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Introduction

ADAM S. POSEN AND CHANGYONG RHEE

Financial crises are terrible things, and yet they keep happening. During the Asian financial crisis of 1997–98, a substantial amount of policy knowledge was learned through experimentation but at substantial cost. One of the costs was the diminished good will between the then creditor countries of the richer West and the International Monetary Fund (IMF), on the one hand, and the crisis-hit economies of developing Asia, on the other. Policy research and intergovernmental consultation proceeded wholesale from there, with some lessons drawn regarding crisis prevention, mitigation, and resolution. Yet, barely a decade later, the United States and Western Europe suffered a historically significant financial crisis, with large negative spillovers on the whole world economy, particularly on the export-oriented economies of developing Asia. Had we learned nothing? Or were the lessons from Asia's crisis inapplicable to the problems of a global financial crisis (2008–10) that centered on the United States and Europe? Or was there some sort of failure of politics and institutions remaining to be addressed, that somehow extended to the advanced countries of the Organisation for Economic Co-operation and Development (OECD) as well as to emerging Asia?

The studies in this volume address these questions head-on. We came together, Asian and American economists, in order to get past any defensive delusions regarding our own regions' and governments' performance up to and during financial crises, as well as to identify where the commonalities across the Pacific lie. And rewardingly (and perhaps surprisingly), we have been able

Adam S. Posen is the president of the Peterson Institute for International Economics. Changyong Rhee is the chief economist of the Asian Development Bank. *They thank Steven Weisman, who contributed greatly to the formulation of this overview and of the volume overall. Wendy Dobson and Morris Goldstein provided helpful comments as well.* *The views expressed in this chapter are those of the authors and do not necessarily reflect the views and policies of the Asian Development Bank or its Board of Governors or the governments they represent.*

to agree broadly on a number of key lessons that do apply to developing Asia as well as to recovering America and Europe. The contrast in Asia's performance during the more recent crisis with its performance during its own crisis 15 years earlier, and the gap between what the US and EU leaders recommended to Asia then and what they practiced on themselves later, is particularly revealing. In short, Asia recovered quickly from the crisis by following the consensus view that emerged after its crisis, while the United States and Europe did themselves harm by not following the advice they gave others and ignoring others' experience. We hope to reaffirm what is good in the developing Asian experience and get it accepted in the North Atlantic economies before the next set of crises emerges.

What kind of lessons are we talking about for the policymakers of such a broad range of economies and polities? General guidelines that are more binding than mere broad bromides, but which will require tailored implementation country by country, emerge very clearly from this volume of essays. In terms of responding to the challenge of financial crises, the arguments of our assembled authors would be:

- *Prepare as though you cannot prevent.* No economy can ever rule out the possibility that it will suffer a financial crisis. Whether looking at the highly deregulated financial systems of the United Kingdom and United States in the mid-2000s, or at the more limited and concentrated banking systems of Japan and developing Asia of the mid-1990s, or even at the state-controlled financial system of the People's Republic of China today, it seems that everyone is subject to financial fragility. The ability of surveillance and early warning indicators to preempt crises remains more aspirational than practical to date. But governments can meaningfully improve the resilience of their economies ahead of crises and thereby reduce their cost and duration. Having fiscal space, limiting currency mismatch on debt, accumulating sufficient (but not excessive) foreign exchange reserves, and especially preventing excessive domestic credit creation—all are pragmatic policies that should be adopted to promote economic robustness.
- *Make sure you have room for stabilization policy, and then use it.* Once a financial crisis hits, aggressive monetary easing combined with rapid tough recapitalization or closure of damaged banks can materially improve recovery, in both speed and depth. Japan failed to implement this approach in the 1990s and prolonged its misery; the United States has come closer to following these precepts, and it has had a faster, more sustained, though still suboptimal, recovery as a result. The euro area, on the other hand, has done less on monetary stimulus and far less on bank cleanup than ideal and is suffering stagnation at best as a consequence. Failure to address banking system problems encourages moral hazard and crony capitalism every bit as much in the North Atlantic economies as in East Asia. Lacking macroeconomic room to maneuver because of preexisting debt or vulnerable exchange rate pegs is every bit as costly in Southern Europe today as it was in Southeast Asia in 1998.

