The Financial Crisis in Emerging Markets: Lessons for Eastern Europe and Asia

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at the EastWest Institute
New York
April 23, 1999

Perhaps it is just that spring is in the air, but is seems now that the global financial crisis whose start was marked by the Thai devaluation in July 1997, is easing. Activity appears to have turned around in Korea and bottomed out in Thailand; and the rest of Asia seems to be recovering or about to do so, too. Encouraged by the revival of confidence in Brazil since early March, the tender shoots of a revival of capital flows to the emerging market countries are visible in declining spreads and a return of Latin American countries to the market — and we saw yesterday that Brazil raised $2 billion from the markets.

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.

I. The Crisis

Why was the Asian crisis such a surprise? Mainly because no-one expected that countries whose economic policies and performance had for so long looked exemplary — they had experienced decades of extraordinary growth, based on outward-oriented policies, high rates of saving and investment, investments in human capital, governments oriented to economic development, and prudent macroeconomic policies — would get into a crisis, least of all one as deep as it turned out to be.

The financial crisis in Asia was followed by increasing pressures on Russia's financial markets, exacerbated by the declining price of oil and other commodities, and the Russian devaluation and unilateral debt restructuring of August 1998. While Russia's crisis was less surprising than Asia's, given the problems that had beset that country's reform and stabilization process for the past several years, the collapse was certainly a stark contrast from the euphoric mood that seemed to prevail amongst Russia-watchers only months earlier (in early to mid 1997).

From Russia, the crisis spread through a process of contagion to Latin America, and even to the financial markets of the United States, so that when the Annual Meetings of the IMF and the World Bank were held in October last year, there were many who feared we could

be in the worst financial crisis of the post-World War II era. Fortunately — and also through good economic management, especially by the Fed — we seem to have averted that fate.

Now we are grappling with a host of questions raised by these crises and the Mexican crisis that preceded it: about the need to reform the international financial system; about economic management in emerging market countries; the role of highly leveraged institutions; capital controls, and more. Chou-en Lai, asked about the lessons of the French revolution, replied that it was too early to draw conclusions. Still, we are living in a new age — albeit an age closer to that of a century ago than that of a quarter century ago — and we need to think through the implications of the changes in technology and the seemingly irresistible tide of globalization that is changing the economic (and also the political) environment in which all countries operate.

II. Some Early Lessons

The first lesson, and it could be a controversial view, is that globalization is here to stay — that 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 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. I will turn later to the work now under way to strengthen the international system.

The second lesson is that 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, 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.

A third lesson relates to 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.

A fourth lesson is the critical importance of, in the jargon of the international financial institutions, ownership. 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 soar. And in this regard, the existence of a friendly neighbor offering discernable benefits to integrating with the global economy helps — the goal of joining theEU seems clearly to have 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.

III. Improving the International Financial System

As we move into the post-crisis period, it is critical not to allow the momentum for reform

to slow. The spring meetings of the IMF and World Bank start in a few days, and I believe we will be able to demonstrate that significant progress is being made in changing the system. Let me mention a few highlights.

First, the Executive Board of the IMF has been discussing the possibility of establishing a **CCL, Contingent Credit Lines**. This would allow a country to put in place contingent credit lines from the IMF, that would be activated in the event the country was hit by contagion from developments in other countries. There were many technical problems to be solved in setting up a CCL, but good progress has been made, and final agreement is likely very soon. The CCL will be an important change in the international system, for it will put in place a variety of incentives to countries to strengthen their economies and particularly their ability to deal with a potential financial crisis — critically, it enables IMF support to be provided in a *preventive* rather than in a *reactive* mode.

Second, a great deal of work is being done on the development of **international standards** in a variety of areas, that will help strengthen the economies and financial systems of all countries, and especially emerging market countries. The IMF's Special Data Dissemination Standard was established in the wake of the Mexican crisis, and is now in operation — it sets standards of data practices that countries that want to operate in the global economy should meet. Nearly fifty countries, both industrial and emerging market, have subscribed, and the information can be accessed through the IMF's web site. The IMF has also developed standards for fiscal transparency, and for monetary and financial policy transparency, and these are in the process of being put into operation as a means for countries to improve their own standards of information provision — and in all likelihood their policies more generally — about monetary, fiscal, and financial policies. The core banking standards of the Basle Committee on Banking Supervision were developed in 1997, and set standards for the management and supervision of banks that should be applied by countries that wish tostrengthen their banking systems. Other codes have been prepared, or are being prepared, in the areas of social safety networks, corporate governance, accounting, insurance, and securities markets.

The *development* of these standards is an important step forward. Far more important will be their *adoption* by countries, including some industrialized countries, that do not now meet them. The regular surveillance by the IMF of the economies of member countries provides one key to monitoring the implementation of these standards, but in doing so, we shall have to develop new modes of cooperation with other agencies that have the relevant expertize in some of the areas that are far from the original activities of the IMF. A positive incentive for the adoption of these standards is provided by one of the conditions for access to the CCL, that countries should be making progress in attempting to meet the standards. Further incentives could be provided by regulators in industrialized countries, who could condition risk weightings on exposures to particular countries on the extent to which those countries meet certain standards.

Most important of all, the success of these efforts to strengthen emerging market countries by encouraging them to meet the specified standards will depend on how the private sector responds: if the terms on which countries can borrow depend on how well they are doing in meeting the standards, we can be sure that countries will be encouraged to adopt the standards. If not, the standards effort will be far less successful than it deserves to be.

Third, the **Financial Stability Forum**, which brings together the G-7 with the international financial agencies and the international regulatory agencies that deal with the financial sector, including the Basle Committee on Banking Supervision, IOSCO, and the bodies that deal with international accounting standards and insurance regulation, has been established, and met for the first time last week in Washington. This will be the first time that all these agencies, all of which deal with important aspects of the financial system, have met; they will now meet regularly and work together to try to deal with major issues in the international financial system, for instance the role of highly levered institutions, on which so much attention has focused in the recent crisis.

Finally, progress is beginning to be made on the critically important, but extremely difficult and sensitive matter of involving the private sector in the prevention, mitigation, and solution of financial crises. There are no set answers, no simple or single formula, but rather where necessary, an attempt will have to be made to involve the private sector 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. 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 certain 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.

I believe that we have started making important progress in dealing with some of the weaknesses of the international financial system that have contributed to the virulence of the recent crises. But we are at the beginning, not the end of the reform process, and we must press ahead now and in the coming years to ensure that we do everything we can to strengthen the system to which so many countries have demonstrated such strong commitment despite the difficulties of the last few years.

[1]International Monetary Fund. This is an outline of comments prepared for delivery at the EastWest Institute conference, New York, April 23 1999. The views expressed are those of the author, and are not necessarily those of the IMF. I am grateful to Dan Citrin for his assistance.