Speech

ASIAN CRISIS: ASKING THE RIGHT QUESTIONS*

Y. V. Reddy

I am grateful to the organisers for giving me this opportunity to be with you and, derive the benefit of interaction, with a set of distinguished and knowledgeable people. The Asian crisis has been a matter of wide debate, and I doubt whether much new light can be shed on it. At the same time, I wonder whether many of us have been able to fully comprehend the causes, cure or consequences of the crisis. Perhaps one useful way of crystallising our thoughts would be to ask, what I may call the right questions. I would attempt to raise a series of questions and, indicate tentative answers or view points that have been given.

The first set of questions relates to the features of the crisis, responses to the crisis and outlook for Asia. The second set of questions concern the potential for recurrence of such crises, and appropriate international mechanisms to minimise the adverse fall-outs from such crises. The third set of questions would relate to India – impact so far, outlook for us, and implications for policy. Finally, there are a few broader and fundamental questions that emerge from the recent experience which need to engage the attention of both scholars and policy makers.

You would agree that we should approach this subject with a sense of humility and pragmatism. We should be humble enough to recognise the difficulties in understanding this complex phenomenon. We should be pragmatic enough not to seek or build theories to fit this complex reality. I will, therefore, present different points of view while attempting to answer the questions.

Finally, we should also recognise that the canvas is large. So, some aspects which appear to be critical are mentioned here. Recourse to generalisations is also inevitable under the circumstances. Given the time constraints, and by now fairly well-known facts, I have avoided use of statistics. Instead, the focus is on questions that address problems and prospects.

Features

What are the unique features of this crisis?

At the outset, we need to be clear about what we mean by Asia in the context of this crisis. The focus is on the seriously affected countries, viz., Malaysia, Thailand, Korea, Philippines and Indonesia with stray

*** Address delivered by Dr. Y. V. Reddy, Deputy Governor, Reserve Bank of India at India International Centre, New Delhi on May 1, 1998.**

references to the experience of Hong Kong and Singapore. While there are many common features, there are also differences among the affected Asian countries, and their experiences. For example, Thailand, Indonesia and Korea suffered serious loss of confidence and their currencies were depreciated. But, while Thailand had large current account deficit, Korea's current account deficit was narrowing up to 1995 and Indonesia's was manageable. Capital account regimes were also varied, with Korea having controls on equity inflow and a very large share of borrowings in capital flows. Leverage of debt to equity was very high in Korea. The rate of inflation also varied among countries between about 4 and 9 per cent just before the onset of the crisis. It is, therefore, necessary to recognise that in discussing the Asian crisis, we are making broad generalisations.

The extent of currency depreciation in the affected countries has been very large in a very short period of time. However, it can be argued that steep currency depreciation has occurred in other cases also in the past, viz., Czech Republic, Mexico and the recent experience of countries in transition including Russia. It is, perhaps, the pervasive nature of the crisis that stands out prominently, i.e., it is a combination of crises of currencies, corporate stocks and banking, and not merely the suddenness or extent of exchange rate adjustment.

It was unexpected by almost all concerned, i.e., Governments, multilateral institutions, rating agencies and market participants. No doubt, some multilateral agencies (for example UNCTAD in its Trade Development Report of 1996), had pointed out a few weaknesses in some of the Asian countries. Certain scholars had also warned that the Asian miracle was mostly infusion of higher capital and labour without significant productivity gains. Overall, none of the players seem to have expected that these 'weaknesses' would invite anything resembling a crisis of such proportions as had actually occurred, and in any case, none had anticipated that such a crisis would affect so many countries. However, it can be argued that by its very nature, a crisis comes about only when it is unexpected. The surprise element may be attributable to the fact that the early warning indicators that we normally look for, were not relevant in the Asian context. The usual suspects, viz., low growth, low savings, financial repression, fiscal deficit, inflation, and public sector inefficiency as measured by dissavings did not exist in the affected countries. Since the usual suspects were conspicuous by their absence, vigorous search for new suspects is in order.

What distinguishes this crisis, perhaps, is the contagion effect. The contagion effect is evident from the fact that it quickly spread to the neighbouring countries, though with different degrees of impact. There can be different explanations for such a contagion occurring, but the fact remains that there was a contagion, which affected not only other developing countries, but had global ramifications too. In any case, perhaps for the first time in history, the financial crisis in the South had a profound impact, though short-lived on the capital markets in the North, and is continuing to have an impact on their economies.

