Lessons From The East Asian Crisis For Turkish Policy Makers

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Ladies and Gentlemen,

I would like to speak today about "Lessons from the East Asian Crisis for Turkish Policymakers." The financial crisis in the East Asian countries has had strong effects on the economies of the world, on industrial and emerging market countries alike. Some of these effects have made themselves felt very quickly, while others will not run their course before two or three years longer. I may say that these effects are strong but not dangerous. One area of particular concern is capital flows to emerging market economies, which may increase spreads and bring about a capital market retrenchment.

According to a study conducted by the Institute of International Finance, net private capital flows to major emerging market economies have slowed only slightly below their 1997 level of $223 billion, but are well below their 1996 level of $304 billion. But the share coming from commercial banks and direct equity investments from private creditors will decrease more than was expected, which means that capital flows will be smaller.

I do not wish to review the origins of the East Asian Crisis in detail, but it shows us that it is the structural weakness of domestic financial systems and the growing foreign perception of that weakness that triggers a crisis in an economy. Like the Mexican peso crisis, the East Asian crisis was a classic "self-fulfilling prophecy" panic initiated by Jeffrey Sachs.

It is widely recognized that both the Mexican crisis and the crisis in the East Asian countries stemmed from incorrect macroeconomic policies and structural imbalances. Exchange rate policies in particular, combined with irresponsible fiscal policies, put enormous strain on the balance of payments. Weak domestic financial systems and rapid expansion of domestic credit, combined with pegged exchange rate regimes, deepen the economies' dependence on short-term external borrowing.

But it is a distinctive feature of the East Asian crisis that it is based more on the private sector than were the public sector crises seen during the 1970s and 1980s. The solutions found for the public-sector based crises of those years were simpler. Programs supported by the IMF, and much less government borrowing from international institutions, were the main elements in the solution of those crises. The private-sector-based crises of today are more complicated and harder to understand.

Let me follow up this brief summary by focusing my remarks this morning on four main areas where lessons from the recent East Asian crisis may be found.

First, it was the countries' ongoing exchange rate policies that contributed to the build up of crisis conditions. The countries of the East Asian region chose to pursue a fixed exchange rate policy, or one pegged to the US dollar, for about a decade after the Plaza Accord. In the beginning these policies contributed to stronger growth and low inflation in these countries. But starting in 1995, the appreciation of their currencies had begun to threaten their balance-of-payments positions.

Second, to offset the weakness of their economies, the authorities relied heavily on much short-term financing, which concealed the weaknesses of their macroeconomic policies. The nature and direction of the flow of short-term international capital had not been properly analyzed. The ratios of short-term debt to useable foreign exchange reserves were in the range of 170-200 percent for Indonesia, Korea and the Philippines, much higher than the average ratio of 70 percent for the other major emerging market economies.

Third, transparency of banking systems, including central banks, is essential for analyzing ongoing developments in countries' financial sectors. In particular, trends in their off-balance-sheet items, cross-border interbank funding and their transactions with offshore centers should first of all be transparent, and second should be available for making judgments about the system. The absence of a sufficiently thorough system of banking supervision and the lack of transparency not only became problematic before the crisis, but also caused confidence problems later on.

Fourth, the quality of the assets of the banking system is vital for the soundness of macroeconomic policy. In allocating savings to investment use, the banks should be extremely careful about the risks that must be taken for a variety of reasons. There are five main types of risk that the banking system and of course the appropriate authorities have to deal with: interest risk, foreign exchange risk, maturity risk, loan risk, and market risk. A sound financial system is the best assurance of efficient monetary and fiscal policies.

In my view, all four of these factors contributed to the change of foreign perceptions and sentiment and produced a cutback in normal financing (in fact, 95 percent of external flows to emerging market countries come from the private marketplace). This cutback, in turn, weakened the external reserve positions of these countries. Then the combination of weak reserves and a weak financial sector brought on a liquidity crisis.

We are now in a position to draw some lessons from the East Asian crisis. First, policy implementation must pursue sound macroeconomic policies in order not to lose the confidence of the markets. And second, four main principles must constantly be kept in mind:

The currency should not be allowed to appreciate, except as part of a bold anti-inflation program.

Any short-term international capital flows that occur must be carefully examined to determine their direction and nature. In addition, the ratio of useable external reserves to short-term debt must be kept at reasonable and internationally accepted levels.

Weak banking systems have been the most important contributors to past crises. A sound and transparent banking system is an absolute requirement for avoiding future crises.

Risk-taking strategies should be appropriate to a market system. Off-balance-sheet items and cross-border lending should be under tight discipline. An independent supervisory authority is the best guarantee of efficient, sound, and effective banking supervision.

Last but not least, the pursuit of sound macroeconomic policies in a low-inflation environment is an essential precondition for building public and market confidence. Confidence also requires that both public and private sector institutions be guided by strong, high quality governance and accepted ethical rules.

The last point that I want to make is that I disagree with those economists who speak of the difficulty of anticipating the East Asian crisis, since these countries had assembled all the ingredients of a perfect crisis recipe;

An appreciated exchange rate;

A high and worsening ratio of short-term debt to useable foreign reserves;

Untransparent off-balance-sheet items in the banking sector;

A widening current account deficit;

Steep growth of domestic credits;

And a continuous decline, during recent years, in emerging markets’ borrowing spreads without matching improvement in their economic fundamentals.

If someone should combine all these elements, it is conceivable that they might succeed in creating a crisis.

But the world’s financial centers turned away from the existence of this perfect crisis recipe and turned toward the Turkish economy, for which, ignoring the developments in East Asia, they predicted a crisis during the last couple of years.

The Turkish economy does not satisfy the perfect crisis recipe described above. Of course we have high inflation, a high nominal budget deficit, and high short-term domestic debt, but on the other hand Turkey's exchange rate policy, current account situation, the nature of its short-term external debt, and other fundamentals do not indicate an alarming situation.

The East Asian crisis should have greatly improved the ability of economists to predict an episode. I would be glad to see some evidence of this improvement.