- *Address the need for self-insurance globally if we can, regionally if we must.* The biggest gap between the developing Asian and North Atlantic economies arises in the differing needs for self-insurance by accumulation of foreign exchange reserves. This is partly an inevitable matter of need, given respective access to debt markets in home currencies. Still, all countries have the need for some form of liquidity provision in time of financial crisis—hence the very helpful and much used bilateral dollar swap lines that the US Federal Reserve provided to a number of countries in 2008–10, including in Western Europe. All countries recognize that conditional lending, as carried out primarily by the IMF, is a critical component to promoting adjustment in economies, whereas competing conditionality adds to instability. And all countries acknowledge that the current weight of voting in the IMF is out of balance with the actual economic realities of today, which causes both distrust and inequality in the generosity of lending programs. Regional monetary funds, in addition to swaps arrangements, show some promise for diminishing the perceived need to self-insure on hard currency liquidity, but a significant effort at coordination with global institutions is required to make them work.

Our approach in this volume is intentionally based on a comparative case study approach, along specific themes. That is, our authors are neither doing pure cross-sectional regression work with many observations, which while informative miss some critical details, nor focusing solely on the events in one episode in isolation, which loses perspective. Together with our Asian-American set of authors, we believe this framework allows us to deliver practical yet widely applicable lessons about financial crises for developing Asia and beyond. Most of all, by coming together in this approach we hope to get beyond the claims of hypocrisy or the self-serving nature of various policies promoted in the 1990s in Asia versus those pursued by the United States and European Union for their own economies in the last few years. If anything, our message is that the North Atlantic policymakers should have followed the lessons that came out of the Asian financial crisis a decade earlier—where they have "let themselves off easy," with regard to banking cleanup or utilizing fiscal room or trumping IMF conditionality with regional resources, Western countries have done harm to their own economies' recoveries.

In the remaining part of this chapter, we summarize the individual chapters that make up this volume.

The United States and Europe Can Learn from Japan's "Lost Decades"

In chapter 2, Masahiro Kawai and Peter Morgan use the example of Japan's "two lost decades" to draw lessons for other countries. Although other countries have experienced prolonged economic stagnation after the collapse of asset values and resulting banking crises, Japan's period of weak growth, deflation, and mounting debts was exceptionally severe. Japan's plight stemmed from bad policy choices (including inadequate monetary policy) and failure to restructure banks with loans to dead or "zombie" entities. Economic rigidities led to inadequate corporate investment and a slowdown in productivity. Aggravating these factors was the economic and budget cost of Japan's aging society.

The authors use these factors as criteria by which to examine the economic problems in three groups of countries that subsequently experienced economic stagnation resulting from banking crises—the advanced economies of the OECD and the developing or emerging-market countries in Asia and Latin America. Growth in Japan ahead of the crisis was much higher than that in its advanced-country peers and in countries in Latin America but was on a par with the emerging-market countries in Asia. Japan's high growth rate was also related to a higher level of domestic credit than in other countries, and its decline in capital stock was similar to that in developing Asian countries driven by the investment-led growth model. Thus the factors that were unique to Japan were the dramatic decline in stock and real estate prices, price deflation, poor GDP growth, and its aging population. The authors' econometric analysis of long-term growth rates finds that low rates of consumer price index (CPI) inflation (or deflation), low levels of net investment, lack of openness to foreign direct investment, and an aging population explain much of Japan's slowdown.

