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Lessons from the Financial Crisis in Asia

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Preface

This paper was originally presented at our *Distinguished Lecture Series DLS* on 18 March 2002 at the Cultural Centre of the University of Macau for the 20th anniversary of our University.

Awarded the 2001 Nobel Prize in Economics, Professor Stiglitz made his first public speech in Asia at our University after receiving the prize. On the same occasion, he was conferred an honorary Degree of Doctor of Social Sciences *honoris causa* by our University.

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Lessons from the Financial Crisis in Asia

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The scandals having to do with Enron and Arthur Anderson highlight again that some faith in long-accepted theory and practice was misplaced. American accounting practices, and corporate governance were all oversold, it seems. There are problems both in America and elsewhere with generally-accepted accounting and corporate governance issues. Policies were inadequate. Mistakes were made. Lessons will hopefully be learned and applied.

An investigation into the lessons learned from the very-different behaviors and experiences of Korea, Thailand and Malaysia—focusing on their level of adherence to IMF recommendations (recommendations based on orthodox economic theory)--follows. Malaysia's downturn was the shortest and the shallowest of any of the countries. Thailand, who followed the prescriptions of the IMF most closely, still has not yet reached the levels of the GDP that it had at the beginning of the crisis. Malaysia was castigated by the IMF for the introduction of capital market interventions, and capital controls. The IMF said that this move would result in untold disasters that would not help the country recover -- they were wrong again. Malaysia not only recovered quickly, but as a result of these capital controls, were able to lower interest rates, and as a result of that, the amount of corporate restructuring that was required was far less. As a result, Malaysia has left the crisis with less of a debt than the other countries and therefore in a better position to resume economic growth. Even in Korea, which did undertake the IMF program, was successful in its recovery, largely because it did not follow the prescriptions of the IMF. The IMF directed Korea, for example, to shut down a large number of its banks. It did not, choosing instead to restructure them. The IMF told them to close much of its computer chip industry; again it did not follow that prescription and recovery in the computer-chip industry provided the basis of Korea's recovery.

In short, because Korea followed an independent course, not because it followed the advice of IMF that it recovered. Was IMF right about the nature of the diagnosis of the problem? Its diagnosis of the problem was that there were deep-seated structural problems within Korea. If this were the case, it is inconceivable that in the short span of 6-months-to-a-year Korea could have rectified those problems and gone on to the success that followed. In short, the IMF diagnosis of the problem was wrong, and it follows that its prescription was also wrong.

This goes to the heart of the matter? What is the use of revisiting these issues today? These issues which in many quarters seemed well-settled. There is an aphorism in America that says that those who do not learn from history are condemned to repeat it. They are condemned to repeat the mistakes of the past. That is why this issue is not just a question of passing the IMF with other international economic institutions. The issues that were at the core of the crisis in East Asia, have since spread, causing the global financial crisis embracing Russia and Brazil.

The lessons that can be extracted from those crises are relevant to the world of today. That point has been brought forcefully to our attention by the experience in Argentina. The same mistakes that were made in East Asia, for instance, the same pursuit of excessively contractionary fiscal policy which led to the deepening of the crisis in East Asia, were pursued in Argentina with the same disastrous consequences.

The debate continues today even in East Asia. There are some who said that China was too loose in pursuing a large deficit. I believe that the deficits that China adopted saved China from the fate that many of the other countries in East Asia suffered. As a result of that deficit spending, China was able to maintain an economic growth of 7 percent, while the rest of the developing world including East Asia went into recession or even depression. The deficits were used to finance investment so that while the

economy was surviving in the short-run the foundation for long-run economic growth was simultaneously being laid. In short, the kind of policies that China pursued were precisely the kind of policies that other countries in East Asia should have pursued, despite their being discouraged from doing so by the IMF.

Similarly today, there is a debate about the reform of the global economic architecture. Those debates were very heated in the years 1998 to 1999. But in spite of the thousands and millions of words exchanged, very little change has occurred. Some of this discussion placed much blame on developing countries regarding their accounting standards (This was in the days before America's own accounting practices were recognized to have weaknesses). But nothing fundamental emerged from these debates, and the reason for this again has to do with the failure to understand the mistakes and lessons of the financial crisis. Some of the mistakes of globalization that led to the crisis are today the same mistakes responsible for the lack of subsequent progress in the reform of the global institutions. Fundamentally, the problem has to do with the fact that the same players are at the table, the same finance ministers and central bank governors. Those same people are now trying to dictate new reforms in the international economic systems and the consequences and failures are again the same.

