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Lessons of the Asian Crisis and Concluding Remarks

No study of financial crises would be complete without some mention of the lessons learned. Because the Asian financial crises has so many interrelated origins and because the geographical scope of the crisis has been so wide, it generates a longer set of potential candidates than most other crises. My nominations for the *top 10 list of lessons learned* from, or reinforced by, the Asian crisis would be the following:

1. Leaving reform of the financial sector and of the prudential/supervisory framework to late in the economic development process is a bad idea—even when the country's macroeconomic-policy record and growth performance place it in the first division of emerging economies. When the financial markets finally discover the true (sorry) state of balance sheets in the financial sector, the cost (in terms of both reduced growth and the fiscal costs of recapitalizing the banking system) can be enormous.

2. The composition of foreign borrowing deserves as much attention as the overall debt burden. In particular, a high and rapidly rising ratio of short-term debt to net international reserves has (ever since the Mexican peso crisis) become a red flag for financial market operators—especially when reserves have been plummeting in the course of defending an overvalued fixed exchange rate. The original saving obtained from shortening the maturity and denominating external debt in foreign currency is likely to be swamped by the ultimate price paid if rollover and currency risk ignite a successful speculative attack.

3. Rapid expansion of bank and nonbank credit (far in excess of the growth of the real economy), cum high concentration of credit to the real estate and equity markets, is almost always a harbinger of trouble, in developing and industrial countries alike. The risk is multiplied when lenders don't do careful analysis of creditworthiness (taking property as collateral instead) and when high loan-to-valuation ratios and low bank capital don't provide much of a cushion when the credit cycle turns south.

4. Large current-account deficits that are used to finance investment may render economies less vulnerable to speculative attacks than those used almost exclusively to finance a boom in consumption, but if the quality of that investment is poor, the former can come to the same unhappy end as the latter.

5. Efforts to promote financial and capital account liberalization without first strengthening the prudential framework—such as the ill-fated Bangkok International Banking Facility in Thailand—are a recipe for disaster.

6. Long-standing weaknesses in the economy that lenders seemingly ignored for long periods of time can take on a different character in the midst of crises elsewhere in the region. Once the process of contagion begins, it takes bold and determined defensive and reform measures to stem the tide in individual countries—especially if a lack of transparency and disclosure make it difficult for investors to differentiate weak from strong firms.

7. Overshooting of exchange rates and equity prices can be much larger than we thought in an atmosphere of political instability, uncertainty about reform, and wide-ranging contagion.

8. It's much tougher to battle your way out of a crisis when the region's largest economy is struggling with its own macroeconomic, financial, and exchange rate problems (Japan) than when (as in Mexico's case) that regional hub (the United States) is in good overall shape.

9. The distinction that was drawn after the Mexican peso crisis between sovereign debt and private debt (in the G-10 report [1996]) has turned out to be not nearly so neat and tidy. When much of the banking system becomes insolvent, debt that starts out in the private sector doesn't stay there long. If we want spreads on emerging-market paper to reflect true underlying risks and if we want market discipline to operate tolerably well, something needs to be done to reduce the moral hazard associated with providing guarantees and other forms of financial support to large uninsured private creditors—both within the country and from abroad. Unless these creditors are made to absorb an equitable part of the adjustment burden, the political sup-

port for IMF-led rescue packages will be very difficult to sustain. Relying more and at an earlier stage on (ad hoc) debt rescheduling to handle private-sector insolvencies is the only way to get these rescue packages back to a reasonable size. Forsaking early intervention to bail out private creditors may make management in the current crisis subject to higher short-term volatility, but this is intrinsic to reducing the frequency of serious crises in the future.

10. There's nothing like a major crisis to focus people's minds on why it is important to improve the international financial architecture. In this sense, there is no better time to put forth a specific agenda for improving the international financial architecture. The emphasis should be on reducing moral hazard and increasing the orderliness and flexibility in private debt rescheduling, convincing developing countries to implement strong international prudential standards, improving transparency and disclosure in international financial markets, putting more punch in IMF surveillance, and shoring up risk management in global financial firms.

The Asian financial crisis has also raised a lot of questions about the future role of the IMF. Despite the depth and breadth of the Asian financial crisis and the limited success achieved so far in combating it, the successful resolution of this crisis does not require a new IMF. Much more has been right than wrong about the overall design of these official rescue packages, and there are mechanisms that if utilized more fully in the future can improve the market discipline and burden-sharing aspects. Those who argue for abolishing the IMF have forgotten the lessons of the 1920s and 1930s, and those who maintain that the crisis would already be over if the IMF simply supplied the crisis countries with large liquidity injections (cum little macroeconomic or structural policy conditionality) are engaged in wishful thinking. Denying the IMF the financial resources it needs to do its job will be harmful to the economic and foreign-policy interests of the United States.

A sustained turn in the Asian financial crisis will come when the crisis countries have made enough progress in implementing structural reforms (especially in their financial sectors) to convince markets that the factors that gave rise to the crisis have really changed, and when there has been enough rescheduling of private debt to reduce uncertainty and to make creditors comfortable enough to provide new lending.