

**Lessons from the Asian Crisis**  
Janet Yellen, Chair  
Council of Economic Advisers  
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I would like to spend my time today on three topics: What were the fundamental causes of the East Asian crisis?; how appropriate has the response of the IMF and the international community been?; and what consequences might the crisis have for countries both within and outside of East Asia?.

*Ex post* attempts to identify the fundamental causes of a financial crisis always suffer from the problem of distinguishing insight from hindsight. Any financial journalist today can tell you that the crisis was the inevitable consequence of overvalued exchange rates, large current account deficits, short-term capital inflows, opaque financial systems, ìcrony capitalism,î more generally the problems of the ìJapanese modelî of capital markets, 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 such a calamity was remotely possible, although all of what 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 was superior to the ìAnglo-Saxon model.î

The reason for the recent widespread admiration of both financial and nonfinancial aspects of East Asian economies is obvious: these countries must have been doing *something* very right, because over the course of 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. Still, at the risk of overgeneralizing, I think these countries do share some important similarities that are likely at the heart of the problems they have all suffered. In particular, the crisis countries favored centralized and behind-the-scenes mechanisms for the allocation of capital. The particular institutions varied from the captive banks of the Korean *chaebols* to the finance companies of Thailand to government-linked banks in Indonesia, but in general a large part of capital allocations were not made by a decentralized open capital market via arms-length transactions; instead, decisions were made out of the public eye and often were based on personal and business relationships or governmental influence more than on reliable accounting or other information about the borrowers or their investment projects.

It is useful to recall again that this system worked remarkably well for a long time. Reliance on personal, business, or governmental ties in the allocation of capital apparently can work as long as the ultimate investment decisions are generally sound *and* savers retain their confidence in that soundness.

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. 'Relationship lending' would work at early stages of development because the borrower stands to reap large economic rewards from pursuing the high-return projects, but might break down at later stages because when overall economic returns are lower 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 compensation to the lender like 'commissions.' Still, it is important to emphasize that these comments are somewhat speculative; while anecdotes abound about poor investment decisions in East Asia in the last few years, the evidence for a large and general deterioration in *ex ante* investment quality is by no means overwhelming at this point, although there is certainly some evidence that *ex post* returns in the last few years prior to the crisis were lower than previous returns had been. Of course, an alternative explanation for the immediate pre-crisis decline in returns is that it reflects the slowdown in growth that most East Asian countries experienced at the time. Note, however, that, to the extent that the pre-crisis growth slowdown was interpreted as evidence of a permanent downshifting of these countries' growth engines, it could have had a negative effect on expected future returns just as real as any effect associated with increasingly poor investment choices.

Regardless of whether or not there was a real deterioration in investment quality before the crisis, what does seem clear from the East Asian crisis is that a 'relationships' model of capital allocation is extraordinarily susceptible to a deterioration in *perceptions* about the quality of investment decisions. If depositors who had previously been willing to rely on past performance as a guarantee of future success suddenly become concerned that capital allocation decisions *may* have gone awry, the lack of transparent and direct information on the quality of investment decisions can be a fatal blow to market confidence in the quality of those decisions. Even if many or most of the capital allocation decisions have been sound, the lack of information means that savers cannot properly evaluate which banks or *chaebols* or other institutions have made good

decisions and which have made bad ones, and this can lead them to decide to withdraw their capital from all institutions indiscriminately. Because the long-term investments that have been undertaken on the basis of those short-term deposits cannot be liquidated except at enormous losses, such as a deterioration in confidence can bring the entire financial system to the brink of collapse.

This interpretation helps resolve the problem that it is difficult to identify a consistent macroeconomic explanation of the crisis that works well in all affected countries. Overvalued exchange rates were perhaps a problem in some countries but not all; the current account deficit was large in Thailand but small in Korea; the slump in the semiconductor industry posed large problems in Korea but few in Indonesia or Thailand; and so on. If, however, the fundamental trigger of crisis in each case was a decline in investors' confidence in the soundness of the long-term investments backing up their short-term deposits, then there would be no necessary reason to expect the same macroeconomic precursors in each case. Instead, in a financial system organized around relationships rather than information, the confidence of investors in the soundness of relationship lending itself is an absolute fundamental. And the potential for contagion from one country to another may depend more on the extent to which investors *perceive* similarities between the two countries' financial systems than on the extent of actual similarity.

One irony of this interpretation is that the extensive press coverage of the crisis, and the view commonly expressed in the press that the crisis revealed the failure of an East Asian or Japanese model of capitalism, may actually have substantially accelerated and exacerbated the failure of that model. Again, the point is that a transparent financial system in which investors can judge the soundness of banks and corporations on the basis of objective and reliable data would have been much less vulnerable to such contagion.

