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The Financial Crisis in Emerging Markets: Some Lessons

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Perhaps it is just that spring is in the air, but is does seem that the global financial crisis whose start was marked by the Thai devaluation in July 1997, is easing. Activity has turned around in Korea and bottomed out in Thailand; and the rest of Asia seems to be recovering or about to do so, too. Although the most recent data on Japan are at best mixed, there is a definite air of optimism about Japan too, an optimism which derives from the strong fiscal measures, and the more decisive actions on the banking system, that were put in place in the last year. Encouraged by the revival of confidence in Brazil since early March, a revival of capital flows to the emerging market countries is visible in declining spreads and a return of Latin American countries to the market — exemplified by Brazil's success in raising $2 billion in new money from the markets last week.

All this is fragile, and we cannot afford to be complacent about the difficulties ahead — but the environment is very different now than it was six months ago, or even three months ago, when Brazil was in the midst of its devaluation crisis. And negotiations between Russia and the IMF are making some progress.

Controversy about the lessons for the policies of individual countries and the structure of the international system — not to mention controversy about the policies supported by the IMF — has swirled practically from the day the crisis began. Many lessons have been drawn, and work is going on now to adapt the international system to deal with the realities of the globalized world in which we live, and will continue to live. I believe we are making progress in changing the international architecture, but I will not talk about that topic today.

Rather let me reflect on a few lessons of the crisis:

1. **Globalization is here to stay**. That is to say, the approach to economic management based on openness to and increasing integration with the rest of the world, and on vigorous structural reforms aimed at strengthening the economy and the role of market forces, in it, has not been abandoned, but if anything strengthened. This conclusion is not one of theory, but rather the practical outcome of the decisions taken by policymakers in emerging market countries as they confronted the crisis. Virtually all of them rejected the siren calls to

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withdraw from the system, to close down their capital markets, and to retreat into financial isolation.

Last September, the Finance Minister of Argentina made the remarkably prescient comment: "Crises come, and eventually they go. Our success after the crisis will be determined by how we behave during the crisis. We must maintain our policies if we want to continue to be successful." His government has maintained its policies of openness; so have governments all over Latin America; and so have almost all the governments in the crisis countries, including those in the transition countries most affected by crisis.

The fact that emerging market governments have decided to remain engaged in the global economy and the global capital markets, of course places all the more responsibility on the advanced countries and the international institutions to improve the system, to try to prevent the inevitable crises of future years from being as bad as this one has been. That work is under way, and we must ensure that the momentum continues.

2. **Domestic policy — and especially the strength of the financial system — is critical.**

In Asia, although country circumstances varied, the crisis reflected to a major extent fundamental structural problems, financial sector weakness and poor corporate governance. While crises may happen even when the financial system is relatively strong, as in Brazil, the extent of the crisis is importantly affected by the strength of the financial system.

A related lesson, of especial importance in the transition economies, is that structural reform matters a great deal. In Russia, while at the macroeconomic level the foreign exchange and debt crisis was due to the persistence of large fiscal deficits over a period of years, fiscal imbalance itself reflected insufficient reform and industrial restructuring, which has been behind the inability of the government to both collect taxes and cut spending. This lack of structural reform also lies behind the inability of the economy to begin a sustainable process of growth.

In this regard, and this is lesson 2.5, **moving fast generally works**. Some have argued that, particularly in the midst of an economic downturn caused by a financial crisis, a country should move more gingerly in attempting fundamental structural reforms. No doubt it is theoretically possible to try to do too much too fast. But the experience of the transition economies over the past 10 years shows that the countries that moved fastest and most persistently on structural reforms have done best. And in Asia too, we are beginning to see in the Korean case the benefits of moving very fast to correct structural imbalances in the financial and corporate sectors — not only for technical reasons, but also for political economy reasons, for the political impetus to make needed changes may wane after the crisis ends.

This lesson applies to the macro front as well. Russia is a vivid example of the cost of gradualism on the fiscal front. The failure to bring the budget deficit under control was responsible for the increases in the government debt that increased the vulnerability of the

economy to external economic developments, and that set off the unsustainable debt dynamics that culminated in the crisis of August 1998.

3. **Exchange rate systems**. The crises in Thailand, Indonesia, Korea, Russia, and Brazil, were all associated with exchange rates that had been more or less fixed. That is powerful evidence suggesting that such systems are crisis-prone. Equally striking is the evidence from other countries, among them Mexico, Turkey, and South Africa, that faced strong financial pressures but whose flexible exchange rates allowed them to manage those pressures far better. We are thus likely in coming years to see more countries adopting flexible exchange rate systems or, if they choose to fix, to do so in a definitive way, for example by adopting a currency board arrangement.

