The Impact of the East Asian Crisis on the U.S.

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I would like to spend my time this evening sharing with you some thoughts about the recent economic crisis in Asia and what lessons that crisis may have for the role of the United States and international financial institutions in future crises.

Let me start with a little recent history. The past ten or fifteen years have seen an unprecedented expansion in the extent to which the countries of the world are tied together, both by instant communication and by international trade, institutions, and markets, including financial markets. On the whole, this process of globalization has been an enormously positive development. It has opened new markets, enhanced competition, spurred innovation, and provided new opportunities for workers, farmers, and businesses around the world. For example, more than 40 percent of US exports today are absorbed by developing countries, an extraordinary increase over past export patterns, and the jobs associated with these exports are high-paying, good jobs. The increasing productivity of our trading partners has helped keep inflation down and improve standards of living in the United States. And outside the US, literally hundreds of millions of people have been lifted out of poverty around the world by the economic growth and trade over the past twenty or thirty years.

In this new global economy, countries are more tightly linked than ever before to each other’s fates. A decade ago, a collapse in the currency of a small, distant country’s like Thailand would barely have rated a mention in the typical American newspaper. Last year, however, that currency crash triggered a crisis in other East Asian countries that has dominated news coverage in a way that no other foreign financial crisis has ever done before in this country.
The reason for the change is that we now have more at stake than ever before in the economic performance of these countries. Not only are they major customers for our products; the rich countries and developing countries are also increasingly linked by financial ties. In 1996, the developed countries including the US invested more than $250 billion in emerging markets -- compared to roughly $20 billion ten years earlier. Much of this money was from banks (especially in Japan and Europe), although US mutual funds, pension funds, and individual investors also participated. But whatever its source, the extent of this investment means that economic turmoil in East Asia has a direct financial impact on the developed worldís capital markets, including our own. Indeed, a brief plunge in US stocks last October was widely attributed to turmoil in the Hong Kong stock market that was, in turn, linked to the crisis set off by Thailandís currency crash.

We cannot afford to be indifferent to the East Asian crisis -- because indifference and inaction would undermine our own interests. But to identify the proper response to the crisis, it is necessary to determine its cause -- which is no easy task. Attempts to identify the fundamental causes of a financial crisis always suffer from the problem of distinguishing insight from hindsight. Many a financial journalist today will tell you that the crisis was the inevitable consequence of: overvalued exchange rates, large current account deficits, short-term capital inflows, opaque financial systems, or one of several other supposedly fatal flaws in East Asian capitalism. But it seems fair to say that a year ago nobody suspected that a calamity like what we have seen was possible, although all of the characteristics that are now described as the fatal flaws of the East Asian economies were reasonably widely understood even then, at least by experts. Indeed, as recently as the early 1990s economists were debating vigorously whether the Japanese model of capital markets that was adopted in East Asia was superior to the American model.
The reason for the recent widespread admiration of East Asian economies is obvious: these countries must have been doing something very right, because over the last thirty years or so they achieved the single greatest spurt of economic growth in the history of mankind. There is little dispute about the importance of some of the things these countries got right: high saving rates, rapidly increasing levels of education, and hard work. The role of these countries' financial systems in fostering growth may be more murky, but it is at least clear that the flaws of those financial systems were not sufficient to prevent some remarkable accomplishments. A key element in any successful explanation of the East Asian crisis must therefore be an answer to the question of how a system that worked so well for so long could suddenly fail.

One problem in coming up with an overarching explanation of the East Asian crisis is that the afflicted countries differ from each other in many important respects. In sorting through the many and conflicting stories about What Went Wrong in Asia, I find it helpful as a preliminary to go back to the basic question of what capital markets do: they transform financial savings into physical investments. This transformation is difficult for three reasons: first, the people with savings generally want convenient and guaranteed short-term access to them (that is, they want liquidity); second, almost all investment opportunities require a long-term commitment to yield a good return, and can be liquidated only at a heavy loss; and, finally, the gathering, processing, and comprehension of information about investment projects are costly and time-consuming.

The traditional solution to this set of problems is a bank, which accepts the short-term deposits of savers, gathers and processes information about potential borrowers, and (if the bank is functioning properly) offers long-term loans to those borrowers judged to be sufficiently likely to repay at a sufficiently high interest rate. The hat trick of providing savers with short-term liquidity backed up by illiquid long-term assets is accomplished by relying on an assumption that all the savers are not likely to want to withdraw their deposits at the same time. As long as this
assumption holds true, small reserves of cash can meet the demands of whatever depositors happen to want to withdraw their savings on a given day.