Causes

As usual, a variety of factors have been identified (*post facto*) as responsible for the crisis. Broadly speaking, the questions would be: (a) Do they reflect sentiments or fundamentals? (b) Do they relate predominantly to domestic or external factors? and (c) If they are domestic, are they macro, i.e., policy-related or micro, i.e., institutional related?

Sentiments Vs. Fundamentals:

The 'sentiments' or 'panic' or 'herd' instinct approach holds that all the affected Asian economies exhibited what is generally accepted as strong fundamentals and, in any case there was no provocation for anybody to anticipate a default. Yet, there was sheer panic that originated with Thailand. Since, the world view or at least the market participants' view was that 'East Asia is one', there was cessation of capital inflow and withdrawal of capital from these countries, which, in combination proved to be a massive turn around. In the absence of a credible lender of last resort or provider of confidence, the sentiments turned what was apparently a normal situation into panic proportions. They also argue that political uncertainties played a role. Apparently there were elections or other events involving a possible change in political leadership in most of the affected countries at about the same time. A somewhat rational explanation for sentiments turning adverse is that deceleration or disruption in exports or adverse terms of trade gave rise to doubts among lenders about the borrowers' capacity to service debt. The rush by domestic borrowers to cover their exposures added to the adverse sentiments.

The "fundamentals are at fault" approach accepts, by and large, that the Asian economies ran fairly prudent fiscal policies and had high savings and low inflation rates. But, they point out to one or several weaknesses, viz., inappropriate exchange rate policies, large current account deficits which had the potential of becoming unsustainable, weaknesses in the Asian banking system, non-transparency or poor governance or crony capitalism, highly leveraged corporate balance sheets, large credit growth, and/or inefficient investments, excessive dependence on short-term external debt, etc. They also put forward the argument of excessive investments by the lenders without adequate attention to credit risks. Briefly stated, the crisis is considered to be a case of sudden correction of excess capital flows enabled by irresponsible lending to sustain irresponsible borrowing. Often the flows were shorter in tenor and ended in financing not-so-productive investments. An enabling macro-economic policy coupled with weak regulatory framework facilitated this phenomenon. It is also argued that contagion can be explained by strong intra-regional trade and economic linkages, and not merely by the world view of East Asia as one.

Could we then say that the trigger was sentiment but vulnerability was relatable to fundamentals; fundamentals not in the traditional macro-economic sense only but in broader sense to encompass relevant institutional fundamentals? In other words, our view of fundamentals may need to be enlarged to include the state of financial system. Similarly, we may have to recognise that investors tend to be not only short-term in their view but also pro-cyclical, and not dismiss it as herd instinct.

Domestic Vs. External Factors:

Those who emphasise that 'domestic' factors as responsible for the crisis refer to five major areas.

First, and perhaps foremost, relates to the state of the financial sector. The arguments run as follows: banks were not subject to effective prudential regulation and supervision or currency and maturity matching conditions for assets and liabilities. There was large domestic credit expansion resulting in unproductive investments financed by external funds, often of short-term nature. The imprudent intermediation by banks which have a special role to play in financial intermediation in developing economies, is the most critical cause. The banks had large off-balance sheet liabilities which moved on to balance sheet once there was adversity. Further, there was large inter-bank funding, especially in foreign currency and of course, short-term. Large scale asset financing by the financial sector leading to asset-boom, followed by a bust was a logical outcome. Non-banking financial companies also contributed to the crisis and these were subject to little or no regulation.

Second, the corporates were highly leveraged. Since debt, especially external, was available at relatively low interest rates with a perceived exchange rate guarantee, corporates held large unhedged positions. Further, there were in many cases large non-bank private borrowings from abroad. There was, thus, an inherent vulnerability of the corporate sector. In addition, the standards of accounting practices, financial reporting and disclosure norms in these countries were somewhat inadequate. The institutional development in affected economies (unlike in Hong Kong or Singapore) lagged much behind the real sector. The Asian values, implying help to friends, were stretched to misuse of public resources. In other words, contact overtook contract in economic transactions thus undermining efficiency.

