Mr Lee examines some of the major themes for strengthening the global financial system against the background of the financial crisis in Asia

Opening address by Mr Lee Hsien Loong, Chairman of the Board of Directors of The Monetary Authority of Singapore and Deputy Prime Minister at the fifth meeting of Finance and Central Bank deputies on the Manila Framework at Shangri-La Hotel on 29 August 1999.

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Introduction

I am happy to address the Manila Framework Group.

Prospects for the region have brightened considerably since your inaugural gathering in November 1997, in the depths of the regional economic turmoil. The worst of the crisis is now well past. Most of the crisis-countries are seeing growth again. Investor sentiment, while edgy, is generally upbeat. Equity markets have surged, some beyond pre-crisis levels. Currencies have stabilised; indeed some governments have had to temper the appreciation of their currencies.

But financial markets are notorious for their short-term memories. An upturn does not necessarily mean that basic problems have been solved. It remains important for financial regulators and policymakers to remain mindful of the lessons thrown up by the crisis and to tackle them before another storm blows up.

No two Asian economies are the same. During the crisis, hardly any were spared the panic and contagion. But how each was struck, how external problems interacted with internal weaknesses and how each government responded, varied from country to country. These diverse experiences offer rich materials for study and contrast. Lessons learnt at great cost of human suffering and political upheaval may help us formulate sounder policies for the future. A thorough comparative study would occupy several PhD theses. But a brief review of what happened in each country will be a useful basis for examining some of the major themes for strengthening the global financial system.

Asian crisis – what happened

Thailand

The crisis began in Thailand after a long boom. The establishment of the Bangkok International Banking Facility or BIBF and the implicit guarantee of a fixed exchange rate encouraged unhedged borrowing in foreign currency by Thai companies. This led to a build-up of external debt and an asset bubble.

As the Thai economy weakened, the balance of payments deteriorated and the baht came under pressure. Attempts to defend the baht were costly and ultimately unsuccessful. When the baht was finally allowed to weaken, its sharp fall triggered the collapse of many Thai corporations as well as the banking system. The Thai economy contracted sharply.

The aftershocks of the Thai problem affected many other Asian economies. Confidence in the whole region was shaken. Both domestic residents and foreign investors alike rushed to hedge or reduce their exposure to the region.

Malaysia

Malaysia was among the next to be affected. Its economy was fundamentally sound although there were concerns over a property boom and over investment in infrastructure. An acute loss of confidence, partially prompted by Thailand's problems, led to a sell-off of Malaysian shares and the ringgit. The stock market and exchange rate crashed.

Unlike other countries, Malaysia did not have excessive external borrowing. However, domestic borrowing was very high as banks had lent large sums, often against share collateral and to large property projects. The crash exposed these weaknesses in the private sector. On 1 September 1998, Malaysia decided to impose capital controls.

Indonesia

Indonesia was also believed to be fundamentally sound, even well after the initial outbreak of the regional currency turmoil. In late 1997, analysts continued to be upbeat on Indonesia's economic prospects, expecting, on average, a strong 6-7% GDP growth in 1998. But as regional problems stacked up, Indonesia too could not escape the progressive erosion of confidence.

The Indonesian economy had two domestic weaknesses: unsound banks and companies that had borrowed excessively abroad in short-term loans unbeknown to the government. These companies started hedging their exposures, sending the rupiah into a downward spiral. The companies became insolvent, badly affecting the banking system. Policy errors by the Suharto government compounded this. Grave social and political difficulties eventually led to a political crisis and a political transition that is still not completed.

Korea

Korea's dynamic economy had certain weaknesses, but these were long-standing and well known: chaebols were very highly leveraged and banks often made lending decisions on government direction instead of commercial viability. Like Indonesia, Korea's short-term foreign debt was high. When the crisis broke, foreign creditors refused to roll-over credit lines. Korean banks which had borrowed heavily overseas came under severe pressure.

However, unlike in Indonesia, the major creditor countries, particularly the United States, got together and agreed on an orderly roll-over of Korean banks' short-term debt. This stabilised the situation and enabled the Korean economy to resume growth quickly.

Hong Kong

Hong Kong and Singapore were the two economies with the least structural problems or foreign borrowings, yet neither could escape the contagion. Hong Kong's economy benefited from its linkages with China which was relatively unaffected by the regional currency turmoil. But the Hong Kong dollar's (HK$) peg to the US$ caused Hong Kong's real exchange rate to appreciate significantly when all the other regional currencies fell. The full adjustment to the changed external environment had to be borne internally, through nominal prices of assets and wages. The result was a sharp recession from which Hong Kong is just beginning to emerge.

