Economic Crises and the Financial Sector

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1. It is a pleasure to be here this morning, to have the opportunity to speak before such a distinguished and knowledgeable audience, on so timely a topic. The crisis that began in Thailand in mid-1997 has spread beyond Asia to Russia and is now affecting countries all over the globe. In addition to the breadth and speed of the global financial contagion, a key feature has been the central role of banking and financial sector problems.

2. Well before developments in Asia began to dominate the news, we at the IMF had been expressing the fear that the next major economic upheaval would have its origins in a banking crisis, or would be compounded by one. This was not particularly prescient for the evidence had increasingly shown that macroeconomic stability and sound banking go together. For this reason, the occurrence of major banking failures throughout the world has been a matter of great import for anyone concerned with the stability and prosperity of the world economy. The phenomenon has been remarkably pervasive. More than three quarters of the Fund's members have been affected during the last two decades. Over the last 18 months, events in Asia and elsewhere, including most recently Russia, have vividly illustrated the consequences of the combination of a weak financial system and inadequate macroeconomic policies -- with weakness in one area feeding on and exacerbating problems in the other.

3. Today I will first outline the general approach the Fund takes to banking and financial sector issues, and then briefly describe how this approach has been applied and developed in Asian countries in programs supported by the IMF, as well as the Japanese banking situation. Finally I will talk about unfinished business for countries and for international organizations in the current environment.

I. The IMF's Approach to Banking and Financial Sector Issues

4. As a long-term matter, the globalization of trade and financial markets and the associated liberalization of international capital markets may turn out to be the most important economic development of the late 20th century. If this trend continues, and if it is managed well -- and its continuation depends on its being managed well -- the benefits will be measured ultimately in higher standards of living, as resources are allocated with increased efficiency and risk sharing is improved. However, the increased volume and

volatility of capital flows have exposed critical problems in the domestic and international financial systems that will need to be dealt with, including financial sector vulnerabilities, often in the form of unsound financial and banking systems and deficiencies in financial incentive structures, institutions, and policies.

5. The frequency of financial sector problems in a range of countries have underscored the need for countries to move quickly to adopt international best practices in financial supervision and regulation. Capital account opening has to be accompanied by -- and preferably preceded by -- the strengthening of bank supervision and regulation so that the domestic financial system can cope with the complications that go with free capital movements. Moreover, recent events have reminded us that these are not issues for individual countries alone. A country that receives a large volume of capital inflows and does not make the necessary reforms and institutional improvements may not only fail to reap the full benefits of inflows and risk damage to the living standards of its people, by increasing its own vulnerability; it may also become the epicenter of contagion effects that can have significant adverse effects on other countries. Thus these are not just matters of domestic policy interest but are of concern for the international community as a whole.

6. By now, policymakers have a good idea of what needs to be done to strengthen financial systems, by improving supervision and prudential standards, by ensuring that banks meet capital requirements, provision for bad loans, limit connected lending, publish informative financial information, and by ensuring that insolvent institutions are dealt with rapidly. Implementing those changes, particularly in a banking system already in trouble, is frequently difficult, especially where political pressures hamper the supervisory authorities. The task is nonetheless urgent: it cannot be emphasized strongly enough that a healthy banking and financial system is essential for the growth of the economy, and that a weak banking system is both a standing invitation to a macroeconomic crisis and a guarantee of the severity of any such crisis.

7. The importance of this task has been well understood by the international community, which has responded among other ways by the introduction of the Basle Committee's *Core Principles* for banking behavior and supervision. Together with our colleagues in the World Bank, the regional development banks, the BIS, and the banking supervisory community, the IMF is increasing its efforts in the banking and financial areas. With our near universal membership, we can play an important role in international efforts to promote financial sector stability, not just in the emerging markets but across the entire membership. The IMF seeks to improve the macroeconomic environment and policies of member countries through individual-country *surveillance* with members -- our regular Article IV consultations with each member, and other visits to discuss problems in the economy and particular sectors, the results of which are then generally presented to our full membership -- through the provision of technical assistance, and by the publication of data and other reports. In addition to assessing the macroeconomic effects of any problems in the financial system, the policy dialogue has increasingly focused on identifying financial sector vulnerabilities with potential macroeconomic implications and on suggesting corrective policy steps. In our surveillance efforts, we seek to promote financial sector policy frameworks consistent with internationally accepted standards, as developed by the supervisory community and other bodies; we also assess progress in implementation of those standards.