Third, the management of external sector was characterised by a regime of exchange rates which was pegged and became, over time, overvalued. While some feel that it is only a symptom or one element, the exchange rate management is considered to be the most important reason by others. This regime encouraged large capital inflows, which resulted in excess liquidity and consequently, large credit expansion extending to non-tradables. Productive use of capital flows was not being ensured. The composition of the capital flows, which was initially dominated by Foreign Direct Investment moved towards a greater dependence on portfolio flows and finally large borrowings, especially short-term, thus, enhancing volatility of flows and vulnerability to attacks. External debt was high, short-term, leveraged and also concentrated in the private sector. Foreign currency reserves were thus built, in a way, with large-scale short-term borrowings, and the level of reserves was of no real significance when there was a crisis of confidence.

Fourth, while macro-economic management was highly conducive to rapid growth with price stability, it involved large current account deficits financed by huge capital flows. A system whose momentum depended on large capital inflows was inherently vulnerable to deceleration or reversal of flows. The authorities, it is held, did not dampen overheating pressure, and there was a denial or delay in initiating proper adjustment. Macro-management concealed weaknesses in terms of extra-budget fiscal transactions and quasi-fiscal activities of the central bank.

Fifth, apart from lack of transparency in operations of corporates or Government-controlled regulatory bodies, even matters relating to forward liabilities of foreign currency reserves of central banks were not made transparent. In fact, the dismantling of capital controls resulted in lack of information and hence, monitoring as well as data dissemination by regulators was poor, thereby adversely affecting transparency.

The role of external factors has been emphasised by others and their arguments run on the following lines:

Firstly, the international lenders have overreacted in lending to Asian countries without due regard to the prevailing state of these economies, i.e., fundamentals or structural conditions. The excessive or 'irresponsible' lending was not curtailed by the regulators in major financial centres. The lenders underestimated the credit risks involved and attached very low risk premium. The lenders were equally irresponsible and followed herd instinct when they were calling back loans, just as they followed while lending.

Secondly, the appreciation of the US dollar from mid-1995 led to the appreciation of the currencies in the region, as they were pegged to the dollar in as much as the countries believed in stable pattern of exchange rates. Their choice of exchange rate regimes might have been on considerations of cost/ effectiveness of sterilisation, lack of scope for further fiscal consolidation, limit on monetary tightening, etc.

Thirdly, a glut has emerged for a number of products manufactured in the region, such as electronics.

Fourthly, the devaluation of Yuan (currency of People's Republic of China) in 1994 and sluggishness in Japan's economic growth about the same time depressed the demand for products in Asia. The somewhat weak growth in Western Europe added to the difficulties. The effect was felt on export demand and export earnings.

Fifthly, there was a tendency for flows into and out of Asia largely influenced by the opportunities for investments in Europe and the USA. In fact, the macro-policies of leading industrialised nations, especially their exchange rate and interest rate policies played a dominant role in determining capital flows.

Sixthly, the arguments about domestic factors, weak financial system, non-transparency and inadequate regulatory framework are not tenable because these were well-known. Even macro, or bank, or corporate level information was broadly, if not in precise terms, known to all market participants - especially foreign investors and lenders who conduct their own research.

Perhaps, it is appropriate to accept that both domestic and external factors were to be blamed though it is difficult to assign precise weights to each of these factors.

Macro Vs. Micro

There is some difference of opinion on the relative significance of macroeconomic variables and micro conditions in the evolution of the crisis.

The macro policy that led to the crisis is briefly described as follows : The South Asian countries witnessed sharp increases in investment rates during the nineties, mainly as a result of strong macroeconomic fundamentals. These continued to be strong, but the policy mix of 1994-96 added to the incentives for banks and corporates to borrow abroad on an unhedged basis. There was an acceleration in growth of domestic demand and demand pressures (in Indonesia, Malaysia, Thailand and Korea during this period, though Philippines was slightly different). While acceleration in domestic demand reflected pick-up in growth of investment and consumption, the contribution of the external sector to growth in GDP turned negative during the period. In dealing with the demand pressures, relatively greater reliance was placed on monetary policy. The differential between the domestic interest rates and international interest rates increased. The rising domestic rates adjusted for actual exchange rate movements were sustained through sterilisation efforts during 1994-96, thus encouraging further inflows of capital. Since short-term capital flows tend to respond quickly to interest rate differentials, the composition of external liabilities got concentrated at the short end. This imparted vulnerability to the external sector.