However, even a well-run bank can be destroyed overnight if too many people decide to withdraw their savings at the same time. Once the bank’s cash reserves are gone, in the absence of some outside help it, must either tell depositors that they cannot withdraw their savings, or it must sell off its illiquid assets, likely at a huge loss, and distribute the inadequate proceeds to the remaining unsatisfied depositors.

The remarkable point in this story is that even for a well-run bank the outcome is a self-fulfilling prophecy: If everybody believes the bank is sound, its reserves will be sufficient to meet liquidity demands, and the bank, its depositors, and its borrowers will all reap their just rewards. But if for some reason depositors begin to suspect that too many other depositors may try to withdraw their deposits, then each depositor has an incentive to rush to the bank and try to withdraw their own savings first -- causing a bank run. If everyone does this, the bank collapses. Even worse, if the failure of one bank makes depositors in other banks think that their savings may be at risk too, there is a real possibility of a contagion in which one bank failure prompts many more.

A bank run will not happen if depositors are absolutely certain that they will be able to withdraw their funds upon demand, and so the simple solution to the problem of bank runs is to create a lender of last resort or a deposit insurance agency who can step in to provide the necessary cash in case of a bank run. And here is where the problem economists call immoral hazardı rears its ugly head. If depositors will be bailed out even in the worst of circumstances, and the bank has too little of its own capital at stake, the bank may have an incentive to take excessive risks with the depositors' money, because from the bank’s point of view, if the risk pays off, the bank keeps the profits, but if the risky investments go bad, the government bails out
depositors. It's heads I win, tails the government loses. Thus, it is essential to tie deposit insurance protection to prudential bank regulation and monitoring, where the word prudential conveys that the purpose of the regulation is to prevent banks from taking undue risks.

Thus far everything I have said is straight from Money and Banking 101, and I apologize to anyone for whom it may be review. But setting out the story explicitly is useful because it highlights two essential ways in which human judgment enters the problem. The first concerns the confidence of depositors. A collapse in their beliefs that their money is safe can lead to bank runs with possibly severe economic consequences such as bank failures, the termination of long-term investment projects at heavy losses, and chains of bankruptcies in the economy. The second channel of judgment is the process by which bank managers decide how to dispense their loanable funds. In my view, most of the plausible stories about what happened in East Asia can be interpreted as stories about these two channels of judgement and their interactions. And realizing that real economic outcomes depend critically on changeable human judgements helps to answer the question that many laypeople and journalists have asked about this crisis: why didn't the experts on these economies know beforehand that something was wrong? Part of the answer is that the crisis reflects a wholesale, and self-fulfilling, change of opinion among investors about whether East Asian investments are sound. Nobody predicted the crisis partly because it is very difficult to anticipate such a profound change in other people's judgements.

This emphasis on the importance of judgement leads naturally to the question of how people make judgements. Patrick Henry once said 'I know no way of judging the future but by the past.' If Patrick Henry had been a money manager in the early 1990s he would probably have been very enthusiastic about investment in East Asia. And therein may lie a large part of the problem. Consider two alternative methods of making investment decisions. The first is to adopt Patrick Henry's method and invest in investments similar to whatever has performed well in the past, without bothering too much about what lay behind this good performance; because
you can think of this method as basing future expectations on charts of past performance, I will call this investment method "chartism." The second method of judging investments is to gather lots of relevant financial information about alternative investments, consider the circumstances under which each is likely to perform well and how likely those circumstances are to prevail, and choose accordingly. This strategy, which I will call "fundamentalism" because it relies on an analysis of the fundamental financial information that determine success or failure of the investment, is difficult and can require large amounts of data and expertise to implement -- and is impossible if accurate and careful financial information about alternative projects is simply unavailable.

With these thoughts in place, let me start with the simplest story about the nature of the East Asia crisis: that it was conceptually no more than series of giant bank runs. To understand this story it is necessary to realize that foreign banks had extended enormous amounts of short-term loans to banks and companies in the East Asian countries, and that these short-term loans were then used to finance long-term investments. Because the lender always has the option not to renew a short-term loan, such loans pose exactly the same kinds of problem that bank deposits do: if all lenders suddenly decide that their short-term loans are riskier than they had thought, they will not be willing to renew those loans when they expire. The sudden unwillingness to renew short-term loans is like a sudden decision of all depositors to withdraw their bank deposits: it can lead to a collapse of the borrowing bank or corporation, which has likely used the proceeds of the short-term loan to finance long-term investments that cannot be liquidated except at a very heavy cost.