At the same time, the high HK$ led the markets to assess the risks of a devaluation. Interest rates rose, further squeezing the economy. After several speculative attacks on the currency and "double-play" on the currency and share markets, the HKMA intervened directly to buy shares in August 1998. The speculative attacks were successfully beaten off, but the Hong Kong Government remains extremely concerned over the dangers posed by speculators, and particularly hedge funds, to their economic stability.

Singapore

Singapore was more directly affected by the crisis than Hong Kong because of our close economic linkages to Thailand, Malaysia and Indonesia. Our growth slowed down drastically, turning negative for several quarters. However, unlike Hong Kong, the S$ exchange rate could and did adjust down relative to the US$, in line with its trading partners. This extra degree of freedom helped to soften the impact of the sharp regional slowdown and depreciation of its neighbours' currencies.

In addition, the Government sought to make prompt and direct adjustments to the real economy, cutting taxes and levies, reducing the CPF contributions with the support of unions and workers and building capabilities for the longer term. These measures helped see Singapore through the storm and are now enabling Singapore to recover, together with the rest of the region.

Lessons from the crisis

When the Asian currency crisis first broke out, many observers blamed the "Asian model". But then other emerging markets, even the developed world, came under fire. It became clear that the problem was not just Asia, but also weaknesses in the structure of the global financial system.

There is general agreement on what the key weaknesses were, but not yet on their solutions. Very broadly, I identify five issues:

- Capital controls – can they help?
- Exchange rate regimes – fixed or floating?
- Hedge funds – what do they imply for global systemic stability?
- Global financial supervision – is this possible?
- Strengthening domestic institutions – a prerequisite to participation in the global system.

Capital controls

This crisis has prompted a reconsideration of the merits of capital controls. In an ideal world, the global capital market should be one integrated whole, with no restraints on the movement of capital. Then savings could be channelled to their most productive uses and countries could fund their investment needs at the lowest possible cost.

But in reality many economies still lack the institutional framework to deal with free capital flows. Furthermore, investors are prone to herd behaviour which can result in large surges of capital into and out of countries. These surges cause bubbles and crashes which can do great harm to economies, especially small and vulnerable ones.

The liberalisation of capital accounts must thus be treated with caution. It must not proceed faster than the strength of countries' domestic financial systems and institutional capability. Controls on "hot money" are difficult to administer and subject to evasion, but they can help make countries less vulnerable to volatile financial markets.

For instance in Indonesia, following the liberalisation of the banking sector in the late 1980s, companies made large short-term borrowings in foreign currencies. They circumvented rules intended to prevent this. When the crisis struck, the Indonesian government did not know how much the companies had borrowed. Yet the total was almost US$ 50 billion[1], more than double Indonesia's gross foreign reserves.

The effects of the capital controls which Malaysia imposed in September 1998 are still being debated. But even Malaysia, which is implacably opposed to speculators out to make a quick profit, still welcomes foreign investors including portfolio investors buying Malaysian shares. Ultimately, all countries still hope to enjoy the benefits of global capital markets such as more foreign investments and transfers of technology.

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[1] External debt of the non-bank sector totalled US$ 47 billion in FY1997, accounting for 83% of total private external debt and 41% of Indonesia's total external debt.

In Singapore, our currency is fully convertible. We abolished exchange controls in 1978. We have no restrictions either on the inflow or outflow of funds. Because we are a financial centre, these flows are large relative to the size of our economy. Hence we want to be careful not to let them overwhelm or damage our real economy.

This is why we have maintained a policy of non-internationalisation of the Singapore dollar (S$). This is not a form of exchange or capital control. It is a monetary policy measure to deter speculation against the S$. It prevents non-residents from borrowing the S$ for purposes unrelated to our economy for example to fund a short position in the S$.

We believe that the S$ exchange rate should be appropriate to prevailing economic conditions and the underlying state of the Singapore economy. Indeed in the long term, keeping the currency in line with fundamentals is the best way to avoid offering speculators too tempting a target.

Exchange rate regimes

Massive speculative attacks on exchange rates are a common element in financial crises. Misaligned fixed exchange rates have figured prominently in financial crises throughout the 1990s, even the 1980s and 1970s.

In the post-crisis era, the conventional wisdom is that emerging markets should choose either a free-floating or fixed exchange rate system.

But neither is a panacea. Fixed exchange rates are hard to sustain in a world of global capital mobility. Furthermore, they tend to be viable only when supported by large foreign reserves and strong institutional arrangements. Even then, the exchange rate can still become misaligned and vulnerable, as has happened in Argentina.

In Hong Kong, strong foreign reserves and well-developed financial authorities and institutions made its currency board workable and credible. But even the Hong Kong dollar came under fierce attack in this crisis. In other countries a fixed exchange rate may be completely infeasible. Thus Professor Steve Hanke’s proposal to set up a currency board system to stabilise the rupiah was viewed with deep scepticism by policymakers both in Indonesia as well as the IMF and the World Bank.

