Lessons of the Asian Crisis 10 Years Later

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San Francisco—Ten years ago, as the Asian financial meltdown spread from country to country, there was deep concern about how big the impact would be on the global economy.

The markets certainly were jittery. That October, the Dow Jones Industrial Average plunged more than 500 points. For the five Asian nations most associated with the crisis—Thailand, South Korea, Indonesia, the Philippines and Malaysia—the toll in both human and economic terms was enormous. In 1998, these countries saw their economies shrink by an average of 7.7 percent and many millions of their people lost their jobs. More broadly, there was concern that the crisis had revealed new sources of risk in the international financial system.

Ten years on, it is instructive to look at the remarkable recovery of Asia and take the lessons of that recovery into account for the future.

The financial crisis in Asia was in many ways very different from others. For example, earlier in the 1990s, both Mexico and Argentina suffered financial crises, largely stemming from their unsustainably high budget deficits and soaring inflation. By contrast, in most of the affected Asian countries, during the years leading up to the crisis, growth in economic activity was strong, inflation was relatively tame, investment was robust, and, with their budgets in surplus, their fiscal houses appeared to be in order.

Indeed, these countries had enjoyed extraordinarily fast growth for decades. As their success grew, the international community encouraged them to open their economies to foreign capital and to liberalize their financial sectors, and there was movement in that direction beginning in the late 1980s. With freer capital markets and fewer distortions in the financial sector, foreign capital flooded in, typically as short-term loans to banks; by 1996, capital inflows had grown to $93 billion.
In 1997, it all came to a “sudden stop” in East Asia. Foreign investors not only stopped flooding these countries with capital, but, in fact, reversed course and pulled capital out, in a dramatic way, as $93 billion of inflows became more than $12 billion of outflows.

There are several views on what happened. The first view is that this was a classic “liquidity” crisis—much like a banking panic, where depositors’ fears about insolvency, well-grounded or not, become a self-fulfilling prophecy as their withdrawals en masse bring the bank to ruin.

The second view focuses more on the vulnerabilities that existed in these nations’ economic fundamentals, which threatened to lead to solvency difficulties. One such vulnerability was the pursuit of risky lending practices by financial intermediaries. In part this was due to problems with the quality of supervision and regulation of the financial sector. But the problem also lay with the long tradition of so-called “relationship lending.” Rather than basing lending decisions on sound information about the fundamental economic value of specific investment projects, banks and other financial intermediaries based them on personal, business or governmental connections. As a result, bank loan portfolios became particularly risky. And these risks became grim realities when economic conditions slowed in these countries in early 1997.

In spite of the risky lending practices that prevailed before the crisis, foreign investors poured money into these countries at record rates. Their willingness to do so appears to have stemmed in part from a perception that the governments of these nations stood ready to intervene to forestall bank failures.

This led to another vulnerability—explicitly or implicitly pegged exchange-rate regimes, which are subject to speculative attacks if the markets perceive that the true value of the currency is misaligned with its pegged value. One explanation for the attacks that drove currency values down in Asia is tied to concerns about possible big government bailouts of the strained banking sector. If foreign investors expected that the bailouts would lead to high fiscal deficits, that expectation, in turn, would raise concerns that the governments might force their central banks to monetize their deficits, resulting in higher inflation and depressed currency values.

With their economies at such a low ebb after the crash, the expectations that the Asia crisis nations would stage a full and fast recovery were, frankly, not very high. Yet, remarkably, a full and fast recovery is exactly what happened. Between 1999 and 2005, these nations enjoyed average per capita income growth of 8.2 percent and investment growth averaging nearly 9 percent, with foreign direct investment...
booming at an average annual rate of 17.5 percent. Moreover, all of the loans associated with the International Monetary Fund’s assistance programs during the crisis have been paid back and the terms of those programs have been fulfilled.

At least part of this success is likely due to policy changes that have gone some way toward addressing the vulnerabilities I have pointed out. One such policy change has been an increasing shift away from targeting exchange rates and toward targeting an explicit desired inflation rate. South Korea moved in this direction in 1998, followed by Thailand in 2000 and Indonesia in 2005. Changing the anchor for these countries’ monetary and foreign exchange policies has helped to mitigate the possibility of currency mismatches by encouraging private investors to hedge their currency positions, while also allowing for greater domestic flexibility in response to external shocks.

The more typical way for these countries to limit exchange rate movements has been through intervention and the accumulation of dollar reserves. As a result, between 1997 and 2005, foreign exchange holdings in the five crisis countries quadrupled to more than $378 billion.

