Asia and the Financial Sector

Talk by the Deputy Governor, Dr S.A. Grenville, to the 10th Annual Australasian Finance and Banking Conference, Sydney, 4 December 1997.

The Managing Director of the IMF described the Mexican economic problems of 1994/95 as 'the first crisis of the 21st century', with the implication that this was something new and, more ominously, perhaps there would be more of them. Before the new century has dawned, there have now been a series of similar problems, concentrated in the region of most interest to us – East Asia. This is relevant to a conference on finance and banking, because the financial sector in each of these countries has been the key factor in the crisis and is central to its resolution. Those who spend time thinking about financial sectors and how they evolve over time may find some interest in examining what went wrong, why it went wrong, and how it might be put right. It is also of considerable importance to Australia – not just for the effect on our economy (which is hard to quantify at this stage), but also for the opportunity it presents for Australia to deepen its engagement with the region.

What Went Wrong?

The problems in Asia, like the Mexican crisis of 1994, exhibit a variety of symptoms, with the most prominent being large falls in exchange rates and equity markets. But exchange rate changes of this size are not unknown in other countries which have not experienced the trauma currently underway in Asia. In Australia in the mid 1980s the exchange rate fell by 35 per cent, and in the early 1990s it fell by close to 25 per cent. Nor is this uncommon internationally. Even the mighty US dollar went up and down by amounts like this in the mid 1980s. More recently, Japan, between April 1995 and April 1997, experienced a depreciation of similar size. These exchange rate changes may well have been a trigger which set off a chain reaction of other events. But by themselves, the exchange rate changes would have been an uncomfortable policy problem, not a crisis.

An uncomfortable problem became a crisis because the weakness in the exchange rate infected the financial sector. This occurred through a variety of channels – in some cases, banks had borrowed heavily in foreign currency; more often, the borrowers were the non-bank business sector. As the exchange rate fell, their burgeoning foreign exchange obligations pushed the enterprises under water, and they defaulted on their debts to the domestic banking sector. At the same time, foreign lenders, who had felt protected by the foreign currency denomination of the loans, now realised that a fall in the exchange rate increased their *credit* risk, and so they pulled credit lines or failed to roll over short-term debt.

This exchange rate shock impinged on financial systems which already had fracture lines and structural tensions. There were a number of specific weaknesses – connected lending, government-directed loans, poor credit evaluation, lack of transparency, and inadequate prudential supervision. The situation was sustainable if growth and capital flows were maintained, but was not sustainable in the harsh world in which we live, where confidence is fragile, capital flows are flighty, and the stabilising forces of the 'fundamentals' are slow to assert themselves.

Why Did it Happen?

The first point that should be made is that the praise which had been heaped on these countries for several decades is entirely understandable. These countries have been high savers, budgets have been balanced or in surplus, inflation has been reasonably well contained, and exports had been the dynamic driving-force of growth (with the globalisation that this implies). They ran high current account deficits because, however much they were saving, they were investing even more. Who could, *ex ante*, have criticised the broad-brush developments in the financial sector? Open capital markets were a merit-badge of economic maturity and a requirement for entry into the industrial-nations' economics club – the OECD. Not only were these markets generally opened up and linked in with international capital markets, they embraced this eagerly, including the latest sophisticated products of the financial sector. Equity markets burgeoned and the arcane products of Wall Street were readily available. International agencies urged further and faster deregulation, commercial financial interests (domestic and foreign) were eager to stake out a role for themselves in the fast-growing sector, and sophistication in financial products was seen as being as important as having the latest in industrial technology.

While it is easy enough now to see the fracture lines and lack of resilience of these financial sectors, it was less easy to predict the outcomes beforehand. The transition from a regulated financial system to a deregulated financial system is intrinsically difficult. Under the best of circumstances, it was inevitably going to be accompanied by false starts and miscues. The pace of growth of credit is difficult to evaluate in a world where you would *expect* it to be growing quickly because financial repression (McKinnon's phrase) is ending. The transition leaves the financial system quite fragile during the process. There is a fair bit of evidence that problems have arisen for almost every country during the transition, with the problem usually taking the form of excessive lending as each institution in the deregulated financial sector competes vigorously for its share in the new world. In the process, poor loans are made and asset prices are bid up. These two things come together in mutual reinforcement when the problems come to a head. Lenders who had used collateral as their main loan-evaluation technique find their security to be illiquid and inadequate.

