove ill-founded - as indeed they largely do already in respect of many forms of overseas investment.

The second condition for more stable capital flows is stronger financial systems. That includes for example the broadening of capital markets so that the allocation of capital is less concentrated on local banking systems. It includes robust financial infrastructure - for example payments and settlements systems. And it includes crucially more effective financial regulation and supervision. A key feature of future arrangements for me in this area is the encouragement, not just of more published information about the short-term foreign currency assets, relative to liabilities, of the public sector and the banking system, but more positive management of the country's foreign currency liquidity position, taking account of the nature of the exchange rate regime. It was weaknesses in this area, above all, in my view that turned the Asian financial problem into a panic.

These various steps - which need a great deal of elaboration and refinement - in themselves represent a huge agenda for the future. But however much we try to prevent accidents we need nevertheless to be prepared for them to happen. The third condition for living with freedom of capital movements, therefore, is a more consistent view of how, when a crisis does break, the burden might be expected to be shared in future between official and private sector financing.

In this context, one thing seems clear: given the evidence of public resistance, we cannot assume that massive official financing packages will in fact be deliverable in the future to bail out private foreign currency creditors. Various ideas have been put forward for involving private foreign currency lenders in an extension of maturities in case of a serious foreign exchange crisis - perhaps within a framework of insolvency principles or some other form of code of practice. These ideas, too, need to be developed and refined; and we need to establish suitable incentives and conditions to ensure that the financing burden is in fact shared between official and private sector creditors. The general point here is that it may help to discourage excessive, potentially volatile, short-term foreign currency lending in future if the lenders clearly understand from the outset that they will indeed be expected to carry a substantial part of the load.

Mr Chairman, the debate on all these issues is still at a relatively early stage, and is being carried forward seemingly whenever two or more monetary officials, or indeed private sector analysts or commentators, are gathered together in one place. It is a key part of the present international monetary agenda, and as the debate crystallises into policy consensus, it will become an important element in the environment in which you take your decisions on investment in the emerging markets. I have no doubt that massive capital flows to the emerging markets will be a continuing feature of the financial landscape - it is in the long-term interests of the recipient countries, the investing community, and the world economy that they should. The task is to try to introduce greater stability into the process.