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Reading 02

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SESSION 1

Lessons Learned from Crises: Asia

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Policy Panel 1: Lessons from Crises: Asia
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Governor
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Policy Panel 1 focused on the Asian financial crisis and the lessons learned from it. Participants discussed financial stability and resilience in Asia and associated policy implications. Panelists agreed that while certain lessons of the Asian financial crisis are applicable to all economies in the region, country specific conditions should be accounted for when drawing policy lessons.

The Republic of Korea, for instance, showed that while a capital account crisis is usually associated with disruptive macroeconomic adjustments, the run-up to the 1997 crisis had a few vulnerabilities. Still, the economy was facing twin maturity and currency mismatches, resulting in large exposure to credit risk. Foreign investors were not rolling over short-term foreign-currency loans, putting domestic banks under massive pressure because a large share of their assets were in longer-term credit in domestic currency. At the same time, an overvalued won—due to a misalignment of exchange rates in Asia caused by the variety of fixed-exchange rates regimes—meant that the country's current-account imbalance failed to adjust under its own floating exchange rate. Financial sectors in countries with insufficient foreign reserve buffers were left vulnerable to speculative attacks.

In reference to Indonesia, the panel stressed the insufficiency of one single policy instrument to address all the risks threatening the economy. In fact, it was the right interplay of policies during the global financial crisis that helped mitigate the effects of the crisis on the Indonesian economy. It was pointed out that tightening monetary and fiscal policy in 1998 in response to the Asian financial crisis contrasted sharply with the expansionary monetary and fiscal measures implemented in the wake of the global financial crisis. Considering countercyclical policies during good times, even though politically hard to implement, could also turn out to be very valuable. The introduction of a legally binding maximum deficit criteria helped impose more discipline on policy makers.

In addition, a healthy banking system and the policy responses toward the banking sector during periods of distress need to be carefully considered. In Indonesia, during the Asian financial crisis, 16 banks were closed, whereas

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during the global financial crisis the policy response was rather targeted toward bailouts and the introduction of deposit insurance schemes to help the sector withstand turbulent times.

Discussing Malaysia, the panel highlighted the relationship between increasing financial integration and heightened financial vulnerability. Structural reforms undertaken in the wake of the Asian financial crisis simultaneously paved the way for greater resilience to withstand external shocks such as the global financial crisis and a build-up of financial imbalances and vulnerabilities that accompanied the debt-driven accumulation of wealth of many economies in the region.

Greater financial integration has, moreover, widened the exposure of economies to external shocks and financial volatilities. Increased financial interconnectedness has amplified the risk of financial contagion across borders. The large presence of foreign investors in domestic bond markets was highlighted as one example of a potential source of financial vulnerability. In Malaysia, for example, nonresident holdings of domestic government bonds peaked at the end of 2016, but has moderated since the US election.

Increased financial interconnectedness has amplified the risk of financial contagion across borders.

In response to these developments, the panel emphasized the need for targeted, bold, but pragmatic measures to respond to financial imbalances. Since 2010, for instance, Malaysia has implemented prudential measures to contain risks in the property sector. Macroprudential and other regulatory policies must be timely in order to contain risks, reduce short-term vulnerabilities, and preserve financial stability. Such measures need to be tailored to country-specific needs given Asia's economies. Small open economies, for example, are especially vulnerable to fluctuating foreign demand and volatile capital flows.

The panel called for preemptive policies and an openness to less conventional approaches. As technology evolves, policy lifespans shorten, and integration widens, policy makers must consider the unintended consequences of policy responses more carefully and undertake sequential reforms strategically. Effective governance is crucial.

For the Thai economy, also hit hard by the crisis, currency and maturity mismatches were also prevalent. Before the Asian financial crisis, high growth, elevated interest rates, and big capital inflows characterized the economy. But the capital inflows were not always channeled to productive sectors. A large amount of hot money went to the booming property sector, boosting the ratio of nonperforming loans (47% at the peak of the Asian financial crisis).

The severity of the crisis in Thailand reflected the lack of institutional capacity in general, which resulted in a distorted incentive structure, the panel concluded. It also reflected investor's huge appetite for short-term gain, ignoring the long-term risks. The absence of incentives to slow the overheated economy exacerbated the effects of the crisis. Indeed, neither the Bank of Thailand, which was not sufficiently independent by then, nor political think tanks could play a counteracting role.

Countercyclical policies were unpopular for political economy reasons. In addition, policy makers lacked the information needed to be effective. In particular, granular microdata, which would have been necessary to estimate financial linkages, were not readily available. The same applied to good and timely data on central banks' international reserve positions, nonperforming loans, and even export data.