8. In its multilateral surveillance--primarily through the *World Economic Outlook* and the *International Capital Markets* exercises--the Fund seeks to identify financial vulnerabilities and risks with a potential for generating regional and international spillovers. This work involves identifying deficiencies in areas such as: systemically important banking systems; international aspects of financial supervision and regulation; the design and operation of wholesale payments systems; and the functioning of the financial infrastructures underlying the major international financial markets. There is also an increasingly important role for regional surveillance--policy discussions at fora involving policymakers from a particular region together with officials from international and regional institutions. The meeting last week of finance ministers and central bank governors from the Western Hemisphere with officials of the IMF, World Bank and the InterAmerican Development Bank provides a useful case in point.

9. IMF-supported adjustment programs often include conditionality related to financial sector reforms, such as legal and regulatory improvements, systemic bank restructuring, privatization of banks, and the introduction of appropriate monetary instruments and market based systems of monetary management. The Fund also provides technical assistance, at the request of members, focussing on key banking and financial sector matters.

10. Fund staff have developed a general framework for identifying the strengths and weaknesses of financial systems and have produced a distillation of widely-accepted views of what might constitute a framework for financial stability, focussing on banking soundness and pinpointing the deficiencies that have frequently led to macroeconomic repercussions. This work was condensed into a paper, *Toward a Framework for Financial Stability*, produced in collaboration with the World Bank, other key institutions and supervisors from various regions. [2] The paper provides guidance for the Fund's financial sector surveillance work and aids Fund staff in the design of appropriate and consistent lending programs and in technical assistance. And we are continuing to strengthen our collaboration with our World Bank colleagues, to ensure that the limited resources in this area of financial sector supervision are efficiently deployed.

II. Banking and Financial Sector Issues in the Asian Crisis Countries

11. The problems facing Asia's banking systems are the legacy of years of bad lending practices and inadequate supervision and regulation that led to rapid lending growth and excessive risk taking. Very high leverage ratios heightened financial fragility. Most of the countries in the region displayed lending growth well in excess of GDP growth for several years and had higher loan leverage ratios than industrial countries with better developed financial infrastructures. Moreover, credit growth in some of these countries was led in part by under-regulated nonbank financial intermediaries, such as finance companies in Thailand and merchant banks in Korea.

12. The large capital inflows to the region, driven by partial financial liberalization and implicit guarantees of stable exchange rates, fueled an expansion of banks' balance sheets and increased exposure to liquidity, market and credit risks. In Korea, regulations limiting international issuance of securities to entities with high ratings, combined with perceived official support for banks, encouraged the channeling of international borrowing through

the financial system for onlending to corporates. In Thailand, the establishment of the Bangkok International Banking facility in 1993, with the aim of promoting a regional financial center, led to a substantial increase in mostly short-term offshore borrowing and also opened the door to aggressive lending by foreign banks. These funds were channeled in part to finance real estate and stock purchases.

13. Note the critical role of the liberalization of *short-term* international capital flows in Korea and Thailand. Although country circumstances differ, the general advice on international financial sector liberalization is first to open to longer-term investment, particularly foreign direct investment, and only to open at the short end when the necessary preconditions, in the form of macroeconomic stability and a strong banking and financial system, are in place. This was not the path chosen in Korea and Thailand. It needs also to beemphasized that lenders need to consider carefully the environment into which they are lending.

14. As is always the case, lending and investment decisions looked good as long as growth continued. But once the system came under strain, the consequences of poor accounting, regulatory and supervisory standards, combined with implicit and explicit guarantees that had fueled excessive risk taking -- including through borrowing in dollars --took their toll in all three countries. As the exchange crises in Thailand, Indonesia and Korea unfolded, it became clear that financial sector and corporate financing weaknesses severely exacerbated the consequences of the necessary exchange and interest rate adjustments, and that these problems needed urgently to be addressed.