Turning to policy implications, the authors argue that once bubbles build up and collapse, authorities should undertake accommodative monetary policies, combined with steps to encourage banks to clean up their balance sheets. Japan stands as an example of inadequate policy response and too much forbearance toward the banking sector. Its experience has much in common with the United States and European Union, though it has surface resemblance to the experiences of countries hit by the Asian financial crisis, particularly Indonesia, the Republic of Korea, Malaysia, and Thailand. As for whether the United States and some euro area countries face stagnation comparable to Japan's, the authors' conclusion is mixed. On the one hand, the United States, the United Kingdom, and Italy did not go through as much "excessive" growth in GDP and capital stocks as Japan in the run-up to the crisis. On the other, low consumer price inflation and net investment suggest that these economies are in some danger of "Japanization" of their economies. The slow response to banking sector problems in the euro area is particularly reminiscent of Japan's inadequate responses.

Central Bank Actions in Advanced Economies during the Global Financial Crisis Had Net Positive Impact

In chapter 3, Joseph E. Gagnon and Marc Hinterschweiger assess the responses of central banks in advanced economies (the US Federal Reserve System, Bank of England, Bank of Japan, and European Central Bank) to the global financial crisis. They note that four years after the onset of the crisis, none of the major advanced economies is close to a full recovery. The crisis exposed the fault lines in European monetary policymaking even though central banks generally pushed policy interest rates to historically low levels and undertook nontraditional macroeconomic stimulus to ease financial market strains. Most research indicates that central bank actions have made a positive contribution to economic and fiscal conditions. Central banks sought to renew credit flows by returning liquidity and credit risk spreads to normal levels, reducing some of the "headwinds" impeding economic activity. But the macroeconomic stimulus has been limited.

Gagnon and Hinterschweiger note that preventing the failure of large financial institutions can avert a negative shock but that, by themselves, such actions do not constitute a "positive shock" to the economy. They assess the positive effects from the approach of some central banks, including the US Federal Reserve, especially the policy known as quantitative easing (QE), and the effort to manage expectations about the future path of short-term interest rates. There are potential costs of both "ultra-low" interest rates and QE but so far they are smaller than the benefits. Indeed, more aggressive QE would have been preferred, not less.

The authors acknowledge that "moral hazard" concerns have arisen as a result of steps taken by central banks in cooperation with other authorities to prevent the failure of large financial institutions. The concern arises from the perception of some banks that they will not be allowed to fail and therefore may repeat some of their reckless practices. But such concerns, while legitimate, should be more properly addressed through reforms of the financial system.

Asian Countries Fared Better during the Global Financial Crisis than during the Asian Crisis

In chapter 4, Donghyun Park, Arief Ramayandi, and Kwanho Shin investigate why Asian countries fared better during the global financial crisis than they did during the Asian financial crisis. Asia was hardly immune from the global financial crisis, the authors acknowledge, citing the drop in growth and trade throughout the region. But from the beginning, the global financial crisis had less of an impact on developing countries than on the advanced economies, where the crisis originated, and developing countries "have largely shrugged off the effects" and are recovering. Nevertheless, the crisis heralds a new era of diminished growth expectations in Asia, in part because of the region's reliance on the ailing advanced economies as export markets. But with massive fiscal and monetary stimulus, countries in Asia were able to minimize the downturn and limit the effects of the crisis on financial institutions, eventually using stimulative policies to produce a robust recovery.

The authors caution against "hubris or overconfidence" in Asia, however, recalling that Asian countries suffered the crisis of 1997–98 on their own. Both crises were marked by an abrupt flight of foreign capital from developing Asia. During the Asian crisis, this outflow resulted from a loss of investor confidence in the region, however, whereas in the recent crisis the capital flight resulted from the need of US and European financial institutions to withdraw loans to support their damaged balance sheets at home. As for why the Asian countries fared better in the more recent crisis, the authors say that improved macroeconomic fundamentals helped cushion the blow and provide resources for a response of economic and monetary stimulus.

