

TEN LESSONS LEARNED FROM THE ASIAN FINANCIAL CRISIS

*Jeffrey Frankel**

Frankel questioned the received wisdom from the crisis: Have we learned anything new or are these the same lessons that we learned during previous crises? The recent data on Korea are encouraging, especially in comparison with Mexico, indicating that a turnaround may have actually begun in Korea. Nevertheless, there are ten lessons which can be learned from the Asian economic crisis:

1. Lawson's Rule that it is okay to run a current account deficit without a budget deficit has proven to be a fallacy;
2. Foreign exchange reserves are important;
3. Information and transparency are key;
4. The composition of capital inflows does matter;
5. Exchange rate regimes are extremely difficult to maintain;
6. Financial markets are not perfectly efficient;
7. Moral hazard is the central market failure;
8. IMF programs should consist of both macroeconomic and structural reforms;
9. Inevitably, countries will have to raise interest rates and lower exchange rates; and
10. Keynesianism is alive and well in Asia.

The fallacy of Lawson's Rule is not a new discovery. We have seen this phenomenon before in Chile and the United Kingdom. On the issue of foreign exchange reserves, we have relearned the lesson that countries with high reserves, like Taiwan, are better able to weather crises. The issue of transparency is not new either. More information must be made available, and it should be utilized properly. Perhaps the two biggest new lessons from the crisis are that the composition of capital flows matters, and that exchange rate regimes

** Dr. Frankel is a Senior Fellow at the Brookings Institution in Washington, D.C. and soon to be Professor of Economics at Harvard University's Kennedy School of Government. This informal summary is drawn from his remarks at the May 1999 session of the Korea economic working group sponsored by the Korea Economic Institute of America at the World Bank*

are difficult to maintain. However, we should not generalize these lessons for all countries all the time. There may be moments when a country should maintain foreign exchange controls.

Financial Market Vulnerabilities

Many government officials had forgotten the lesson that financial markets are not always perfectly efficient. Hedge funds should not be blamed for this; rather, bandwagoning presents a major challenge to emerging financial markets. Financial contagion is not new, but the Asian crisis was the first time that unrelated countries in different regions were hit by such a crisis. This implies the need for a greater role for governments in the domestic financial system, but governments are not perfect either. Capital controls must be used sparingly, as in the case of Chile.

Moral Hazard and IMF Conditionality

The lesson learned about the central role of moral hazard in the crisis is both important and useful. U.S. congressmen now seem to have a grasp of the issue. To say that the IMF programs cause moral hazard is wrong; domestic practices are crucial. The next lesson is equally important: There must be conditionality when the IMF makes loans. Macroeconomic policies had been fairly good in the crisis countries; the financial and corporate sectors were the problems. Latin America's experience demonstrates that reform may be easier during a crisis, and the downside risk of social unrest may not be as great as feared. International financial institutions must also evolve, but there are three important reasons why conditions should be attached to loans. First, loan conditions must address the root causes of the crisis. Second, conditions imposed by international financial institutions (IFIs) provide great political cover for the required bitter reform medicine. Finally, IFI conditions reassure investors that positive changes are in fact being made.

The Role of Government

Governments may have to devalue the local currency, raise interest rates, and experience a recession in order to stabilize the economy. High interest rates alone do not sufficiently reassure investors. The effect of a devaluation is much greater in the first year than originally predicted. It is also important to realize that Keynesianism is alive and well. The initial budget cuts in Korea and Thailand proved to be too severe. The governments can now play a key role in reflatting the economy.

Working Group Discussion

The Appropriate Level of Foreign Reserves: The more you have, the less likely you are to experience a crisis, but this comes at a price. The optimum level of reserves is an important area for research. When asked if high foreign exchange reserves are tied to maintaining an undervalued exchange rate, Frankel responded that he was not aware of any currencies being significantly undervalued.

External Risks and the Role of Governments: The biggest threat is an increase in interest rates by the U.S. Federal Reserve. Restructuring takes time, but governments do have a role to play, especially on the financial side. On the extent to which IFI conditionalities lead to even greater market intervention by governments, Frankel conceded that this is tricky and depends on the specific case. Antitrust activity, for example, is extremely important.

Should Banks Be Forced to Grant Forbearance? The private sector should participate more in bailouts, but there are limits. The transition from a managed to a floating exchange rate is not easy, but converting helps to eliminate currency speculation. He was optimistic about Korea's economic recovery, noting that: "If structural reforms are maintained, Korea should return to solid growth."