Neither does a free-floating exchange rate always work. Even developed countries do not remain impassive when capital flows overwhelm trade flows and threaten the competitiveness of the country’s exports. A prime example is Japan. And despite a free-float, the exchange rate may spiral downwards if there is a loss of confidence. This happened in Indonesia and Brazil after they abandoned their exchange rate pegs.

Singapore operates a managed float. This policy has prevented the currency from getting too far out of line and rendering our exports uncompetitive as a fixed rate might have done. A managed float has not totally eliminated speculative pressures on the S$, but for our circumstances it is the most appropriate approach.

The best exchange rate regime depends on the specific circumstances of each economy. While it is important to get this right, the exchange rate does not exist in a vacuum. Ultimately, it is the strength of the country’s economy, the soundness of its fiscal and monetary policies and the confidence of both foreign investors and its own citizens in the country that determines whether or not the currency is stable. If these fundamentals are out of kilter, no technical fix of the exchange rate regime will avert a crisis.

Hedge funds

Perhaps the most controversial issue to have arisen from the crisis is that of hedge funds. They undoubtedly took positions successfully against the Thai baht. The Malaysian Government is certain that hedge funds were behind the collapse of its stock market and currency. Hong Kong and Australia are similarly convinced that hedge funds led attacks on their currencies.

On the other hand there is some evidence that except in Thailand the hedge funds may have been wrong footed in the crisis. George Soros has denied being short on the ringgit, during and several months before the crisis[2]. A spokesman for Soros Fund Management said in October 1997: "Recent volatility in world financial markets is reflected in the volatility of the Quantum Group's performance", a nice cryptic way to say that they had incurred substantial losses.

While the facts are still hotly disputed, they are ascertainable. What role hedge funds played in different countries is an empirical question and not a matter of opinion. A Working Group on HLIs has been set up under the Financial Stability Forum. I hope it will settle the facts unambiguously so that the debate can move on to consider what, if anything, should be done.

In deciding whether to restrict the activities of hedge funds, there are three considerations. First, who are the shareholders of hedge funds? They do not represent the retail public. Typically, hedge funds invest on behalf of wealthy individuals and institutional investors who do not need consumer protection. From this point of view, the activities of hedge funds are private business and need not be subject to the same strict regulations and disclosure demands as financial institutions that collect monies from the public.

The second is a prudential concern. Are financial institutions that lend to hedge funds being sufficiently prudent and provisioning enough capital in relation to the lending? Hedge funds are not rated by commercial rating agencies, unlike most large banks and corporations. They often keep their portfolios and strategies secret which hampers a proper assessment of their financial soundness. The existing regulatory framework is not tight enough in this respect. As LTCM showed, creditors often lent independently of one another and were not setting aside sufficient capital to cover their lending to highly leveraged funds.

The third is a systemic consideration. Are hedge funds a source of instability in the global financial system? While their role in the Asian crisis remains controversial, the LTCM incident shows clearly that on occasion hedge funds can be destabilising, through their sheer size and leverage.

Banning hedge funds altogether is not the solution. Many other institutions make similar plays as the hedge funds. Indeed hedge funds can play a positive role in international financial markets. Their signature contrarian and arbitrage strategies can help to stabilise and even enhance the efficiency of financial markets. However, checks are necessary to prevent them from accumulating excessive positions, unknown to the market and to regulators.

Directly regulating hedge funds will also not work. There is the practical problem of regulatory arbitrage – such players can easily relocate if regulation is forced on them. Besides, not all hedge funds are large and highly leveraged. There is no need to regulate all of them in the same way.

One possible approach is indirect regulation, through their lenders and other counterparties. This means bringing the private sector into the surveillance picture. We should create incentives in the supervisory framework for the counterparties of hedge funds to become more vigilant and prudent. Lenders must strengthen their own credit assessment systems, while regulators should find ways to encourage risky borrowers to disclose more, voluntarily, to their creditors. For example, we could introduce a higher risk weighting for borrowers who are large and highly leveraged and who do not disclose enough to either their creditors or the credit rating agencies. This would spur hedge funds to disclose more or to obtain a credit rating.

Global financial supervision

The crisis has set off debate as to whether the global capital market needs a global regulator. I doubt this is workable, or even desirable. A global financial super-regulator requires countries to give up national sovereignty. This is politically unrealistic; witness how carefully the IMF had needed to

[2] George Soros in *The Crisis of Global Capitalism*, Ch. 7 *The Global Financial Crisis*, p. 136.

canvas its major shareholders to support its prescriptions and how closely the US Congress scrutinises the IMF's actions.

A more practical, albeit modest, solution is the establishment of the Financial Stability Forum. This brings together both the G7 countries as well as non-G7 financial centres and international organisations such as the IMF, World Bank and the BIS to discuss the vulnerabilities of the world system. The Forum should be able to get best practices and supervisory standards implemented more widely and effectively.