While efforts to limit exchange rate appreciation may be motivated in part by competitiveness considerations, this build-up in reserves may also be motivated by memories of the crisis, as these funds could be used to smooth the effects if another “sudden stop” occurred.

In any event, it is fair to say that the East Asian nations as a group have come a long way toward achieving exchange rate flexibility and price stability compared to where they were in the 1990s, and the improved macroeconomic conditions likely have played a role in their superior performance and in their renewed attractiveness as destinations for foreign direct investment.

South Korea, Malaysia, Thailand and Indonesia have also moved to improve banking supervision and regulation and to introduce more market discipline since the crisis. South Korean commercial banks, for example, have adopted Western-style board governance systems, where the majority of board members are outside directors, and they have reformed their executive compensation processes, with banks introducing or strengthening executive stock option programs geared toward tying compensation more closely to bank performance. South Korean banks also quickly cleaned their balance sheets of non-performing loans.

Among the other crisis nations, supervision and accounting transparency also have improved, and banks in Thailand, Malaysia and the Philippines have succeeded in ridding their balance sheets of non-performing loans.

Malaysian banks’ new emphasis on lending to consumers and small and medium-sized enterprises has moved them away from relationship-based lending that was the
norm prior to the crisis. Thailand has brought its previously unregulated finance companies under central bank supervision.

Another step toward decreasing the extent of bank-centered finance and the scope of implicit government guarantees on investment has been the development of local currency bond markets. Prices in these 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 complements the other reforms, because, in order to function well, bond markets require timely, honest and credible reporting of firms’ financial circumstances—in other words, a transparent, well-regulated and well-functioning set of capital markets. Thus, borrowing in bonds from a large number of creditors could reduce the relationship lending problems believed to have played a role in poor lending decisions made by Asian banks before the crisis.

Some lessons have clearly been learned. One relates to the conditions for opening a country’s capital markets. With a strong financial system, the arguments in favor of unfettered capital flows are strong. But during a transition from a financial system with evident vulnerabilities, the path to the liberalization of capital markets should be gradual and carefully managed.

Another lesson is that adjustment programs by the International Monetary Fund should be tailored to individual nations’ characteristics. For example, some critics have charged that while the austerity measures it advocated may have worked well in other financial crises, in the case of Asia they may have actually exacerbated the downturn. Although that claim remains controversial, the IMF has adopted new guidelines to ensure that its adjustment programs are shaped by individual country characteristics and that local authorities have a voice in steering adjustment policies during IMF-supported lending programs going forward.

A third lesson is that transparency concerning both overall macroeconomic conditions and individual firm accounting is needed to guide successful domestic investment decisions.

In assessing financial conditions in Asia 10 years after the financial crisis, one must consider the ascendance of China as a key economic power in the region. China stood apart from the crisis a decade ago because it differed from the crisis countries in two important respects. First, its capital account was more closed, and second, much of
the foreign investment was not short-term loans but direct investment, which in many cases involved actual plants and factories—“steel in the ground.”

Today, despite China’s recent successes, it still shares some of the vulnerabilities faced by the Asia crisis countries in the 1990s. For example, although it has made significant progress in reforming its banking sector through reducing non-performing loans, the government still has a degree of influence in Chinese bank lending decisions, and some have expressed continuing concern over the health of the banking sector.

While China has increased the flexibility of the renminbi, permitting it to appreciate by 6.5 percent against the dollar since it was officially unpegged in July 2005, it is still much less flexible than the currencies of the Asia crisis countries. The central bank has resisted pressures for more rapid appreciation of the renminbi by intervening in the foreign exchange market and building up its holdings of foreign reserves. Limiting appreciation of the currency in this manner complicates the use of monetary policy to produce an orderly slowdown in China’s currently booming economy.

In conclusion, the crisis a decade ago illuminated the importance of sound financial policies, including strong accounting principles and adequate regulatory oversight, as well as the importance of sound macroeconomic policies, including exchange rate flexibility. The good news is that, since the crisis, the Asian countries as a group have made great progress in these areas. Still, there are reasons to believe that continued vigilance will be required to prevent or ameliorate crises in the future.

There is some risk that the policy reforms that were achieved in the wake of the disastrous crisis could be scaled back in the current era of relative regional prosperity. Further, private investors may respond to the relatively tranquil current economic environment by dropping some of the prudent investment practices that were adopted following the crisis.

The best way to avert another such crisis in the future is to review the fundamental causes of the 1997 crisis and heed the lessons yielded on the path to recovery. We must also remain vigilantly aware of any current vulnerabilities that could undermine the stability of the global financial system that links us all to East Asia.