15. Comprehensive reform of financial systems has provided the centerpiece of the structural economic reforms implemented by the crisis countries. These programs have involved:

- the recapitalization of undercapitalized institutions;
- close supervision of weak institutions;
- the closure of unviable financial institutions, with an associated writedown of shareholders' capital;
- improvement of supervisory and regulatory systems; and
- increased potential for foreign participation in domestic financial systems.

To address the related governance issues, the reform of financial systems is being buttressed by measures such as increased disclosure to improve the efficiency of markets; break the close links between business, governments, and connected financial institutions; and to liberalize capital markets prudently.

16. The closure of deeply insolvent financial institutions was a prominent feature of the programs in Korea, Indonesia and Thailand. The Thai authorities suspended 16 finance companies in June 1997 and a further 42 in August 1997. All but two of these were closed permanently in December 1997. In Indonesia, 16 small banks were closed in November 1997 and in April 1998 another 7 small banks were closed. In Korea, 14 merchant banks

were closed between December 1997 and April 1998.

17. To help boost confidence as steps were taken to improve the underlying strength of the financial sector, Thailand announced guarantees for all depositors and non-subordinated debtholders of banks and remaining finance companies in August 1997. In January 1998, the Indonesian authorities announced a government guarantee for depositors and creditors of banks. Koreaannounced guarantees on the external liabilities of Korean financial institutions in August 1997. Subsequently, almost all the domestic liabilities of financial institutions were consolidated under the Korean Deposit Insurance Corporation.

18. The Thai authorities announced in October 1997 the creation of the Financial Sector Restructuring Authority and an Asset Management Corporation to act as the agency to manage and sell bad assets of the financial sector. In January 1998, Indonesia announced the formation of the Indonesian Bank Restructuring Agency to take over management of weak banks and for disposal of nonperforming assets of the banking system. In Korea, a special fund was set up in August 1997 within the Korea Asset Management Corporation as a unit to buy impaired assets from banks.

19. Tighter loan classification and provisioning rules were announced by Thailand in October 1997 as part of the financial sector restructuring package. Capital adequacy standards were also introduced as part of the measures to strengthen the financial system. Strategies for recapitalization in Thailand were aimed at raising new capital privately, except for the four intervened banks. The Indonesian authorities announced a sharp increase in minimum capital requirements for banks and tightened loan classification and provisioning guidelines for banks in January 1998, though the increase in capital requirements was later reversed. In Korea, banks not meeting the minimum capital requirements under full provisioning had to submit plans for recapitalization in early 1998. The administration of deposit insurance funds for financial institutions in Korea was consolidated under the Korea Deposit Insurance Corporation. The Indonesian authorities announced a general government guarantee on all loans and deposits of locally incorporated banks in late January, to remain in effect for at least two years. While this does not amount to a formal deposit insurance scheme, the guarantee continues to be in effect. Indonesia and Thailand also plan the creation of formal deposit insurance schemes, in due course.

20. Critics of these efforts have at times argued that the closure of financial institutions at a time of economic crisis may have exacerbated the loss of confidence, contributing to an international banking panic. However, the alternative of allowing insolvent financial institutions to continue to operate and to accumulate still larger losses would have been no solution at all. With the benefit of hindsight, it would clearly have been better for countries to address financial sector weaknesses when times were good. But this was not done and, as financial weaknesses intensified, the authorities were left with few attractive options. Some critics have also argued that countries should have pursued an approach based on regulatory forbearance, rather than lancing the deep-seated problems. However experience suggests that this is a way to perpetuate banking sector problems and lengthen the associated period of economic stagnation.

