Comment on "Reflections on the Asian Crisis: Causes, Culprits and Consequences," by Jack Boorman

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This is a very good paper which has a lot of interesting and valuable information on the domestic causes of the crisis, the differences between the countries, and the role of derivatives. I want to complement and develop points, rather than necessarily argue with Jack's paper.

At first, a general point is that people who have in the past criticised institutions like the IMF, should consider that there are too many difficult issues out there that need to be resolved. I think that we all need to work together as the world has become so complex – among other things, because of the globalisation of capital markets – that the simple black and white solutions don't really work anymore. The paper's emphasis is on domestic financial imperfections, but what doesn't come out so strongly in the paper, although it did much more in the presentation, is the emphasis on imperfections in the international capital markets. What Greenspan has called these "visceral engulfing fears" that shake markets are a deeply worrying trend. The fact is that these imperfections in the financial sectors, both domestic and international, have undermined the extremely dynamic and strong economies in Asia. I think that the most worrying thing about the Asian crisis, and previously about the Mexican crisis, is that these imperfections in capital markets seem to be strongest for economies that either are, or are perceived to be, highly successful. Mexico was supposed to be the most successful reformer in Latin American, the Czech Republic was supposed to be the most successful reformer in Central Europe, and the same was said about the Asian tigers. It's a sort of curse of the successful economies, curse of the successful reformers, and we see this pattern again and again, as Charles Wyplosz shows in his paper.

The pattern you see is when economies are successful, the capital flows in, eased by capital account liberalisation. Then exchange rates get overvalued, or overvalued exchange rates get sustained, and the prices of key assets like land, buildings and shares increase sharply. As a result of increased real incomes and perceived wealth effects, individuals increase consumption and companies increase investment. Banks, of course, are also contributing to this process because they are intermediating these capital

From: Regulatory and Supervisory Challenges in a New Era of Global Finance
FONDAD, The Hague, 1998, www.fondad.org

flows. Inevitably the current account deteriorates. Initially this doesn't seem to matter because everybody is loving this country so much that they continue pouring money into it. However, at some point there is a change – it can either be big or small, economic or political, domestic or international – which triggers a very large change in perception, even though the change in the real economy, may actually be far smaller. Then there is this massive outflux. None of us knows how to fully deal with this extremely complex issue, but I think that we have to see what can be done to prevent this from happening. Also, to prevent the problem that I think is a little bit underplayed in Jack's paper, the problem of contagion. I mean, would Korea have had such a massive crisis if things hadn't developed in Thailand? Or, back in the 1980s, would Brasil have had such a big debt crisis if there hadn't been other countries in the region which had previously entered into debt problems as well?

I would like to stress the need for more study on the supply and lend factors. How do different investors and lenders behave? In Jack Boorman's paper there is an analysis of hedge funds, which apparently didn't play as big a role as some people think. However, we need to revise the roles that different institutions – whether it is banks, mutual funds, hedge funds, or non-financial companies – play. How do they behave? Then, from understanding that, we should also explore how their behaviour can be modified. We have to look at issues like more regulations in source countries, or perhaps tax incentives to stimulate more long-term behaviour in the source countries. Returning to the point that was made, for example, by Mr. Witteveen, I think that there is a need for better regulation in the source countries, especially of short-term flows by banks. If it isn't done at the level of the source countries, you may have either recipient countries that are overwhelmed by these flows, even if they try to stop them, or you may have countries that don't seem to be able to sufficiently stop them. I mean, I find it very surprising that the Koreans with their tradition of always being very cautious, always privileging long-term flows, suddenly were receiving these massive amounts of short-term flows. I am afraid that this may happen again and again. One part of the jigsaw must be that the source countries apply tighter regulations on these potentially volatile flows. Regulations of institutional investors, like mutual funds, should also be considered, because at the moment they are totally unregulated from the macroeconomic point of view. The mutual funds played an important role in the Mexican crisis so there is a need not just to focus on improving on what countries can do, but also improving the functioning of international capital markets. Together with Jane d'Arista of Boston University I have elaborated some measures that could be taken, which I will present at the end of my comment.