As a final preliminary remark I want to focus for a moment on economic policy. But I want to make it clear that one cannot truly separate economic policy from the social and political context in which it applies -- a fact that, affected the East Asia crisis itself so clearly. In Indonesia, the contractionary fiscal and monetary policies were pursued (which exacerbated the downturn and led to recession/depression). The consequences those policies had on social stability were predictable and predicted. They were predicted for instance, at a meeting in Kuala Lumpur in early December 1997 at which the finance ministers and central bank

governors of the G7 and most of the countries in East Asia were present along with the head of the IMF. At the meeting I made clear my belief that if the IMF continued to push its policies, (the contractionary fiscal and monetary policies they were pursuing at the time), given the history of ethnic factionalism in Indonesia it was likely that within 6 months, that social and political turmoil will break out in that country.

As it turns out I was overly optimistic. It took only 5 months for chaos to break out, because I had not really counted on the fact that the IMF would not only have pursued these policies that led to recession and depression, but (seeing as unemployment was soaring 10 fold, and as real wage was falling) the IMF went even one step further. It rather literally put billions and billions to bailouts western but fewer subsidies for the poor and so it made the IMF recommended that those fewer subsidies be cut off and when that happened, the very next day, social and political turmoil broke out. That bad social policy was clearly also bad economic policy because countries facing that kind of social and political turmoil are not going to attract capital. It was to attract capital that those budget cuts were established in the first place--to make it more attractive for western investors to invest-but that context was not one which brought in capital. Instead, capital flew out of the country and the depression deepened further. In short, one cannot separate out economics from the social and political context. And doing so is both bad social policy and bad economic policy.

The question that should come to mind when examining the East Asian Crisis is: what major economic lessons can be drawn? The first thing to note when examining this question is that this is not the first crisis. Indeed, over the past 30 years, approximately 100 countries have had an economic crisis, so that it is more usual to have had a crisis than not. The fact that there have been so many crises is actually, for economists, a good thing. Whereas for the country it's clearly terrible. So why do I say a good

thing for economists? Because we have lots of data, and economists love data, and that data allows us to ask the question about the factors that cause crises or are systematically related to crises. At the beginning of the crisis of 1997, all kinds of cursory explanations were put forward especially by the IMF, and the US Treasury. Most of the explanations were not impressive. In fact, even a few minutes' reflection showed how bad most of those diagnoses were. For instance, consider one factor that was continually put forward: the lack of transparency. Let me make it clear that my position on the general favorability of transparency is very strong. Transparency and economic, political information are important. The question is not whether it is important, but whether lack of it causes crises—and whether the presence of it prevents them.

Among this reflection, the record of the recent crises that have plagued the developed western world's countries shows that the major set of crises before the East Asia crisis were in Scandinavia: Norway, Sweden and Finland, all countries which shared the reputation of having the most transparent political and economic systems. So, if these highly transparent systems faced severe crises, it is very clear that transparency does not inoculate you against a crisis. Increasing transparency is a good thing, but it certainly does not provide a protection against another crisis.

Indeed, it clearly is not the real cause of the problem. It is clear today that the major factor causing the crises was the capital- and financial-market liberalization that was pushed on these countries and it was this that led to the vulnerability. Even in the United States, excessive deregulation in the financial markets in the 1980s led to the savings and loan debacle, which resulted in a bailout by the federal government of several hundred billion dollars. The irony of course is that after this disastrous experience of deregulation, the IMF pushed for the deregulation of financial and capital markets around the world. I sometimes jokingly say that the IMF wanted to make sure that everybody got their share of the painful American

experience. There was no reason to save it just for ourselves.

Adding to this tragic irony is the fact that East Asia had a remarkable history of relative economic stability. Two of the countries involved in the crisis hadn't seen a single year of economic downturn in 3 decades, and the other 2 witnessed only one year of economic downturn in 3 decades. In short, the economic performance in terms of stability was better than in any of the OECD or any of the industrialized countries. If these countries were vulnerable, it was a new founded vulnerability? It was the fact that these countries had been pushed into premature capital and financial market liberalization that turned bad into worse.

The example of Thailand illustrates this point. In the 1970s and 80s, Thailand had quite strict financial regulations. It restricted, for instance, banks and other financial institutions from excessively speculating in real estate. The reason for this was obvious and two fold. Firstly, in Thailand, excessive real estate speculation is one of the major sources of economic volatility. The boom and bust cycle in real estate gives rise to the boom and bust in economies and has done so for decades around the world-- this was something Thailand wanted to avoid. And secondly, for a poor country, it makes more sense to take the scarce capital and invest it in factories that create employment, rather than in empty office buildings.