21. At the same time as the Fund, together with the World Bank, has assisted in the restructuring of banking sectors in countries with IMF programs, we have continued our

surveillance activities in other countries, including Japan. We regard the measures announced so far by the authorities as providing a useful starting point for the resolution of the problems of the banking sector. However an effective and lasting solution requires more decisive andrapid action on a number of fronts. The prompt corrective action framework introduced this April will have to be applied more systematically to smaller banks, and those judged insolvent should be closed. There should also be quicker action in fully recognizing and cleaning up the bad loans of the bigger banks and recapitalizing those that fall short of meeting capital adequacy requirements. For the bridge bank facility to be effective, clear procedures need to be laid out to ensure that bad assets are identified, that assets are subjected to proper valuation, and that new loans are provided only on commercial criteria. Private sector buyers for the bridge banks will also need to be identified quickly. The bridge bank scheme is a mechanism for dealing with failed institutions. However it is just as important to advance the restructuring of those major banks that are undercapitalized but solvent. Contemplating the scale of what needs doing, it is possible to understand why actions have so far been too slow. But the consequences of inaction for Japan and for other countries are already unfortunately clear and massive, and the importance of rapid action cannot be exaggerated.

III. Next Steps and Lessons

22. What are the next steps that countries and the international community need to take in order to improve the chances of a rebound from this crisis? The affected countries and other emerging market economies need to continue to undertake the hard work of disciplined macroeconomic policies, involving sound public finance, a stability oriented monetary policy and a pragmatic and transparent approach to exchange rate management. Attention needs to be paid to the size of external current account deficits and to keeping external liabilities --especially short-term external debt -- low and manageable.

23. And if recipient countries are to reap the benefits of open capital movements, they need to undertake as rapidly as possible necessary reforms to domestic banking and financial systems. Such efforts will enable countries to reap the benefits of capital inflows while reducing the risk of disturbances. The experience of this crisis and the Mexican crisis before it is that shifts in market sentiment can be punishingly swift with positive sentiment evaporating very fast. To shield itself from such swings in sentiment, a country needs to focus during good times on sound macroeconomic policies and instituting international best-practice financial supervision and regulation.

24. For those responsible for the international financial system, including the IMF, a central lesson is the need to press on with the vital work of enhancing the **architecture of the international monetary system**. The focus is on *crisis prevention* through strengthening surveillance and improving the arrangements for monitoring flows of international capital, and *crisis response* to improve the system's response when a crisis occurs. On *crisis prevention*, one element is the need to increase the flow of timely, accurate, and comprehensive data to the public. Through the *Special Data Dissemination Standard*, the IMF is encouraging countries to move toward greater transparency and fuller disclosure; and it will be necessary to strengthen the standard,for instance by providing data on forward transactions by central banks. Better data provision should lead not only to better informed investor decisions, but also to better policies by governments, for some of the off-balance sheet activities of central banks that were instrumental in the recent crisis

could not have continued had they been public knowledge. We also need better and more timely data on short term debt. The Bank for International Settlements is already working hard to improve the short-term debt data. Ways also need to be found to enhance the effectiveness of Fund surveillance -- by ensuring, among other things, that all the relevant data is being supplied to the Fund, that countries' exchange rate regimes are consistent with other policies, and that capital inflows are sustainable. Many have argued that the efficient functioning of the international system requires greater transparency at the IMF itself. This is happening, and should continue.

25. The international system also needs to monitor international capital flows more actively, to identify potential trouble spots. The provision of better data on short-term debt flows and exposures will be critical to this effort. Since crises are often provoked by problems in the financial sector, much more needs to be done to strengthen domestic financial systems. The IMF has been working in this direction by helping to develop and disseminate a set of best practices in the banking area, so that standards and practices that have worked well in some countries can be adapted and applied in others. We need to improve the way capital markets operate, in both advanced and emerging market countries. One possibility would be to encourage countries to adopt international standards in areas needed for the smooth operation of financial markets, such as bankruptcy codes, securities trading, and corporate governance, including accounting. Market participants would then have clearer basis for making their lending decisions. Once again the international system would need to find a way of monitoring the implementation of these standards, and this is a formidable task. Observance of these standards would be encouraged if the risk weightings on international loans applied by bank regulators in the lending countries reflected compliance of the borrowing countries with the standards.