The story, roughly speaking, is that the collapse of the Thai baht in July, and the subsequent closing of a large number of Thai financial institutions, which foreign lenders might previously have supposed were safe borrowers, spurred a fear that similar short-term loans to other East Asian borrowers were not so safe as lenders had supposed. Since those loans had been made at interest rates barely above rates available in truly safe investments at home, even a
modest increase in doubt was enough to induce the foreign lenders to want to bring their savings home. But because it was impossible for the borrowers to repay all of the short-term loans simultaneously, a crisis ensued. The proponents of this 'bank run' view of the crisis deny quite explicitly that the long-term investments made by borrower banks and corporations were generally unsound (of course, they do not deny that there are some specific examples of bad lending, but they do deny that there was a major deterioration in the quality of long-term lending decisions). If this story is right, then the main policy error in the crisis was a failure of government authorities to promise a prompt and unconditional bailout to all bank depositors.

It seems fair to say that this is not the majority view of the crisis. Certainly the journalistic focus has been on examples of poor long-term investment decisions, from the Indonesian national car project to widespread overinvestment in real estate to the extraordinary empire-building of some Korean conglomerates. All of these examples strongly suggest that there was something amiss in the second stage of the financial process, where decisions are made about which real long-term investments are worth financing.

There are several kinds of stories about what was amiss there. Let me start, again, with the simplest: a straight moral hazard story. In this view, the essential problem was insufficient (or nonexistent) prudential bank supervision, giving the banks the classic 'heads I win, tails the government loses' incentives to overinvest in high-risk, high-expected-return ventures. The most convincing application of this model is to the large volume of loans to real estate projects. In hindsight, much of this lending seems obviously foolish; why build huge office towers in cities that already have substantial office vacancy rates? But property prices had been rising quickly for years, and as long as they continued to rise, such loans could be very profitable. If lenders did recognize some prospect of a possible collapse in the real estate market, real estate loans are exactly the kind of high-risk, high-return investments that would be expected from a bank subject to a moral hazard problem.
Although the standard moral hazard story may be a potential explanation for the overinvestment in real estate, it does not capture some of the other kinds of capital allocation problems that seem to have been common in the East Asian economies. One category of such problems has been designated icrony capitalismî; in this view, banks and other financial intermediaries allocated capital on the basis of personal, business, or governmental connections rather than on the basis of any information they had about the fundamental economic value of the specific investment projects they were financing.

One thing we may have learned from the East Asian experience is that in the long run, reliance on such behind-the-scenes relationships for capital allocation may lead to increasingly poor investment decisions. One plausible explanation might come from supposing that at early stages of development, there are many obvious high-return investments to make, but at later stages, after the low-hanging fruit has been plucked, expected returns from investment projects are both lower and harder to perceive. ìRelationship lendingî would work at early stages of development because the borrower stands to reap large economic rewards from pursuing the high-return projects, but such lending practices might break down at later stages when overall economic returns are lower because the borrower may be tempted to indulge in projects with non-economic side benefits such as empire-building or international prestige, or even direct monetary compensations to the borrower like ìcommissions.î

This brings me back to the distinction between the ìchartistî and the ìfundamentalistî methods of making investment decisions, because lending to parties who repaid past loans without requiring careful financial analysis of the new loan is a form of chartism. Similarly, foreign lenders providing short-term loans to East Asian banks were also engaging in chartism if they assumed that their loans were safe simply because similar short-term loans had been repaid in the past. Indeed, given the poor financial disclosure rules and lax regulation that characterized
the banking sectors in some East Asian countries, it is hard to believe that the massive short-term loans to banks in these countries could have been based on any information other than past performance.

I think that perhaps the clearest lesson of the East Asian crisis is that a system based on relationship lending and past performance, rather than fundamental information, is extraordinarily susceptible to collapse if the providers of capital begin to suspect that some borrowers or some banks may have made bad investments. If the only information a lender has about a borrower is that similar borrowers have repaid in the past, then the news that some similar borrowers are suddenly not repaying can have a devastating effect on confidence, and therefore on the financial system and the economy as a whole. If foreign lending to East Asian banks was based on chartism, is not hard to see how the failure of a few Thai banks in the summer of 1997 could have triggered a widespread loss of confidence in East Asian banks.

This story, or something like it, seems to me the most plausible explanation of the broad characteristics of the East Asian crisis. And it is clearly distinguishable from the simple bank run or moral hazard stories in its diagnosis that the severity of the crisis is due in large part to a tendency in these economies to allocate capital not on the basis of sound financial information but rather on the basis of relationships and past experience.

I turn now to the question of what has been and should be done to contain the crisis and to prevent similar future crises.