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FONDAD, The Hague, 1998, www.fondad.org

At the national level, again, I think we need to think of new and creative ways of responding to this new world of highly mobile capital flows. I'm sure that improving the data, improving transparency is very valuable. There are a whole range of new instruments, derivatives and so on, where the information available to central banks is very, very weak. I'm sure that all that can be done by the Fund, and by others, to improve this situation would be extremely valuable. However, there are limits of course, because as we discussed earlier, even when there is very good information, the problem is how it is analysed and how it fits into these changing fads. Then there is this additional problem of rapidly changing circumstances. For example, if you are trying to analyse financial sector soundness, you find that a financial sector looks very different with one particular level of exchange rate and particular interest rate, than it does three months later, in the middle of a crisis, with an exchange rate that is double the level and with an interest rate that is triple the level. So how does one improve information on that? Should we use simulation models? How should one weigh the likelihood of a crisis? I think that these are very serious problems which deserve more thought.

There is also a whole new area for domestic macroeconomic management in this globalising world where crises are not caused by fiscal deficits anymore. Now we have these crises that are caused mainly by private deficits and it is much more difficult to know how to prevent these. Perhaps the key in avoiding these crises is that one should be very prudent in good times, when there is more flexibility, because once things start to deteriorate, the options that the policymakers have are very few and very unpleasant. You can either increase interest rates, or you can let the collapse of your currency happen, or you can cut government spending drastically – none of these being very attractive options. So I think that the main actions must be taken before. In this context, some kind of domestic discouragement of short-term flows could play an important role. Not on its own, but in the context of good macroeconomic policy management. Maybe we have to start thinking of new policies of a more counter-cyclical kind. Maybe if there is a big boom in spending in the economy, spending by the private sector, either in consumption or investment, one should think about increasing tax rates during boom times, so that aggregate spending is slowed down, dampening this overenthusiasm of the private sector. Generating a surplus in the boom times creates space for avoiding future crises. Also, the way in which people borrow, both the government and the private sector, needs to be reevaluated. Borrowers tend to focus too much on the financial costs of borrowing, engaging in short-term borrowing because it is much cheaper. However, if you take into account the risk of any future financial crises, the cheap cost of borrowing may actually

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turn out to be very expensive. Therefore new criteria need to be developed for how you assess the structure of your debt.

To prevent a crisis, you may also need very high levels of reserves. Roy Culpeper rightly said that the two countries that haven't had a crisis in Asia are China and Taiwan, countries that haven't liberalised their capital account. However, they are also countries that have extremely high levels of foreign exchange reserves. Now this, of course, is a great luxury, because not every country is in this position. For poor countries to tell them you must not spend on hospitals, you must not spend on schools, but you must have high levels of reserves is a very difficult trade-off, but maybe it is a necessary condition if you want to have a very open capital account.

In terms of financial regulation, you may need to introduce some cyclical elements. For example, countries that have capital inflows that are very volatile may need more stringent capital adequacy rules and other prudential ratios than developed countries do. The bi-ratios are not enough for developing countries, they need far higher ratios. I think they also need, from a domestic point of view, stricter supervision of short-term flows. I'm not sure what can be done about the issue that Jack raised in the context of Indonesia. That is, what can you do about excessive short-term borrowing by companies? How can you regulate that? I feel that this is one of the most difficult issues. It is not just the Indonesians that are wrong, it is difficult for any central bank to regulate those flows. Finally, one may also think about the explicit introduction of cyclical elements in the regulation of banks and other financial institutions. For example, regulators should be looking at what proportion of bank assets are guaranteed by assets whose prices are inflated during the boom and may collapse during the bust period. Maybe they should limit such potentially volatile priced assets, so as to take into account the risk of future possible crises. In other words, one needs to be a bit more pessimistic during the boom times and a bit more lax during the crises times, in order to have a more counter-cyclical attitude.

Stabilising of Portfolio Flow to Emerging Markets: a Proposal

Capital flows to emerging markets have grown at a breakneck speed in the last ten years. Portfolio flows have grown especially fast. Indeed, portfolio flows to the emerging markets of Latin America and Asia grew by more than fifteen-fold between the late eighties and mid-nineties. A major source for these rapidly growing portfolio flows to emerging markets are institutional investors from developed economies, such as pension funds, US mutual funds and UK unit trusts.

Capital flows to emerging markets have clear and important benefits.