26. As earlier noted, the opening of countries' capital accounts should be handled prudently. This means neither a return to pervasive capital controls, nor a rush to full immediate liberalization, regardless of the risks: the need is for properly sequenced and careful liberalization, so that a larger number of countries can benefit from access to the international capital markets. In particular, macroeconomic balance and a strong and well-supervised financial system, are prerequisites for successful liberalization. To facilitate this process -- to encourage *orderly* liberalization of the capital account -- the IMF is at work on an amendment of its charter that will make the liberalization of capital movements a purpose of the Fund.

27. Some steps have been taken in the direction of **crisis response**. Through the creation of the Emergency Financing Mechanism, the IMF's internal procedures for dealing with crisis situations have been streamlined, an initiative that allowed the initial program for Korea to benegotiated, signed, and approved in less than two weeks. The IMF has also tailored the new Supplemental Reserve Facility to fit the special circumstances of financial crises in emerging markets. Considerable thought is also being given to finding a mechanism for involving the private sector in the resolution of financial crises in a timely way -- the bail-in question. There have been many suggestions, among them that we need the equivalent of an international bankruptcy court or code, and that the international system needs to find a way to authorize a temporary stay on payments in an external financial crisis. There are formidable legal problems in this area, but the search for ways to deal with this problem must continue. Whatever solutions may be suggested, it will be important to bear in mind the dangers of contagion, the possibility that an effort to involve the private sector in

solving the problems of one country will lead to capital outflows from others, thus spreading the crisis even as it may be contained in the originating country.

28. Measures to improve the architecture of the international financial system relate inevitably and mostly to our ability to reduce the scale of future crises. But we need also to be sure that responses in the current crisis minimize the damage it imposes on individual countries, and the potential damage it can do to the international system in the longer run. Let me make two critical points in this regard. First, Russia has recently taken unilateral action to restructure its internal debt. The IMF regards this action as regrettable and unfortunate. We do not regard the unilateral approach as a constructive one for any other country to follow. Nor do we see a similar operation as being in the least justified, nor contemplated, in emerging markets in other regions. The Latin American Finance Ministers and Central Bank Governors taking part in the hemispheric surveillance meeting at the IMF last week left no doubt of their rejection of this approach, emphasizing that they had learned in the 1980s the consequences of attempts to take unilateral actions. Second -- and no less important -- if the international financial system is to operate efficiently, private markets have to differentiate carefully among countries. The widespread contagion now taking place in international markets reflects an overreaction to developments in Russia. Many Latin American and other countries are facing market conditions that are not warranted by either the fundamentals of their economies, which have been greatly improved by major structural reforms in this decade, or by any plausible view of the macroeconomic policies they are following and will follow. At the regional meeting last week, Latin American officials were convincing in their determination to defend their economies and their currencies if they have to. The markets should recognize what has been done in these countries -- *the markets should differentiate.*

29 The recent turmoil has also raised questions about the capacity of the official sector to respond to the difficulties facing countries that have played by the rules of the international system and that continue to do so. The IMF's ability to do its part requires that the envisaged 45 percent quota increase, equivalent to about $90 billion, be implemented. The world economy faces a spreading crisis, and the international community needs to be able to respond to the legitimate requirements of countries affected by the crisis. In the internationalsystem built up over the past fifty years, a system that despite periodic crises has been spectacularly successful in supporting growth around the world, the IMF has had the lead role in providing financing for countries needing international assistance and willing to take the appropriate measures. The Fund's ability to play its financial role, and with it the capacity of the international system to help countries in trouble that require international assistance, is now at stake.

1 First Deputy Managing Director, International Monetary Fund. Prepared for the Federal Deposit Insurance Corporation Conference on Deposit Insurance, Thursday September 10, 1998, Mayflower Hotel, Washington DC. I am grateful to Owen Evans of the IMF staff for his assistance.

2 David Folkerts-Landau and Carl-Johan Lindgren, "Toward a Framework for Financial Stability ", IMF, September 1997, with the Core Principles of the Basle Committee included as an annex to the paper.