Another implication of this interpretation of the crisis is that those who decry the buildup of short-term foreign debt in the pre-crisis period may have a point. Enormous amounts of foreign bank loans flooded into the East Asian countries over the past few years, often at interest rates that reflected only a very modest risk premium relative to safe investments at home. The low risk premia many have reflected a belief that, even in those countries without explicit depositors' insurance, governments could never allow wholesale bank failures and therefore investors' money effectively had a government guarantee. It is precisely these sorts of lenders who are most likely and most able to act in ways that endanger the stability of the financial system. Because they are earning only modest risk premia, it takes only a modest increase in the perception of risk to convince them to withdraw their capital when their loans expire. Since short-term loans by definition expire relatively quickly, massive short-term lending at low risk premia is precisely the combination of factors most likely to lead to sudden and massive capital flight.

This point leads me to my first remarks on the response of the IMF to the crisis. Some commentators have argued that the long-term health of the international financial system has been jeopardized by the willingness of the IMF to come to the rescue of these countries. According to this view, the foreign lenders need to lose some money, preferably a lot of money, in order to discourage them from engaging in similar behavior, and causing similar crises, in the future.

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.

The trick is to find methods by which lenders can be forced to take a financial hit without jeopardizing the stability of the financial system. Perhaps the most straightforward solution would be to encourage capital flows to take the form of equity 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. The problem with this solution is that 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.

On the whole, the IMF seems to have recognized the unique character of the East Asian crisis and to have reacted appropriately: The dimension along which the East Asian programs differ most markedly from any previous IMF program is in their emphasis on the importance of transparency, openness, and accountability in capital markets. Deputy Treasury Secretary Summers recently remarked that one of the most hopeful signs he has seen that the IMF programs are having the right effect came from a conversation with a teacher of night school courses in accounting, who said that in previous years he had normally had 22 students in his winter term classes, but this year he had 385.

As for the longer-term agenda for the reform of international financial institutions, the clearest imperative is to develop more timely, comprehensive, and reliable financial information for IMF member countries. This process is already under way under the auspices of the IMF's Special Data Dissemination Standard, but the scope, accuracy, and timeliness of the data provided need to be improved. A further imperative is to foster the adoption of strong bank and financial regulatory institutions in all IMF member countries. One lesson that emerges from both the East Asian crisis and many previous crises is that the interaction between highly liquid global capital

markets and poorly-regulated, poorly supervised local financial systems can lead to disaster.

This leads me at last to consideration of the consequences of the East Asian crisis for foreign relations. Here one could adopt either an optimistic or a pessimistic view. Pessimism might argue that the crisis is likely to lead to turning inward: increasing trade frictions, increasing trade barriers, a rising surge of protectionism, and in particular a closing of international capital markets to foreign investment. The worst-case scenarios here can be quite awful, and I have no appetite to spin them out. Fortunately, early indications are of a much more benign outcome. The crisis countries have expressed remarkably strong commitment to maintaining open trade. And the elements of the IMF programs emphasizing transparency and openness of capital markets seem to be making considerable headway, especially in Korea, which is fortunate to have as its new President a man who has a passionate commitment to an open society in which behind-the-scenes domination by government and *chaebols* becomes a thing of the past.

I am optimistic, too, about the impact in the United States and Europe. While the crisis will almost surely lead to a substantial increase in the US trade deficit with East Asia, and to an associated slowdown in growth, a negative shock to aggregate demand could hardly come at a better time. 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 growing increasingly tight. The financial markets' consensus is that the East Asian crisis has headed off an interest rate hike by the Federal Reserve, and the net effect is that GDP is likely to grow at a rate nearer potential. 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, a deteriorating trade balance can cause a political backlash even if aggregate macroeconomic effects are modest or positive, and the Administration will need to be prepared to fight hard to keep the US from turning inward in response to those pressures. At the moment, the top priority is to secure a proposed addition to the IMF's capital base, and this task has some urgency because it is

likely to be harder to achieve after a big surge in the trade deficit. In sum, the Administration remains deeply committed to maintaining and building on the world's 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.

Consequences of the crisis for Western Europe will be somewhat different; European banks had more exposure than American banks to the East Asian economies and will likely have to write off larger losses. On the other hand, European trade with East Asia is somewhat smaller than that of the United States, so the net effect on trade balances may be smaller. On the whole, the crisis appears no more likely to have a large effect in Europe than in the United States.

The greatest cause of concern about international repercussions of the crisis has to do with Japan. Japanese banks were rather heavily exposed to East Asia, and, unlike banks in the US or Europe the condition of the Japanese banking system was fragile even before the crisis. Still, the problems East Asia poses for Japan are small compared to that country's homegrown problems. While East Asia could in principle be the straw to break the Japanese camel's back, it is also possible that the apparent collapse of the Japanese model of capital markets abroad will finally persuade the Japanese authorities to take decisive action to address the long-term problems facing that country. The greatest danger to the international financial system remains a collapse in Japan, rather than any further deterioration in the rest of East Asia. Here again, the mantra of transparency, openness, and sound prudential bank regulation needs to be repeated. If the Japanese authorities had acted decisively to clean up their banking system in the early 1990s, and had instituted then the banking reforms that are even now being hesitated over, it seems likely that Japan could have avoided much of its economic stagnation of the past seven years. Let us hope that the Japanese authorities will finally heed the message that international capital markets have been sending them for a long time now; indeed, we can even hope that the East Asian crisis could prove the clarion call that Japan has needed for many years.