Newspaper headlines about the International Monetary Fund's efforts to address the East Asian crisis tend to focus on the enormous sums of money that are involved -- ranging up to a staggering $57 billion in the Korean rescue package. In truth, the amounts of money that have been directly provided by the IMF to the afflicted countries are much more modest - the headline
figures include all possible future commitments by both the IMF and other countries participating in the rescue plans. Indeed, despite the headline focus on dollars, the real news about the IMF's programs in East Asia was that these plans differed from any previous IMF rescue package in several critical respects -- most notably in their novel emphasis on structural reforms in the financial sectors of the affected countries, reforms designed precisely to address the problems of relationship lending, lax bank supervision, and poor accounting and transparency that I have just argued were the real reason the East Asian crisis was so swift and so severe.

One consequence of the high visibility of the IMF programs is the visibility of criticisms of the IMF. A member of the public might well conclude that something must be seriously wrong with the IMF on the grounds that where thereís smoke, thereís fire. What is not obvious except to experts, however, is that most of the criticisms of the IMF are matched by equal and opposite criticisms coming from the other direction. Of course, the fact that the IMF is being attacked from both sides on most issues does not necessarily prove that its policies represent the right balance, and it is probably inevitable that, in hindsight, there are some things the IMF might have done differently in its initial reactions to the crisis. But with the aid of hindsight almost any policy decision can be second-guessed. Bad as the crisis has been, I have no doubt that it would have been far worse if the IMF had not been there to administer some much-needed good advice and to help restore at least some degree of investor confidence in the affected countries.

I disagree, particularly, with those critics who imply that both the US and the world would be better off if the IMF did not exist. The main argument that these critics make is that the mere existence of the IMF encourages international investors to recklessly lend money without worrying about whether the borrowing country or bank is creditworthy, on the assumption that an IMF package will bail them out if the investment proves to have been bad. This is another example of the immoral hazard argument made earlier, but now the entity accused of providing a bailout is not a national government but the IMF. While I heartily agree that
irresponsible lenders should not be bailed out, it turns out to be extraordinarily difficult to punish such lenders without causing catastrophic consequences in the affected countries and perhaps elsewhere. Once again the lack of transparency in the financial system is a critical problem, because potential suppliers of new capital still cannot distinguish the good borrowers from the bad. If existing debt is defaulted on, the likely effect would be to cause a complete withdrawal of capital from the affected country -- potentially leading to a complete financial meltdown. It is simply not acceptable to say that Thailand should be destroyed in order to punish J.P. Morgan. It is even more unacceptable given the real danger of financial contagion that could spread from such a calamity -- even to the US. Recall that in October a sharp plunge in the US stock market was attributed to financial turmoil in Hong Kong that was in turn directly related to the rest of the East Asian crisis. While the US stock market recovered, we have no guarantee that things might not have turned out much worse if the IMF had not been around to provide some assistance to Thailand and the other stricken East Asian economies. And even aside from the possibility of financial market contagion, economic collapse in East Asia would severely damage our trade with that region, hurting US exporters in the short run and the US standard of living in the long run. Finally, there are powerful geopolitical reasons that we should care about economic stability in East Asia. The US still has 37,000 troops in Korea, and has strong military and political ties with Japan and other countries in the region. We therefore have serious national security reasons in addition to economic reasons to care about the recovery of the East Asian economies.

The East Asian crisis has strained the IMF's financial resources nearly to their limit. This means that if a crisis should erupt in another big country, or if the East Asian crisis should take a turn for the worse, the IMF might not be able to provide a credible rescue package. The resulting financial collapse could spread, just as Thailand's crisis spread, and the damage to the global financial system could be severe. As a result I believe it is critical that the Congress quickly approve the Administration's requests to increase the IMF's financial reserves. This should be an
easy decision, because these are not budget expenditures -- they are just lines of credit for the IMF, and so are more akin to investments. Such IMF funding increases have never cost the US taxpayer a dime, and the proposed increases in IMF reserves will also cost nothing. And they provide a real measure of increased security for the US and the world's financial system.

Funding increases for the IMF, however, are only the first and most obvious priority in responding to the crisis. We need to take steps to reduce the likelihood that similar crises will erupt in the future, and to minimize the consequences of such problems as do occur.

It seems to me that there are three elements that should be part of any reform effort. The first is to improve the information available, so that investors can make their lending decisions on the basis of an informed assessment of the fundamentals. To be well-informed, an investor needs to know a great deal about both the specific borrower and about the economic circumstances of the borrowerís country. We therefore need to strongly encourage countries to require improved accounting and reporting from their businesses, and we also need to make sure that data are available on the financial position of the country as a whole. Particularly important in this respect are good data on central bank reserves and more generally on total short-term foreign debt. Investors also need good qualitative information on risk, including assessments of the quality of countriesí banking supervision, bankruptcy procedures, judicial systems, and any other institutional arrangements that can have an important effect on risk.