At the same time, it is almost inevitable that the process of financial deregulation will run ahead of the capacity of the prudential supervisors to devise a suitable regulatory framework. To start with, the climate of deregulation is often inimical to the regulators. This was certainly our experience in Australia during the 1980s: as we tried to put in place the 'rules of the game' for the new deregulated financial sector, many people who should have known better were calling this 're-regulation by the back-door', and criticising us for being out of sympathy with the brave new world of deregulation. This experience seems to have been repeated elsewhere. Managers at all levels have been dealing with products and systems with which they are unfamiliar (but to admit this would disqualify them from participating in this exciting new world), and commercial imperatives encouraged them 'to boldly go where no man has gone before'. As we look at the problems of foreign currency borrowings in some of our Asian neighbours,

one might recall the similar experience with Swiss franc loans in Australia during the 1980s, with the (fortunate) difference that these were, in a macro sense, quite small for Australia.

There is another difficult issue here for the authorities. Even when problems were identified, there was the classic dilemma well known to prudential supervisors – do you 'blow the whistle' on the problem and precipitate a crisis (for which you will surely be blamed), or do you quietly work behind the scenes to try to avert the perceived problem, in the hope that you will succeed or the problem will go away of its own accord, but knowing that if it doesn't, it will be a bigger problem than if you had precipitated it early on. No credit is given for precipitating a crisis early, but there is plenty of blame for being present at the scene of the crime. So it is not surprising that there was, beforehand, a certain amount of hand-wringing about financial sector weaknesses, but this was muted background noise in the general enthusiasm to embrace the new world.

What Might be Done?

The first point that should be made here is that the main burden for getting things sorted out again clearly rests with these countries themselves. The related point here is that, for some, (to borrow the catch-cry from positive-thinking management texts) 'this isn't a problem, it's an opportunity'. For some of these countries, the process of institutional reform may be like punctuated development in evolutionary theory, where progress takes place in jerky stages, with a crisis such as this causing people to focus on the issues and to reform weaknesses. In this view, countries can come out of this trauma stronger than before. It seems quite likely that some countries will be better than others at turning these problems into opportunities.

While part of the reaction to these problems must be institutional strengthening of the financial system, there remains a question whether the broad thrust of macro policy – and, by implication, the spanking rates of growth which these countries have achieved over the past couple of decades – is sustainable. To put this more specifically, is it possible to achieve the sorts of integration with international markets, the large inflows of capital which went with this and the rapid transformation of economies, without leaving these economies vulnerable to the sorts of changes of sentiment that we have seen in recent months? The constraint on growth is not the conventional one of resources and technology. The constraining factor here is just how resilient can the financial sector be made: the more robust it can be made, the faster these countries will be able to travel. We know the historical experience of Singapore, which ran current account deficits averaging 10 per cent of GDP for more than two decades. We know, too, that this was an important element in the extraordinary progress that Singapore has made. We know, however, that large current account deficits were one of the elements which made the other ASEAN countries vulnerable in recent years (and this vulnerability has always been a concern in Australia, too, despite the academic case that current account deficits resulting from private sector decisions were matters between 'consenting adults' and therefore not something with which policy should concern itself).

Analysts have pointed to the problems caused by the US-dollar-fixed exchange rates that prevailed in these countries until recently. They argue that, if exchange rates had been allowed to appreciate, credit growth would have been better contained and the economy held on a tighter rein. Greater exchange rate flexibility is surely an element in the new policy regimes. But the lesson of recent months is that, once a fixed exchange rate is freed, it can move by large amounts. Over-shooting is par for the course. All the more reason why a resilient and robust financial sector must be in place if flexible exchange rate regimes are now the norm.