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Since the crisis, these challenges have been addressed and regulatory and supervisory frameworks have been strengthened, financial safety nets and a resolution structure put in place, and flexible exchange rates adopted. This has made the Thai economy more resilient to external shocks, and the financial sector has been revitalized and developed. Corporate bonds, for example, though they do not yet represent a big market, have developed well and are liquid.

Meanwhile, participants noted that the Philippines was exposed to large capital inflows prior to the Asian financial crisis, similar to other affected economies. A significant share was related to portfolio inflows, which tend to be more volatile than foreign direct investment. But the Philippines had adopted a floating exchange rate, although one that was managed to provide stability to the market. A significant build up in domestic credit, mostly related to the real estate sector, was financed increasingly through short-term borrowings, while risk management capacities were limited.

After the outbreak of the crisis, the Bangko Sentral ng Pilipinas tried to defend the currency, but had only limited foreign reserves. It soon needed to let the peso devalue significantly, but still tightened monetary conditions to restore investor confidence. This led to a surge in nonperforming loans, which took almost a decade to reach precrisis levels. Simultaneously, macroeconomic conditions worsened as unemployment surged and government revenues deteriorated.

In terms of policy responses to the Asian financial crisis, the Philippines government undertook broad-based policies, including a set of macroeconomic measures, such as adopting an inflation targeting monetary policy and the continuation of a floating exchange rate regime. In addition, international reserves were built up and a debt liability management system was established on the fiscal side.

These macroeconomic reforms were accompanied by a national financial reform agenda aimed at sound corporate governance and mitigating the build-up of systemic risk stemming from the financial sector. Higher capital buffers in the system were established through banking supervisory reforms. Market competition was enhanced through looser entry barriers for foreign banks, and financial stability was supported by enhanced financial surveillance.

One recently introduced tool is real estate stress tests to gauge banks' resiliency to shocks in the property market. Finally, capital markets were developed through better financial market infrastructure. All these measures are complemented by increased supervisory capacity through more capacity building for all policy makers.

Generally in the region, of the important lessons learned from the crisis, the panel often pointed to the challenges associated with external imbalances. A flexible exchange rate regime has proven to help cushion the effects of

external shocks and external imbalances, though its effects are also limited to some extent. In addition, an economy needs to accumulate adequate amounts of foreign reserves. Furthermore, it was highlighted that one needs to carefully assess the nature of external capital inflows with which a current account deficit is financed. If these funds are channeled to the productive sector, such as foreign direct investment, a current account deficit is not a major concern per se.

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To avoid the problems of currency mismatches, it would be preferable that these foreign direct investment activities took place in export-oriented sectors. But if a large current account deficit is primarily financed through portfolio investment, which is more volatile, policy makers need to remain vigilant. It was mentioned that a lot of progress has been made to address problems associated with currency mismatches. For instance, these days, many governments issue most bonds in local currency. Nonetheless, foreigners still hold significant proportions of these local currency bonds, which needs to be carefully monitored, highlighting ongoing vulnerability to external shocks.

The panel also pointed out the possible sluggish growth prospects of the world economy and greater capital flow volatility. The latter is facilitated by loose monetary conditions in advanced economies, including nonstandard monetary policy measures such as quantitative easing. How to best manage these volatile capital flows and revitalize real economies is a big challenge for policy makers.

Lastly, the panel identified challenges arising from a changing financial environment and conditions. First, policy makers also need to adapt the effects of rapid technological development on the financial sector.

Authorities should update regulatory frameworks to cope with these recent developments. Second, financial literacy needs to increase to help households deal with rising household debt, a relatively new phenomenon for the region.

During the open floor discussion, both the importance and difficulty of smooth coordination among financial authorities was highlighted. Panelists agreed that such coordination is a lot easier during crises than normal times and noted that regular meetings among key agencies can help facilitate coordination. Outreach, such as through social media, could also play a role in raising public awareness of the views of one agency (such as a central bank) and thus indirectly influence decisions in other agencies.

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Participants also discussed measures to bring down elevated nonperforming loan ratios. In the Thai case, for instance, the bankruptcy act and regulations were tightened significantly to reduce so-called strategic cases of nonperforming loans, in which investors were actually able to pay but decided to withhold payment strategically. The country also tightened the provisioning requirements of banks and facilitated the establishment of asset management companies.

To gain credibility during reforms and thus increase effectiveness, it was pointed out that it is important for authorities to implement consistent reform measures and clearly communicate these to the markets. Inconsistently executed reforms instead will only increase uncertainty and therefore undermine the gains of the reforms. This is one major lesson in comparing the Indonesian crisis in 1998 with 2008, with credibility a lot higher during the global financial crisis.

Finally, the panel noted growing concern that rising household debt—which can result in a low-interest-rate environment and a booming housing sector—cannot be contained by a single measure alone. Instead, it is best to tackle such debt through a combination of policies, including the implementation of macroprudential measures to contain the build-up of systemic risk.