But, the IMF took a different view. The IMF said trust the market, if the market says building empty office buildings, the market must know best. And so they went ahead and built all those empty office buildings--again, I sometimes joke they were trying to imitate the United States, where in Houston for example, before that real estate bubble broke, they got up to 30percent vacancy rates in real estate. In Bangkok, they only got only up to 20percent vacancy rates before the bubble burst. But the fact is that the speculative bubbles were facilitated by the IMF-promoted financial market liberalization and the linkage between that and what happened in Thailand

is perfectly clear.

Although the liberalization of capital markets is indeed a good thing, there is no documented causal link between it and economic growth. What is remarkable, here and I want to emphasize this, is the fact that the international institutions such as the IMF push the doctrine, of capital market liberalization--the opening up of markets to the flow of money that can come in and out overnight--without there being any strong evidence that this is what is good for these economies. When I went to the World Bank, quite quickly I found that scandalous. As an academic, I thought policies were supposed to be based on evidence. Scientifically-based policies are the whole point of what we were doing and research was to provide policy-makers with the knowledge on which to make better economic policies. Surely, I thought, you would not say to a country “Open up your capital markets, Liberalize” if there was not evidence that it clearly promoted economic growth. Surely one would not do this if there was evidence that it may even promote economic instability. But sadly, the fact is that the IMF pushed this agenda when there was no evidence that it promoted economic growth--and there, in fact was plenty of evidence that it promoted economic instability.

I will not try to explain IMF's actions. But some things become obvious, when you think about who makes the decisions and in whose interests they are made. The influences are fairly clear. Just to provide those of you who are not familiar with the IMF some background. The voting power of the IMF is very different from that of the UN. Voting power is based on economics, specifically the economic power as it stood at the end of World War II(with some small modifications). Remember that the UN has a lot of dissatisfaction with the fact that 5 countries have the veto power. But at the IMF, only one country has effective veto power. This country I call the G1. And who speaks for that G1? Not the president, but the secretary of the treasury and the central bank governor.

It is the financial ministers and the central bank governors, effectively deciding on a wide range of issues. In our democracy, economic decision-making ultimately affects labor, justice, trade, indeed every aspect of society. So when the IMF makes decisions for the international community, although it is only the financial community that has a voice, everyone is affected. Furthermore, decisions that get made sometimes do not reflect scientific evidence but rather ideology.

Returning to the more specific issue of why capital-market liberalization does not promote economic growth: The evidence as I say is fairly clear if you look across countries; those that have liberalized have not grown faster. Why isn't that surprising? Well, the first obvious reason can be talked about in terms of, to use the economic jargon, the reserves, the opportunity cost—there is a view that potential behavior, on the part of countries, requires that as their dollar indebtedness (what they owe in short-term dollar debts goes up) they have to put away in reserves a conventional amount. That is to say when you owe money (short-term dollars), the people you owe money to could demand those dollars from you very quickly and if you don't have some dollars in your reserves, you will be put in a very difficult situation.

This view holds that countries need to keep reserve commensurate with those short-term dollar-denominated liabilities. But think about what that means? Take a poor country, say a poor African country, in which a firm borrows a 100 million dollars from an American bank. The American bank charged something like 18 to 20 percent interest. The country then says "Well, I have to put away a 100 million dollars of reserves," So that public money that could have been spent building schools or roads or hospitals, can be spent in building those schools on roads or hospitals, but has to be put into reserves. What does that mean to put money in reserves? That means you can't spend it. How do those countries hold their reserves? They hold them in the form of US treasury bills. What does that mean?

Sounds innocuous, but it means that this poor African country is lending 100 million dollars to the United States treasury, and the US government. At what interest? Around 3 percent. Now think about what that means? This poor African country is borrowing from the US at 20percent and lending to the US at 3percent. Now you can understand why the United States thinks this is a wonderful thing. We make 17 million dollars profit per year on this. But you can also understand why it doesn't promote the growth of the African country. It takes 17 million of hard-earn money, and badly needed money out of that country and puts it into the United States. It's the African program of foreign aid to America.

There is another reason why it is not good for economic growth, and that is because risk, as I said before, increases when money that goes into a country overnight, can be taken out overnight, as happened in Thailand, Korea and Indonesia. What are the consequences when this happens? When money comes out, the country goes into recession. That kind of economic volatility that I described before has increased enormously over the past 30 years. It is bad for firms; firms do not like to invest in an environment of an economy that can go up and down overnight. They required, to use a technical term, a "premium of risk" to compensate them for that risk, and so capital market liberalization absolutely discourages investment.

