

Crises: Past, Present and Future, Asian Perspectives

Takatoshi ITO

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Outline

- Crisis, history
- Crisis, types
- Analysis
- Policy Implications
- Lessons
- Future

History of Crises

- 1994 Mexico
- 1997 Asia (Thailand, Indonesia, Korea)
- 1998 Russia
- 1999 Brazil
- 2001 Argentina
- 2008 US, subprime
- 2010 Euro zone, fiscal

Types of crisis

- **Currency:** Impossible Trinity and Sudden stop
 - Mexico, **Asia**
- **Fiscal:** Too much government borrowing
 - Mexico, (not Asia), Russia, Argentina
 - Greece, Portugal, Italy, Spain, Ireland (after rescuing banks)
- **Banking:**
 - **Thailand (origin) and Asia (after devaluation),**
 - Argentina (after devaluation)
 - **US (origin)**
 - Ireland,
 - Spain, Italy
 - Greece (after sovereign default)

Analysis

- **Impossible trinity**
 - Fixed exchange rate, autonomous monetary policy, and free capital mobility
- **Double Mismatch**
 - Banks borrow in USD, short-term
 - Lend in local currency, long-term
- **Insolvency crisis vs. Contagion (liquidity crisis)**
 - Insolvency crisis. Fundamental inconsistency and unsustainability in policy (Mexico, Thailand)
 - Contagion and Liquidity crisis. Shortage of hard currency or domestic credit (Indonesia, Korea)

Stages of crisis development in Asia

- 1st stage: Success in economic reform and financial deregulation leads to capital inflows causing overheating (and asset price bubble), inflation (real exchange rate appreciation)
 - Fundamental macro policy management
- 2nd stage: Negative shock (uncertainties), housing prices down
 - Warning sign (bubble burst, failing small financial institutions)
- 3rd stage: Capital outflows, shrinking credit and nonperforming loans, small institutions failures
 - Financial fragility
- 4th stage: currency devaluation/depreciation; free fall (Mexico, Dec 1994; Thailand, July 1997)
 - Currency crisis and free fall
- 5th stage: banking crisis from mismatched B/S
 - Full-fledge economic crisis
- 6th stage: Contagion
 - Other countries in the region was affected; and fire wall?

Asian reaction

- Economic crisis/downturn was harsher than fundamental problems the country had
 - Who to blame
 - Hedge funds/Investment banks
 - IMF misguided prescription
 - Fiscal tightening was viewed not necessary (NOT the origin of crisis)
 - Too small the liquidity assistance resulting the exchange rate free fall
 - Credit rating agencies
 - No early warning
 - Thailand (origin of crisis)
 - Bubble and burst → depreciation was necessary but support after devaluation was not adequate
 - Indonesia (contagion, liquidity crisis)
 - Ill-prepared closure of banks in Indonesia caused bank run
 - Too long a structural conditionality led to the loss of credibility

Assessment of IMF policies in Thailand

- Liquidity provision (17.2 bil.) should have been bigger. (It was even less than BOT forward contracts, \$23.4 bil.)
- Fiscal tightening advice was misguided
- Banking problem should have been dealt with by separating insolvencies and liquidity problem
- Corporate restructuring could have been faster
- Manage the exchange rate might have been better

Assessment of IMF policies in Indonesia (Nov 1997 & Jan 1998)

- Liquidity provision (17.2 bil.) should have been bigger. (Second line of defense was window dressing)
- Fiscal tightening advice was misguided
- Monetary tightening advice may be misguided
- Closure of 16 banks as prior action was ill-prepared, which led to a bank run and financial fragility
- Long list of structural reform was counter-productive
- The turmoil became political problem (President Suharto vs. Washington)
- Banks became totally insolvent when the value of the exchange rate became 1/6 of the peak. What do you do when all banks were insolvent?

Assessment of IMF policies in **Korea**

- Closest to the case of liquidity crisis
- Liquidity provision should have been bigger.
(Second line of defense was window dressing)
- Sudden capital outflow
- IMF had lost credibility and the Dec 4 package was disappointment for the market
- Dec 24 “standstill” (form of PSI) worked—
shows it was a liquidity crisis

For future: Prevention

- Against the fundamental problem
 - Correct sequencing of financial liberalization
 - Maintain flexibility of the exchange rate
 - Reduce double mismatch
 - Asian Bond market Initiative
- Against speculative attacks
 - Foreign reserves/short-term debt ratio > 1
- Against spillovers
 - Piling up foreign reserves (in normal times)
 - Building a swap network, Chiang Mai Initiative

Crisis Management (treatment)

- Liquidity assistance
 - Needed to prevent a free fall based on self-fulfilling expectation
- Fiscal tightening
 - Needed (only) if the source of the crisis is fiscal, not in Asia
- Monetary tightening
 - Controversial
- Strengthening banks
 - Avoid double-mismatch during normal times
 - Liquidate and sell distressed assets in early stages
 - Save them with capital injection if near insolvent
- Economic reform in the middle of crisis?
 - Yes, if that is the window of opportunity & politically feasible
 - No, if it is not the source of the problem; & politically infeasible

Lessons

- Crisis Prevention
 - Keep macro fundamentals robust
 - Limit fiscal deficits and sovereign debt
 - Keep inflation rate low
 - Bank supervision, banks maintain adequate capital
 - Macro prudential measures
 - Monitor Loan-to-value ratio and housing price movement
 - Counter-cyclical capital ratio
 - Keep adequate foreign reserves
 - High buffer is needed
- Crisis Management
 - Take bold actions early (confidence game against investors)
 - Use foreign reserves, if necessary (prevent free fall while keeping flexible)
 - (Do not?) Call IMF or regional central bank swap lines

Asia vs. Subprime: crisis management

- Asia
 - Thailand, bubble (1994 – 1996)
 - Thailand, Forbearance (1997)
 - Finance company problem to all banking system
 - Recognize Problems
 - Closure of most of finance companies after due diligence and Royal Decree
 - “Big Sale”—bad asset auction
 - Act, too little too late
 - Distressed asset purchase
 - Corporate Restructuring Corp
 - Big crisis, big action
 - Fiscal expansion
 - Monetary easing → Inflation targeting (2000)
- US
 - Bubble (2004-2007)
 - Forbearance (2007-2008)
 - Liquidity facility
 - Recognize, try to act, but no public support
 - Bear Stearns rescue
 - Refusal of first TARP in Senate
 - TARP difficulty
 - Act, too little too late
 - Big crisis, big action
 - Change TARP to capital injection
 - Make investment bank to commercial bank (holding company)

Potential Risk in Future

- China with lots of “if”s
 - If the exchange rate remains semi-pegged to USD
 - If capital controls are lifted in the name of RMB internationalization allowing foreign capital to invest into Chinese financial and housing markets
 - If bank credit continues to go into real estate sectors, including individuals, developers, and local government “platforms”
 - Then overheating of the economy, in particular real estate sectors, may resume, and then goes burst upon some negative shock (political? External?).
 - Similar to Asian crisis: Impossible Trinity, double mismatch, and hiding losses (in local government “platform”)

References

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