Second, many countries need to strengthen their national financial systems. There are several proposed international standards for banking supervision and regulation that could be adopted; at a minimum there should be some regular system of assessment and surveillance of banks and other financial institutions. An analogy here might be useful. Todayís global financial markets are like superhighways: They get you where you want to go fast. By this, I mean they are useful: they help countries finance investment and therefore growth, and they
help buffer and smooth away economic fluctuations. But when building an exit ramp from a superhighway to a new village, it is essential for the village to pave the roads, install street lights, and make sure the pedestrians understand the new rules of the game before opening up the exit ramp. And drivers should exercise caution in navigating in new and unfamiliar territory.

I do not know how the monitoring and reporting on financial and banking systems should be implemented, though there are several alternative proposals. One possibility is that regulators in countries with strong financial systems could prohibit banks from countries with inadequate regulatory regimes from participating. Regulators might also require greater risk-based capital reserves for loans extended to borrowers in countries with poor financial regulatory systems.

Finally, we need to develop mechanisms so that the private sector bears the consequences of its own investment decisions more fully. Perhaps the most straightforward solution would be to encourage capital flows to take the form of stock and bond investments rather than bank lending in a foreign currency. Prices in stock and bond markets adjust to changes in perceived risk automatically and in ways that can pose substantially less systemic risk than foreign-currency-denominated short-term loans. This solution fits well with the other reform pieces, because in order to function well, stock and bond markets require timely, honest, and credible reporting of firms' financial circumstances -- in other words, a transparent, well-regulated, and well-functioning set of public capital markets. Building such markets is a long-term challenge, not a short-term fix.

I turn, finally, to the implications of the crisis for the United States economy. In the short term, US exports to East Asia are likely to drop sharply, both because the drop in income in East Asian countries will make those countries curtail spending of all kinds, and because the sharp drop in East Asian currencies means that US goods are now much more expensive for East
Asians to buy. At the same time, our imports of goods from East Asia are likely to rise, because the drop in their currencies makes their goods cheaper for us to buy. The net effect of a reduction of our exports and an increase in our imports will be a substantial widening of the US trade deficit with East Asia; indeed, preliminary figures released just a few days ago already show a substantial increase in our trade deficit with East Asian countries.

While an increase in the trade deficit may seem alarming, it is really just a natural and appropriate adjustment of the economic system to the East Asian events. In fact, many economists argue that the slowdown in exports to East Asia may have a beneficial effect for the US. For the past two years, the US economy has been growing at a pace in excess of its estimated long-term trend, with labor markets becoming increasingly tight. The consensus among forecasters is that the East Asian crisis could serve as the brake that subdues growth toward a more sustainable pace, preventing overheating, and permitting continued job growth with a more moderate path for interest rates. There is the further side-benefit that the sharp declines in Asian currencies and the consequent decline in the dollar price of imports from that region will provide a transitory dampening influence on inflation. Of course, there are risks attached to this optimistic assessment; and a deteriorating trade balance can cause a political backlash even if aggregate macroeconomic effects are modest or positive. The Administration will need to be prepared to fight hard to keep the US from reacting to those pressures in counterproductive ways such as by increasing protectionist barriers to trade. In sum, the Administration remains deeply committed to maintaining and building on the worldís increasingly open trading system and the international institutions that preserve that system; given the overall strength of the US economy it seems likely that any political consequences of a rising trade deficit will be manageable.

With respect to the long-term impact of the crisis on the US and the world, I am an optimist. The crisis countries have expressed remarkably strong commitment to maintaining
open trade. Korea and Thailand have taken strong steps to make their economies more open and free, and Koreaís courageous new president Kim Dae Jung has shown a passionate commitment to building a society in which behind-the-scenes domination of the economy and society by government and business conglomerates becomes a thing of the past. At this point it seems reasonable to hope that the ultimate long-range effect of the East Asian crisis will be to build a stronger and more open world economic system. If so, the US can look forward to a future in which the increasingly prosperous trading partners, in East Asia and elsewhere, both become able to buy more and more of our exports, and provide us better and cheaper products as their own productivity improves. Such a future is by no means inevitable -- building a robust financial infrastructure for the 21st century will require serious commitment by all the trading countries of the world. But such commitment seems to be emerging as countries around the world digest the lessons of the East Asian crisis. And so, I repeat, I am an optimist.