What about the argument that capital market liberalization is necessary to provide funds for investment? This argument too is fallacious. First, one cannot build factories on money that can leave over night. The short-term money at the heart of capital market liberalization is not money that builds factories, it is money that goes into speculation. Moreover, what is most curious about this argument in the context of East Asia is that East Asia had an enormously high savings rate of 25, 30, 35, or 40percent. They didn't need more money from outside. They were having a hard time investing all the savings already inside their countries; some countries like

Singapore were actually trying to shift money out.

So the idea that they needed capital for East Asian Investment Finance was completely wrong. The argument was sometimes made for liberalization's ability to encourage increase stability, because it will diverse the source of funding. But that argument too was fallacious. As we have seen over and over again, the nature of short-term capital is that the bankers lend according to the general principle that you should "only lend to people who don't need the money". As soon as these countries needed the money, what do banks and other lenders do? They pull their money out and thus exaggerate the economic downturn.

There are even more arguments, that I will only mention briefly, that even more fallacious. One argument is that you won't be able to attract foreign investment unless you liberalize your capital account. This argument is so wrong headed it is almost embarrassing to mention it, especially considering that the country that has been the most successful in attracting foreign direct investment in the world outside the United States is China and China has yet to liberalize fully its capital account. Indeed, the argument as I said before is that, foreign direct investment wants a stable environment. If capital market liberalization leads to greater instability, it discourages investment. It doesn't encourage it.

Finally, one of the arguments I want to mention because we will hear it quite often, and it too is quite fallacious and that is that you need to liberalize in order to get the discipline of the capital market. The notion is that somehow countries can't be trusted at all, they need the foreign whip, the disciplinarian. The disciplinarian that came in when Mexico didn't repay its foreign debts in the middle of the nineteenth century was the British and French armies. That is not the kind of discipline people like today. They want the discipline of the capital market, but does this make any sense?

If you are going to have a disciplinarian, you should choose a disciplinarian that has two characteristics. One, you want the disciplinarian to be reliable, not capricious (like erratic teachers, who whip our knuckles randomly—such behavior creates a lot of resentment not good behavior) Think about this capriciousness in regards to the international capital market—money inflows and outflows may be extremely volatile. Countries like Argentina in 1998, got punished. By punished, it means that their interest rate(s) had to go up, not because they had done anything wrong, at that point. They were at that point “8 + 2” in the IMF. Instead their interest rates went up because there was a global financial crisis that they had nothing to do with it. It started in East Asia and yet it has affected Brazil and Argentina, so the fact of the matter is that capital markets, short-term capital markets are extremely capricious. They are not a reliable disciplinarian.

But the second characteristic of a disciplinarian is one whose goals coincide with your own. Short-term capital is about making short-term returns. For the kind of growth that’s wanted (long-term economic growth) the appropriate disciplinarian is foreign direct investment. Foreign direct investment looks at the long-term economic prospects, not the day-to-day paper-profits that can come from capital moving in and out. So, the notion that short-term capital flows would be a good disciplinarian is just wrong.

Now, to put it more academically, I would argue that the effect of forcing financial- and capital-market liberalization can be related to the market discrepancies between social and private returns to risk. The basic point here is a very simple one. Markets work well when there is a close correspondence between private and social returns, one of the basic ideas in economics. And in most important market sectors there is a close congruent relation between social and private returns. But in the case of capital market liberalization, clearly large disparities follow. Who were the people that were getting the returns from the capital that were flowing into

Thailand? Those were the people trying to make the capital gains from real estate, who wanted to make a killing in the real estate market in Thailand. The people who were seeking the benefit from Korea and Indonesia were the investors who were putting the money in and believed that the return relative to the risk was greater than investments elsewhere in the world. Those were the sort of people who were to benefit from these capital flows. But who were the people who paid the cost when this system did not work well? That is, who were the people who paid the costs of the crisis? The costs were borne not only by those who lost their money, but also by the workers who were thrown out of jobs, and by the small businesses that were forced into bankruptcy when the IMF forced interest rates to go to 20, 30, 40, 50 or 60 percent. Many people who suffered as a result. The social cost of that risk taking involved in the financial- and capital-market liberalization was not borne by those who made the decisions to have capital moved in and out of the country.

Now, those discrepancies between social and private return is the reason why it is important to discuss, for instance, the huge bailouts. We're talking about many tens of billions of dollars. And if you include the amounts of money spent as a result of the subsequent financial fallout in Russia, in Brazil and more recently in Argentina we're talking about \$150, 200 billion or more. The result, of course, is that many of the people who lent money did not bear the cost of the bailout. There is today wide agreement that the policies were badly designed.