Much of this involves careful, slogging, time-consuming institutional improvement – making accounting systems better, tightening up legal and bankruptcy systems, improving disclosure, and strengthening and deepening experience in prudential supervision. One point that might be noted is that some capital flows seem to create more vulnerability than others, so there is a case for discouraging short-term flows and encouraging direct investment/equity and longer-term bond flows.

The best talent in these countries should go into the core financial institutions – principally banks – even if this means that the latest whiz-bang innovation of the financial rocket scientists remains unexploited. This is not to argue for stepping back from financial development – on the contrary, these countries must move forward to deepen markets. But the resources should go into design and implementation of a robust financial architecture and – to continue the analogy – useful design parameters are simplicity, a strong basic structure, and attention to detail.

One useful objective is to put the banking system in a central position as the guardians on the gateway of investment. If a project has to pass the scrutiny of a bank which will hold the loan on its balance sheet, there is still no guarantee of success but maybe the chances are improved. What is clear is that private businesses have misassessed the risk they faced, tempted by attractively lower foreign currency interest rates but not sufficiently aware of the need to worry about the *variance* of the prospective cash flows. An experienced banker might have helped. Of course, this will only work if the banking system is allowed to do its job, untrammelled by connected or directed lending. Banks cannot provide 'due diligence' scrutiny on loans which they were required to make.

The first priority, always, is to get the banks – the core of the financial system – sorted out quickly. The need is to keep the process of financial intermediation flowing: it is the life-blood of the real business sector. The problems are not, in fact, examples of some new 'crisis of the 21st century': they are, at heart, the old problems of bank collapses and the remedy is, in principle, well established. Restoring confidence is the critical factor and for this (as Bagehot observed) central banks should 'lend freely, but at a penalty rate'. Insolvent institutions must be separated from the solvent, dealt with, and the remaining institutions supported. None of this is easy. Intractable problems of moral hazard exist, but this should not be allowed to paralyse action. Serious money will be required to fix the problems. Experience over the past couple of decades shows just how expensive these financial sector rescues can be. The 1994 Mexican problems have cost about 12–15 per cent of GDP; the Nordic countries spent 4–8 per cent of their GDP fixing their problems a few years ago; even the S&L problems in the United States (merely a small sub-group of the financial sector) cost around 3 per cent of GDP to sort out. But the cost of failing to address these problems decisively can be more painful still – a long drawn-out period of financial introspection and inertia which severely retards real activity. A positive point is the strong fiscal positions (and therefore low government debt outstanding) of these countries, so the capacity to fund the restructuring exists.

All this is, clearly, largely a matter of *domestic* policy, with the costs to be borne mainly by taxpayers in these countries. In a more speculative vein, let me return to the idea that what we are witnessing is a problem of the 21st century, and acknowledge that, while what we see has many of the characteristics of an old-fashioned financial sector crisis, it has one important new element – the major role played by international capital flows. Domestic financial intermediation takes place within a broad set of 'rules of the game', laid down by prudential regulators. There is no international analogue of this. Over time, it can develop, as countries implement consistent rules of prudential supervision, perhaps along the lines of the BIS Core Principles. This might – together with better information on private capital flows and cross-country position-taking – provide a

response to this new element of the current problems – the role of large-scale capital flows.

What relevance is it to Australia, and to this audience (Australian and overseas)? We acknowledge our stake in the outcome, with two-thirds of our exports going to East Asia (including Japan). Australia is taking part in the IMF-co-ordinated facilities for Thailand, Indonesia and Korea. These funds help restore confidence and help the process of adjustment. We will use our relationships – via our regional central bankers group EMEAP and, in due course, the newly formed Asian Surveillance Group – to provide examples of how prudential systems work elsewhere, analysis of how the specifics might be done in particular countries, technical assistance where it can be useful, and – the most difficult and subtle task of all – understated and understanding support for the reform elements who have the task of fashioning a stronger financial sector.

A last word directed specifically at this audience. Some of you come from the countries involved: I wish you well in the vital task ahead. For the rest of us, is this, too, not a problem but rather an opportunity? The countries to our near north are going to be devoting considerable resources to strengthening their financial sectors. I hope some of you will find a role for yourselves in this process, and by doing so will look back on this as an opportunity to strengthen our links with our northern neighbours. ✠