However, I am not sure that this enthusiasm for unvarnished floating rate systems is going to last. Views in the economics profession fluctuate. The choice of exchange rate system is one of those problems that does not have a good solution: the only sure rule is that whatever exchange rate system a country has, it will wish at some times that it had another one. We have seen, for example, in the case of the two largest economies, the United States and Japan, the exchange rate move from 80 yen to the dollar in 1995 to 147 yen to the dollar two years later. There are very few countries that can be as indifferent to the level of the exchange rate as the United States. It is thus likely that smaller developing counties will move to some sort of managed float, possibly a crawling peg system with broad bands.

It is also likely that if the Euro succeeds — and it will succeed — that we will see fewer and fewer national currencies. The Argentine dollarization move and the quiet Mexican dollarization campaign now under way are likely to make progress in the years ahead. A person's views on exchange rate systems are age-related. When you're young and optimistic you're very impressed by all the good things that could happen if you're free to let your exchange rate move. But, when you've watched what countries do with their floating exchange rates over long periods, you become much more concerned about the damage they can do by having their own exchange rate to manipulate.

4. **Ownership**. In the jargon of the international financial institutions, we say that ownership of a program is critical. When a country "owns" its economic program, when it is the program of the government, supported by a broad political consensus, the chances of successful reform are greater. Incidentally, in this regard, the existence of a friendly neighbor offering discernable benefits to integrating with the global economy helps — the goal of joining the EU has clearly spurred the reform process in much of eastern Europe and the Baltic states, and a similar observation applies to Mexico and NAFTA.

To emphasize the importance of ownership is to underline the difficulties for the international community of deciding how to assist the process of reform in a country where the government is weak and political consensus for reform absent. There are no easy solutions in these cases: practically, friendly governments and the international agencies have to do everything they can through the design of programs and financial support to strengthen good policies and the reform process, while recognizing that the chances of success are lower

than would be ideal, and that beyond some point, it may be wise not to continue to provide support.

5. **Keynesianism is alive and well, and living in Asia (and elsewhere).** In the mid-80s there was growing support for the view that fiscal contraction was expansionary. This conclusion was based on the fact that in Ireland and Denmark budget deficit cutting had very positive impacts on economic growth; and somehow this conclusion was generalized to be true in all circumstances, the argument being that by tightening the budget you increase confidence in the economy, and then there is more investment, etc. However, we have seen in Asia that Keynesianism is alive in two regards. First, the budget cuts that took place in Thailand in the IMF program in July 1997, when we thought Asia was booming, were probably too large. Subsequently, all programs in Asia have switched to fiscal expansion on a very large scale. Second, the liquidity trap, which was thought of as a Keynesian curiosum, is indeed happening in Japan, where interest rates are zero. You can't cut interest rates anymore. The authorities have to figure out how to act in this environment and the questions there are all Keynesian questions now.

6. **The question of how to involve the private sector in the prevention, mitigation, and solution of crises is critical, and not yet fully resolved.**

There are two views on how to involve the private sector: one, that the rules should be set out before; the other that that cannot be done. Of course, both views are right: we need to set out as many rules, for example the nature of bond contracts, the terms on which IMF assistance will be available, as clearly as possible, in advance. But the circumstances of each crisis are sufficiently different that no single formula can apply *ex post* and we shall simply have to adapt our methods in each situation, seeking to ensure that the private sector is involved in an appropriate manner.

In the case of prevention, there are suggestions for changes in the forms of contracts, including changes in bond contracts, which are now under discussion. But whatever measures are taken, we need to be aware that certain changes that could make it easier to deal with a crisis after it happens, may make a crisis more likely, or at least increase the volatility of capital flows. After the crisis, a variety of approaches has been followed, including most recently the successful voluntary agreement by foreign creditor banks to maintain their trade and interbank lines to Brazil; a different approach was followed in the case of Ukraine.

It is far from certain how practices will evolve in this difficult area, but a few principles stand out: that contracts must wherever possible be honored, for that is the only basis on which private capital markets can operate; that under all circumstances debtor countries need to cooperate with their creditors in seeking to solve problems that may arise; and that it will not in some cases be possible for the official sector to provide sufficient financing to enable a country to meet all its obligations without a private sector contribution — with the form of that contribution preferably left to discussions between the country and the creditors, and of course depending on the circumstances of the particular country.

There is a seventh lesson:

7. **The IMF is here to stay**. The original purposes for which the IMF was set up remain valid, and we need an institution to help carry them out. As the lessons of the recent crisis — and it has been a crisis of globalization — are drawn, for instance in the communiques of the G-7 and the Interim Committee published in the last two days, it is becoming clear that the international community will continue to rely on the IMF to play its central role in the international system. We do that in at least three ways: through surveillance; through our lending policies; and, in the language of the IMF Articles of Agreement, as the institution that "provides the machinery for consultation and collaboration on international monetary problems". We are carrying out all those functions now, and we do them well, though not perfectly. I believe we have performed well and constructively during this crisis, and the evidence increasingly supports that view. I know we can do better. And we will.