I want to spend a few minutes going through several of the aspects and ways in which these policies were badly designed. The many lessons that have emerged from the East Asia crisis, among the most important are those having to do with the appropriate ways to respond to crises. I have thus far spent my time emphasizing the lessons about the causes of the crisis—of how the capital and financial market liberalization has a high likelihood of causing increased instability and thus should be promoted

with a great deal of caution, and that it was really a mistake in policy because while it did increase risk, it didn't increase economic growth. But there is a second set of issues which is the responses to the crisis.

I want to try to argue that those responses exacerbated the downturns on the one hand and delayed the recovery on the other. The first mistake was the excessive tightness of fiscal policy, even the IMF today admits that they made a mistake in this respect. The principle is a very simple one and the failure of this should be even clearer today. The United States beginning with the year 2001 faced an economic downturn. There was a disagreement about precisely what should be done but there was universal agreement on the principle. The principle was that there should be stimulatory fiscal and monetary policy, that interest rate should be lowered and that expenditure should be increased and tax should be reduced. There should be expansionary fiscal policy and expansionary monetary policy. It was called the stimulus pact. There was a lot of disagreement about the correct composition of the stimulus policy, but there was no disagreement that there *should* be a stimulus policy. Ironically, in each of the cases (in East Asia, in Korea, in Thailand and Indonesia,) the IMF not only suggested, but demanded that the countries have contractionary monetary and fiscal policy. It is just the opposite of what we teach students in every basic course in economics. The interesting issue from my perspective is while IMF now admits that they had made a mistake, they have not explored why that mistake was made. Was it just an accident or was there something systematically wrong with their models? Or was there something systematically wrong with the basic economic framework that they used?

It was because they did not ask these questions that they were left, in the case of Argentina, to make the same mistake again. And, it was because they did not ask these questions that they were left to make the same mistake again in Russia. The general point I want to make is that if we don't learn this lesson, we are going to find ourselves making that same mistake

over and over again.

The other mistake made has to do with monetary policy. The high interest rates in the Arab countries that have high interest rates add especially high leverage, this led to bankruptcy. You don't need to be a rocket scientist to figure out if these firms had the high debt/equity ratio, the high debt ratio. Everybody recognized a high debt. Increasing interest rates forces many firms into bankruptcy. One of the interesting aspects of this is that when I talked to the people of the IMF about this policy they'd say: "Well, don't worry if it turns out that you are right and the economy goes into a recession and depression, we will reverse policy." But what was not taken into account is a fact that is explained to any student in their first year of economics; that it takes 6 months, 9 months, 18 months for a policy to have full effect. So, if you made a mistake, you are not only condemning them to a 6-month recession, you are condemning them to a year-and-a-half to 3 year recession. But the mistake was even greater when you consider that damages are not generally reversible: you don't un-bankrupt the banks that you bankrupted. Once you bankrupted a firm, lowering interest rates doesn't make it recover. The IMF said, "We face the dilemma, if we don't raise the interest rates, the exchange rate will fall, and that too will cause firms to go bankrupt." But here they've made a critical mistake or set of critical mistakes. They didn't look carefully at what was going on inside the country. For those who are economists, the basic point here is that you cannot separate out macro economics from micro economics, you have to ask: who holds the debt, who will be affected?

Take, for example, the case of Thailand. Clearly, there were two groups of firms in Thailand that held a lot of foreign debt. One of them was real estate firms who were already terminally ill--in a macro-economic sense interest-rate/exchange-rate policy will have no effect on this sector of the economy, that was already going bankrupt at an alarming 20% rate. There was however another group of firms that were heavily indebted in dollar

terms and there would be good potential for bankruptcy-prevention here--these were the exporting firms. They would be helped by the fact that the exchange rate was down, they would be able to sell more and if you look at the net, the net will be better off. So, if you look at the micro-economics, it was very clear that the risk of devaluation was not very great comparing to the risk of raising interest rates. For the highly indebted export-oriented firms, raising interest rate was a sure recipe for bankruptcies, and a sure recipe for causing the economy to go down into a deeper recession and depression.

The magnitude of these effects is mind-boggling. In the case of Korea, it was estimated that by the time the IMF got through with it about 50percent of the firms were bankrupt. In the case of Indonesia it was 75percent. Debt is massive economic disruption. In the end, the irony is that the policies did not sustain its exchange rate.