Among the positive fundamentals shared by the Asian countries was their record of keeping inflation and the growth of domestic credit at a sustainable precrisis rate. These economic fundamentals enabled Asian countries to undertake countercyclical expansionary monetary and fiscal policies to mitigate the crisis. In contrast to the 1990s, the authors call on Asian policymakers to continue to pursue the same sound policies and maintain healthy current account balances (and substantial foreign exchange reserve levels) to be able to counter the effects of shortages of US dollar liquidity of the sort that hurt the region during the Asian crisis. The expansionary response during the recent crisis was far more successful than the contractionary response during the Asian crisis.

The West Failed to Practice What It Preached during the Asian Crisis

Simon Johnson and James Kwak note in chapter 5 that the Western countries, particularly the United States, drew lessons from the Asian crisis of the 1990s but later failed to apply these lessons to themselves. In the 1990s, US policymakers understood the importance of two crucial ingredients in the Asian crisis—tight connections between economic and political elites and dependence on short-term flows of foreign capital. But they wrongly concluded that these problems did not threaten the United States itself. In fact, the events of September–October 2008, when Lehman Brothers collapsed, resembled a "classic emerging-market crisis," and the housing bubble that caused the crisis was an instance of overoptimism and excess debt "worthy of any emerging market."

The policy prescriptions for Asia after the crisis were not applied to the United States. For example, in the recent crisis, the US government rescued major banks overseen by wealthy executives while letting smaller banks fail, thus "bailing out a very specific element of the American elite." By contrast, the United States demanded that emerging-market countries in Asia deal with political and economic factors, such as the grip of elites on the financial sector, even though this insistence was perceived as arrogant in the crisis-stricken countries. The policymakers applied "one set of rules for emerging markets and another for the United States." In Asia, the West forced insolvent financial institutions to undergo resolution or restructuring, wiping out equity, converting debts to equity and replacing management. In the US crisis, authorities instead applied various forms of implicit and government financial support. The result is that the United States has increased moral hazard and enshrined the concept of banks "too big to fail," with negative consequences for global financial stability in the future.

The Role of the International Monetary Fund Is Crucial

In his comparative analysis of the evolution of the Asian and European financial crises, Edwin M. Truman focuses on the role of the IMF in chapter 6. He discusses the experiences of five countries in Asia and ten countries in Europe that went through crises requiring IMF programs in support of economic and financial reforms. In Europe, the IMF's role was supplemented by support from the European Central Bank and the European Stability Mechanism established by euro area countries. While there were many differences among the experiences of these countries, the similarities outweighed the differences.

On the other hand, a major difference was that the European countries received more financial support, despite the fact that their problems derived from deeper issues of solvency and not simply liquidity crises that afflicted Asia. In addition, the programs adopted in the European crisis generally have been less demanding and rigorous than those in the Asian crisis. Partly as a result, the negative global impact of the European crisis has been larger than the crisis in Asia. The main lessons drawn by Truman are that despite promises to the contrary, history does tend to repeat itself and that noncrisis countries should realize they have a stake in preventing and managing crises in other countries. Another lesson is that the IMF and its surveillance mechanisms should focus on monetary unions like the one in Europe and not simply on crises that might afflict individual countries.

Regional Financial Arrangements and Global Institutions Should Increase Coordination

In chapter 7, Changyong Rhee, Lea Sumulong, and Shahin Vallée look at the lessons for the development of regional safety nets and insurance mechanisms that might have prevented the crises of Asia in the 1990s, the global crisis of 2008, and the ongoing European crisis. They conclude that the IMF and other institutions created at Bretton Woods responded "imperfectly" to all of these episodes. The 2008 crisis did lead to an improvement in cooperation to deal with the turmoil, however, and central banks employed currency swap arrangements to provide liquidity when the financial system froze. But these steps did not displace let alone discourage efforts at regional cooperation.