The FSF has set up three working groups to study areas of vulnerability highlighted by the crisis: capital flows and exchange rate regimes, highly leveraged institutions and offshore financial centres (OFC).

Singapore has been invited to participate in the FSF, together with Australia, Hong Kong and the Netherlands. We are also in the OFC working group. OFCs have attracted considerable attention because of the significant capital flows they generate. They are a weak link in the maintenance of global best practices and regulatory and supervisory standards. If OFCs do not meet international standards they will provide an opportunity for regulatory arbitrage. Financial institutions may be tempted to migrate to such OFCs. This would make it very difficult for other jurisdictions to maintain or raise their own standards.

There is work ahead to understand the roles and uses of OFCs and their implications for financial stability. Singapore, together with the other members of the OFC working group, will involve OFCs in this study. We aim to find ways to get them to meet international standards of cooperation in cross-border information exchange and enforcement. We must create incentives for OFCs to play by the rules or at least not disregard the rules. Bringing OFCs under the global regulatory umbrella will help raise prudential standards and enhance the stability of the global system.

Strengthening domestic institutions

The most important and reliable safeguard for economies which open themselves up to the global market is a strong domestic institutional framework. Governments must strengthen domestic financial institutions and companies by adopting best practices of financial supervision and corporate governance. Banks need a strong credit culture while other companies too need a rigorous business culture.

In the helter-skelter growth before the crisis, Asian governments had neglected these institutional underpinnings. While this was not the sole cause of the crisis, in many countries weak domestic institutions undoubtedly made things much worse. What Indonesians have termed KKN – corruption, collusion and nepotism – is now generally recognised to be a serious problem to be combated and not just accepted as the way business is done.

Strengthening domestic institutions will enable Asian countries to sustain long-term recovery and growth. Governments must restructure the financial and corporate sectors. Insolvent financial institutions need to be closed down or merged with stronger ones. In the corporate sector, unviable companies must go while weak, but viable companies must restructure their balance sheets and rationalise their operations. This calls for deft handling and sensitive political judgement as to how fast and far to go and how to trade off between social and political objectives on the one hand and economic efficiency on the other.

A sound banking system is fundamental. This starts with the adoption of high standards of financial supervision and regulation supported by a sound legal system. More importantly, regulators and governments should not neglect the establishment of a strong credit culture. This is the "software" of good banking governance. Banks must lend in a disciplined way, based on commercial viability rather than "relationships". A relationships-based system undermines competition and disclosure. It results at best in misallocation of resources and at worst in a collapse of the whole financial system.

Banking governance must be complemented by strong corporate governance. Poor corporate governance practices have allowed massive unreported losses and hidden liabilities to develop.

Upgrading corporate governance means raising the quality and influence of boards of directors, protecting shareholder rights and raising and enforcing accounting and audit standards. All these preconditions are necessary before market discipline can work properly.

It is encouraging that most of the crisis Asia countries have declared their intention to work towards international best practices in corporate governance. But business environments cannot be changed overnight. It involves changing entrenched social relationships and norms that vary from country to country. This will take time. The best hope for individual countries to restore long-term growth in the global village lies in their succeeding in this transformation.

Conclusion

There is no escaping the process of globalisation. In theory, countries can opt out, but in practice the price is prohibitive.

While the globalisation of trade flows undoubtedly benefits all countries, the globalisation of capital flows carries much greater risks. Ideally, capital markets should be self-stabilising and should promote economic efficiency by directing capital to its best uses on a global basis. But whether this always happens in reality is an open question. The frequent crises, of which this is just the most recent, give us reason for doubt.

The Asian crisis has wrought grievous harm on many countries. But one positive consequence is that it has provided a fresh impetus for reconsidering and strengthening the global financial system. Countries will not want to dismantle the existing structure and start from scratch, as happened in Bretton Woods after World War II. More likely and prudently, they will pursue incremental improvements to strengthen the structure and remedy the flaws which have been uncovered. We must find ways to make bubbles and crashes less likely and make countries less vulnerable to such mishaps when they occur.

While we can strengthen the global financial system, we can never eliminate bubbles and crashes completely. Manias, panics and crashes are inherent to capitalism dating back to the tulip mania and South Sea Bubble of the 17th century and probably before. In theory, investors make independent decisions which collectively result in a stable and efficient market outcome. In reality, uncertainty due to incomplete information and a basic human instinct to herd can prove destabilising and disastrous.

For small open economies, the best defence against an uncertain and sometimes dangerous environment is to pursue prudent macroeconomic policies, strengthen their financial systems and improve their governance framework. Sound domestic policies and institutions cannot eliminate panic and contagion. But they can cushion the adverse effects and make the economies more resilient to the financial shocks when they occur.

Thank you.