What was the reasoning behind the IMF? These guys are bright, but they were using a very simplistic model. The reason for telling this particular story is to appreciate the power of models to both guide and mislead, to clarify and distort. Respect and caution must be exercised. The underlying model they were applying was an overly-simple one. Raising interest rates makes it more attractive for capital to go into a country. As capital goes into the country exchange rates are buoyed up. This makes sense except for one fact. What was the reason that capital was leaving these countries? What was the reason that western banks were refusing to roll over loans to Korea? The answer is very simply; they were worrying about the following: People don't care only about the interest rate that has been paid. You can offer a high interest rate but if you are not going to get paid back, what's the difference? What one cares about is both the interest rate and the probability of getting repaid. If you look at the textbooks in macroeconomics, including those written by the deputy managing director of the IMF, you won't see that there is another variable—the perceived

probability of bankruptcy. They just happened to forget about this. But it was the key factor underlying the crisis in the first place. Why didn't they include it? It's too complicated, or so they thought.

But as it happened, when they raised the interest rates and they had the contractionary fiscal policy in place, what did this do to the probability of bankruptcy? It shot up through the roof: with bankruptcy rates of 50 to 75 percent. The increase in interest rate couldn't compensate for the increased probability of bankruptcy, and so rather than attracting capital into the country, it caused a recession, thus encouraging short-term capital to flow out of the country. In other words, it did not have the effect that they thought it was. This is a startling example of how bad models lead to misleading, even disastrous, results. Forget one important variable, and this is the result.

There was another aspect that I would like to mention very briefly. As I have discussed, the bailout policies led to moral hazard, the weakening incentives for lenders to engage induce diligence because they didn't bear the full risk of their lending. But there is another form of moral hazard that has not got much attention – insurance. It led borrowers of foreign currency to obtain, to reduce instead of borrowers of foreign currency to obtain cover. In other words, those who borrowing dollars face a risk. What is the risk? The risk is that the exchange rate may devalue, you should buy insurance.

Now, some people say the real problem with the exchange rate, is that there has been no real fixed exchange rate system in the world. Exchange rate systems change infrequently, but they do always change. Argentina had a fixed exchange rate system, it was absolutely pegged to the dollar for 10 years, and those who believe that it would always be pegged obviously made a mistake. This was also true for Thailand, but interesting enough, is that if everybody believes that it is pegged to the dollar, they weren't sure about

the insurance premium--it wouldn't be very cheap. Insurance works particularly well as a defense, but with the consequence which is exactly the nature of devaluation under the fixed exchange rate system.

Firms should have obtained insurance against this devaluation, but it is the IMF policy itself which discourages firms from doing just that, why? Because for the IMF if no one buys insurance, they can come to the rescue in the end. Infectedly, the IMF said, "Don't buy insurance, don't worry and if anything goes wrong we will help you". It was the IMF that undermined market processes.

A similar case of wrongful-policy recommendations occurred in the area of foreign exchange rate determining mechanisms. The IMF pushed a free-floating regime and discouraged fixed or pegged rates, not realizing the benefit of the latter in providing much-needed insurance against volatile swings of short-term capital. Again, policy recommendations seemed biased in the direction of undermining, rather than helping countries to regain their economic footing.

There are other lessons and I'll just go through them very quickly. One is that closing down banks in the wrong way can lead to runs. The reason why I want to emphasize this is that finance is at the heart of the functioning of an economy. This is why financial crises are so serious. To support all real economic activity, it is important to ensure a flow of finance. This is why it is important to have regulating banks. It is important that when banks are not functioning well, to something about it. But closing down the banks in the wrong way makes things worse. For example take what the IMF did in Indonesia. It was really almost mind-boggling, they shut down 16 banks, and then announced that there were 16 more banks that were going to be closed down. But they were not going to tell anybody which banks they were, and their deposits would not be insured. What do you think people did? They took their money out of those banks

and the whole financial system collapsed. You don't need a Ph.D. to figure out that it was a really poorly planned move. The shortage of finance led to supply disruptions which made it harder to sell goods abroad—despite huge devaluation--bankrupting even more companies.

There are still further problems. The IMF constantly focused on market psychology and kept saying that “if we can restore confidence in the market, then...” all will turn out well. In other words they were acting like psychologists, trying to make people believe in the market. Unfortunately most of the people in IMF did not have psychology degrees and they certainly didn't have degrees in market psychology. As a result, the policy they pursued did not increase market confidence, but instead undermined market confidence. But I actually think it doesn't take a Ph.D. degree in psychology to think through this problem. It is not likely that people would be confident in an economy that is going into a deep recession or depression. Nor is it likely that people will have confidence in a country in which there is a riot going on. This kind of irrational confidence they were after; didn't happen. So while they focused on the psychological contagion, the real contagion they simply didn't pay attention to.

What is the real contagion? Very simply, when one country's output goes down, inevitably, it is going to buy fewer goods from others. But one country's import is another country's exports. So, if Indonesia buys less, it buys less from others, mostly from its neighbors. The result being that its reduction in imports is another country's reduction in exports.