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These benefits are particularly clear for foreign direct investment, but portfolio flows also have important positive effects, such as lowering the cost of capital for creditworthy firms. At a macroeconomic level, foreign capital flows can complement domestic savings, leading to higher investment and growth. Portfolio flows from developed to emerging economies also have significant long-term benefits for savers in developed countries, who should get higher yields in emerging economies, with higher long-term growth rates than developed economies.

However, large surges of capital flows to emerging economies can also have problematic effects. Firstly, these surges pose complex policy dilemmas, for macroeconomic management, if they lead to overvalued exchange rates (and a growing current account deficit) and excessive money supply expansion (with risk of increased inflation). Secondly, and more important, these flows pose the risk of sharp reversals, as experienced by Mexico and other emerging economies in late 1994, and this year by the Asian economies. Particularly if such reversals lead to a currency crisis, this can lead to serious losses of output, investment and employment. The Mexican Gross Domestic Product fell by almost 7% in 1995 and in Asian countries the growth will slow down significantly. Furthermore, currency crises can be very damaging for foreign investors. Also, frequent crises could tempt some developing country governments down the wrong path of closing their capital accounts, which would be very negative for investors as well as for themselves.

As the volatility of some capital flows to emerging economies is both large and damaging, there is a need for measures to encourage greater stability, without discouraging, over time, the average level of capital flows.

One way of achieving this objective is improved information and disclosure. Since 1995, the International Monetary Fund has made important efforts to improve its information output on emerging economies which is now also available on the internet. However, unfortunately, as is clear from recent events, though better information and disclosure is helpful, it is not enough to curb volatility. It is difficult to establish *ex ante* fully problematic trends. The theory of asymmetries of information, between investors and recipients, provides useful insights into why this happens. Secondly, even if most of the relevant information is available, the criteria with which it is analysed is even more crucial. Indeed, a glass can be said either to be half full or half empty, even if the glass is transparent. Similarly, an emerging economy can be seen to be successful and creditworthy at one moment or as weak and uncreditworthy soon after, if the criteria of its evaluation change.

There may be different ways to encourage somewhat greater stability of portfolio flows to emerging markets. We would like to propose one, which

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seems particularly appropriate, as it is consistent with mainstream regulatory thinking which emphasises risk-weighting as a central element.

The proposed measure would imply that institutions like the US mutual funds would be required by their regulators to have risk-weighted capital charge cash requirements for emerging market investments. These cash requirements would be placed as interest-bearing deposits in commercial banks. The risk-weighting would vary by country and through time. The guidelines for risk-weighting would take into account such variables as the ratio of the current account deficit and the external debt to the GDP, the maturity structure of that debt, the banking system's fragility and other relevant factors. This approach is similar to that used by the Bank of England and other central banks to determine risk-weighted provisioning against possible losses on bank loans to developing countries. The guidelines for the US mutual funds would be given by the US securities' regulator (the Securities Exchange Commission) and would be defined by them in consultation with the Federal Reserve and the Treasury, as well as the International Monetary Fund, using these institutions' long experience in analysing currency crises and their causes. Weight would also be given to the views of market analysts. It is important that quite sophisticated analysis is used, to avoid simplistic criteria stigmatising countries arbitrarily.

Given the dominance of institutional investors in the US and the UK markets, this proposal could be adopted first in those two countries, without creating significant competitive disadvantage. However, at a later stage, harmonisation of such a measure should be discussed and coordinated internationally. A clear parallel can be drawn again with bank capital adequacy rules first developed nationally and then coordinated by the Basle Committee.

As the required cash reserves would change with the perceived risk, it would become more profitable to invest in countries with good fundamentals. If these deteriorated in a particular country, investment in it would decline gradually, as its risk-weighting increased. This would hopefully force an early correction, which would encourage a resumption of flows. This smoothing of flows would discourage massive and sudden reversals of flows, thus make currency crises less likely.

The proposed risk-weighted cash requirements could somewhat lower earnings for those mutual funds that do not maintain adequate levels of cash reserves, if deposits have lower yields than other financial assets. However, the introduction of an industry-wide standard of cash requirement would increase investor confidence and attract a larger volume of funding. Our proposal, which would make currency crises less likely, is complementary to measures currently being discussed, such as a new facility by the IMF, which would make currency crises less damaging. Both

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types of measures are necessary. However, medicine teaches us that prevention is better and cheaper than a cure.