The authors then examine the "alternative insurance mechanisms," which have arisen in recent years, most notably in Europe and Asia. They take the reader through different phases of such cooperation, citing a range of accords and initiatives, starting in the 1970s, that have taken various forms throughout the world. The IMF and the G-20 nations can no longer ignore such regional arrangements; accordingly, much remains to be done to coordinate them with global institutions. IMF governance should better reflect the rising power of emerging-market economies and the ability of these economies to self-insure by building up foreign exchange reserves.

The prospects for such reserve buildups will depend in part on the emergence of the euro and perhaps the renminbi as a reserve currency, making the international monetary system less dependent on the dollar. The authors note that many “innocent bystanders” were hit by the recent crises, a fact calling for more preventive steps to avoid crises in the first place. Regional arrangements could be an important feature of such efforts, but regional and global institutions must coordinate with each other to ensure that “regionalism” does not prevent international cooperation in the future.

Regional Financial Institutions Face the Same Challenges as Global Institutions

In chapter 8, Stephan Haggard also examines the emergence of regional cooperation in global financial crises. While developments in Europe and Asia have focused on regional lenders in these regions, Haggard notes that Latin America also has a subregional experiment that bears scrutiny. Like international institutions, these regional mechanisms face problems of providing assistance without introducing moral hazard concerns. One way to address such concerns in advance of crises is through agreed policy constraints. But such agreements are inherently difficult when membership of regional organizations is heterogeneous. The “turbulent history” of such agreements in Europe offers a case in point, Haggard notes, citing disputes over maintaining the Stability and Growth Pact in Europe. Such commitments have been even weaker in Asia and Latin America.

The chapter explores some of the political, financial, and economic factors affecting these commitments in each region. Once crises hit, it is no less difficult for regional arrangements than it has been for international institutions to enforce preexisting rules on bailouts and lender-of-last-resort rules amid conflicting demands by creditors, borrowers, and political actors. As a result, some regional actors rely on the IMF to help devise rules and negotiations on rescues. Haggard offers a history of such arrangements as they have developed in Europe, Asia, and Latin America. These three diverse regional experiences teach several lessons. Among them is the difficulty of establishing robust surveillance ahead of crises and the design of lender-of-last-resort rules after the crises erupt. While coordination between regional arrangements and the IMF would seem ideal, Haggard explains the difficulties in carrying out such cooperation because of the divergent interests of the regional and international parties. Thus “division of labor” between regional and international players might be a more realistic goal than “coordination.”

Most of Emerging Asia Is in a Solid Debt Position, but Japan Faces Challenges

William R. Cline, in chapter 9, looks at three international debt crises—Latin America in the 1980s, East Asia in the late 1990s, and the ongoing European debt crisis—while drawing lessons for the prospects for sovereign creditworthiness in Asia in the future. The countries he examines are the People's Republic of China, India, Indonesia, Japan, the Republic of Korea, Malaysia, the Philippines, Thailand, and Viet Nam. These countries have already learned the lessons of recent sovereign debt crises and have avoided high ratios of external debt to exports and reduced ratios of short-term external debt to reserves. They have also pursued sound management of their fiscal deficits and debts. India faces the challenge of reducing deficits and inflation rates, but its GDP growth has meant that its public debt ratio is not yet at a dangerous level.

Cline concludes that all eight countries "pass the fiscal sustainability test" and are increasingly able to rely on debt denominated in domestic currency instead of foreign currency, another sign of strength. The Republic of Korea and Malaysia have gone the farthest in this direction, he finds. The price paid for relying on domestic market sources has come in terms of higher interest rates, but this premium is relatively small. Perhaps ironically, the inescapable conclusion is that Japan faces the principal sovereign debt challenge in Asia, with high debt ratios and fiscal sustainability challenges. Cline questions whether Japan's pursuit of quantitative easing is addressing the fundamental problem of an aging population and a resulting stagnant labor force. For this reason, monetary expansion might not bring as much growth as many analysts have concluded and could, at the same time, boost interest rates in a way that would compound the debt-to-GDP problems.