During the great depression, there was a great deal of talk about what was called beggar-thy-neighbor policies. What are beggar-thy-neighbor policies? While you said, my economy is going down, I want to protect it, and where I'm going to protect it is to make sure that instead of my people buying goods abroad, I'll have them buy goods at home, and by buying my goods at home that have stimulated my economy. But why is it called

beggar thy neighbor? Because you stimulate you economy, but because you are buying less from your neighbors, thus making them worse off. And beggar thy neighbor policies were blamed for a part of the downward spiral of the great depression. And one of the reasons for founding the international economic institutions was to make sure that this kind of things does not happen again.

But the IMF came up with something even worse — and it is what I call the beggar-thy-self policies. It began the same way, with a focus on reducing your own trade deficit. There are two ways of getting rid of trade deficits: increase exports or reduce imports. Increasing exports is all well and good but if your neighbors are all going into recession, what are you going to do? You'd of course like them to buy more goods, but you know, there is nothing that you can do now to make your goods more attractive to foreigners except devalue, which is to lower the value of your exchange rate that makes your goods cheaper, enabling you to sell more. But the IMF firmly says, "Don't devalue". In fact, they put in billions of dollars to stop the devaluation. So increasing exports is out. Why not then decreasing imports?

Again, there are three ways to decrease imports. One of them is to put tariffs, make it more expensive to buy goods. But, the WTO doesn't allow you to do that, so that was out. The other possibility is devaluation, making foreign goods more expensive. But that too was not allowed, that was part of the IMF strategy of keeping exchange rate value. Now there is only one way left, cut down your income—don't buy, and imports don't go up. The IMF succeeded in getting rid of the trade deficit not by increasing exports, but by shutting down the economies and shutting down the imports.

But think of this from the perspective of the neighbors. They don't care why you are not buying their goods, they don't care whether it's because you decided to hate them or because your exchange rate has

changed. All they care about is they are not selling their goods to you anymore. Their exports have gone down, so the impact on your neighbors of this new beggar thy self-policy is the same as the impact of the beggar thy neighbor policy. So the contagion on the neighbor was exactly the same, but it didn't even have the benefit of the beggar-thy-neighbor policy. With beggar-thy-neighbor policies, it at least has the benefit of you getting your own country better off as your neighbor got worse. Under the IMF beggar-thy-self policies, you got worse off and your neighbor got worse off. It made absolutely no sense.

In the case of Thailand, for example, where 42percent of the loans were not performing, there was the problem of restructuring. And here again, the policies that were pushed by the IMF were misguided. The word restructuring has different meanings. I want to distinguish between financial restructuring and the real restructuring. One of the problems when firms go into bankruptcy, or default, is that there is not a clear owner. The creditors claim to be owners, but, until the thing get sorted out, it is not clear who owns it. What happens when there are not clear property rights or clear owners? There is an incentive to strip the assets, and almost no incentive to increase wealth. If you think that you control the firm today, and you think there may be a bankruptcy, what is your incentive? To take away as much of your wealth as you can before the court give to somebody else. It is at this point that there is an important role for the government to play in helping facilitate that kind of financial restructuring by clarifying ownership under both normal and default conditions. Once the financial restructuring is done, a more important matter is real restructuring. What is real restructuring? That's whether you shut down an automobile plant, whether you shut down the ship factory, whether you sell the ship factory to somebody else, how you reorganize the real production.

The IMF certainly has no training in the ship industry, for example. And yet, they were giving important advice to the governments regarding

policies directed at the ship industry. What was curious was that they managed to get it exactly wrong. They said the government shouldn't get involved in the financial restructuring, and should get involved in the real restructuring. They said they needed new management to sell the assets to foreign firms to get new management. But think about it from another perspective: for 30 years, these countries have had the fastest rate of growth anywhere in the world. You don't have rapid real growth, (with GDP and wages increasing.) without sound management. The countries had proven that they could do a good job of management. They have made only one real mistake; their chief financial officers should have been fired. They got too heavily indebted and what was needed was a change in financial structure, not a change in the management of real operations. Changing the financial structure doesn't require resources; it is basically a reassignment, a re-clarification of asset ownership. Once you have that you can--if you have a good sound business plan and the demonstrated ability to carry it out--you can attract financial resources from banks or from other investors.

There is an enormous social cost of not restructuring. When a single firm goes bankrupt, it doesn't make much of difference for the economy, it can still be done with market processes. But when 20 or 30, 50, even 75 percent of firms are going bankrupt, there has to be negative macro-economic consequences. And as a result, there is a real importance for the government to guide and push that process of restructuring along—but this must be done properly. For Thailand, who followed the IMF advice of not getting involved in the financial restructuring, it appears that in four years just three major firms were restructured. By contrast, in Malaysia and Korea, the government came in and pushed the financial restructuring process and it went forward with remarkable speed. So the fundamental point is that there is an important role for government to push for financial restructuring—and leave the markets to provide the guidance for the real restructuring. The IMF got these two principles exactly

reversed.

Finally, despite IMF warnings, capital controls did work. Malaysia had the shortest and shallowest downturn and was left with the least legacy of debt. In September 1998, in the midst of the worst moments of the global financial crises, Malaysia ignored the IMF's objections and put on its program of capital-market controls. The attack by the establishment of the developed world was just enormous. People like US secretary of the treasury Rubin said "We wish you the worse of luck". But imposing the controls allowed Malaysia to have lower interest rates than other better-behaved countries. Lower interest rates led to fewer bankruptcies. Lower interest rates also encouraged investment, hence, its was able to recover faster from the downturn. It didn't have to rely as much on fiscal policy; didn't have to borrow as much to finance fiscal policy and didn't have to borrow as much to finance the restructuring. So as the recovery proceeded, it recovered faster and when it did recover, it had less debt and it was in a better position to go forward.

Now, what I tried to argue thus far is that the response strategies that were pushed in these countries were misguided. They didn't work, and because they didn't work, many people besides the investors bore enormous cost. The general point is that the existence of such discrepancies creates a *prima facie* case for intervention. It is intellectually incoherent to argue for last-resort bailouts and yet not try to address the underlying source of the problem—volatile flows of short-term capital. I would argue that the thrust of the interventions clearly should have been to stabilize capital flows.

Some people will criticize that and say it is impossible to find interventions that work perfectly--but that's not the point. Think about interventions in the following way. In metaphor, think about a dam, the water is eventually going to go away as the snow melts in the mountain; it is

going to go from the mountain down to the ocean. Without the dam, when the spring comes, the water melts very quickly causing a flood and great disruptions. If you put a dam up, the whole point of the dam is not to stop the water from going from the mountain down to the ocean—It will continue to flow no matter what you do. But by putting a dam up it stabilizes the flow, meaning the water can now be used for irrigation and other constructive purposes and even if the dam is not perfect, and some of the water gets around the dam, it still can make a very big and positive difference.

Before I end, I just want to describe, very briefly, what I think the lessons are for going forward, future policies. We now know for instance, that, thousands of regulations on banks actually contributed to destabilizing capital flows by encouraging short-term capital inflows relative to long-term. Those regulations have to be changed, that is just one example. Another example is that one of the factors that contributed to the problems is how large pension funds in the United States and elsewhere specify that bonds below a certain rating may not be held. So when the rating agencies downgrade bonds emanating from countries experiencing difficulty, huge funds had to sell their bonds overnight, and what happened? That forced the rating of the bonds down even more, exacerbating the problem. Then, of course, the bond-rating agencies could say “As I told you, these bonds were in trouble”. Reforms to the international architecture include reforms that go beyond the simple promotion of transparency and accountability. There needs to be congruence between the country’s exposure to risk, its ability to manage those risks, and the provision it has made to insulate the most vulnerable from the consequences of those risks.

I want to conclude by a discussion of one key issue. There has been some progress over the last few years in learning some of these lessons. I argued very strongly in 1997/1998 that there was an alternative to the big

bailouts, and that alternative was to focus more on dealing with bankruptcies and standstills. Finally, after the Argentina crisis, when 6 bailouts in a row collapsed dramatically, the IMF began to say we are going to find something better. And what they came up with better is what some students of economics had been saying for years and that was to put more emphasis on bankruptcy and standstills, including the design of capital controls and exit taxes.

In private borrowing, this includes something like what I call super chapter 11, a quick work-out recognizing that when there are macro-economic implications, speed is of the essence. In the context of public borrowing, issues are more complicated, of course; there is a need for collective action clauses among other things. There is one important thing that should be cleared up: a major creditor, such as the IMF cannot also be the bankruptcy judge. So the proposal by the IMF to put itself in the place of the bankruptcy judge should be purely as non-starter. In short, there are alternatives to the particular kinds of strategies that were used in East Asia.

Let me conclude by returning to where I began. Economic volatility, even crises, have been an integral, albeit unwanted, part of market capitalism from the very beginning. We have learned how to better manage the market economy since World War II in the United States. The frequency of economic downturns has been reduced, as too, have the size of the downturns. We have learnt something about better economic management. I hope that out of the financial crisis in East Asia, more lessons will be learnt—lessons along the lines that I have just depicted—allowing us to go forward in the future with still fewer and shallower crises than we have had in the past 3 decades.