There are some who dwell at length on microeconomic factors that led to incentives to borrow abroad. Apart from an environment where exchange rate has been relatively stable, the implicit or explicit insurance on liabilities provided (or even perceived to be provided) by the Government to the corporate or financial sector meant that credit risk was underpriced. If to this is added a perception that foreign creditors will be treated more favourably, there is an attraction to borrow large amounts in foreign currencies. Further, the domestic funding costs were high for borrowers, and to this extent there was pressure, especially from large corporates to enable borrowing in foreign currencies. Many financial institutions which had some guarantee appear to have onlent foreign currency funds to preferred sectors/ borrowers as a micro level mechanism to favour a few. Finally, offshore financial markets created with the aim of developing regional financial centres ended up funding domestic firms rather than firms in foreign countries, passing on advantages of tax/ regulatory regime. To these microeconomic factors should be added what have been termed as the weak regulatory regimes – especially of the banking sector, weaknesses in corporate governance and lack of transparency. The net results of the micro-factors were lending boom, financing of riskier projects, and acquiring assets whose prices are subject to bubbles, viz., real estate and stocks.

There appears to be little doubt that the crisis was caused by failure of private sector (and not really public sector). The failure was related more to financial system than fiscal or monetary policy. Further, it was a failure of global financial markets to ensure an optimal allocation of global capital. Finally, it was also a failure of regulatory systems in developing countries, major financial centres and global institutions.

Response

The response to the crisis could be looked at from the point of view of the countries concerned and at regional/multilateral level, especially by IMF.

As regards the response of the concerned countries, for the purpose of convenience, these can be divided into three sets of measures, viz., exchange market intervention, monetary measures and financial restructuring.

Most countries initially attempted exchange market interventions, widening of the band where it existed, and finally gave up defending the currencies. Currencies were allowed to float, and in the meantime, there was erosion of foreign currency reserves. As regards monetary measures, the general response, though in varying degrees, was to hike short-term interest rates. Simultaneously, restructuring of weak financial institutions was taken up, involving liquidation, suspension of operations, and compensation to depositors. There was also rescheduling of short-term debt, and conversion of private debt into sovereign debt.

The questions that arise are : was the response of countries appropriate, adequate and timely ? By and large, the response was on predictable lines. The effectiveness should be judged from the fact that markets simply collapsed as a result of total erosion of confidence, and hence all policy measures that assume price-elastic, incentive-led market-responses could be blunted. What was needed was restoration of confidence and markets, for which real action had to be in global arena.

International financial support was tied to the IMF-programmes in global response to the crisis management. Of the four major affected economies, Malaysia preferred to institute corrective measures without any IMF support/presence.

The IMF - led programme was intended to restore confidence and support a resumption of growth. Separate programmes were, as usual, drawn up in respect of each of the three countries, viz., Indonesia, Thailand and Korea. Broadly, the measures related to monetary policy, financial sector reform, governance and fiscal policies. Firm monetary policy is prescribed to resist excessive currency depreciation; and interest rates are sought to be brought down to normal levels after policy weaknesses are addressed and confidence is restored. An agenda for financial sector reform including restructuring, liquidation, public sector rescue operation, prudential regulation, etc. is agreed for immediate implementation. Improvements in governance, especially corporate governance, are also set out and strong political commitment to transparency and accountability insisted upon. Fiscal policies are designed to reduce reliance on external saving and provide for costs of restructuring/ recapitalising banking systems. The importance of strengthening social safety nets and striking a balance between macro economic stability and undue compression of domestic demand is recognised.

The support from the IMF is supplemented by resources from multilateral agencies and bilateral creditors. The World Bank, in addition to supporting the programme, is assisting the countries in the design of safety nets to complement structural reforms. Regional co-operation was initially mooted but soon given up.

There is an influential view that the rating agencies, having misjudged the pre-crisis situation in Asia; post-crisis, have over reacted to downgrade the rating drastically for the Asian and even all developing countries. It is, thus, held that the rating agencies have also been procyclical in their assessments.

A number of issues have been raised in regard to the timeliness, adequacy and appropriateness of international response. The more important of them are: (a) International response was delayed – except perhaps in the case of Korea. In any case, actual drawal of support is also delayed again except in the case of Korea compared to needs as also precedents. (b) The prescription provided was standard, not tailored to the requirements of individual countries and above all inappropriate since it was restrictive rather than confidence-boosting and expansionary. In particular, it is argued that measures are constraining demand instead of boosting confidence and injecting liquidity. (c) The magnitudes of assistance were small compared to the needs. (d) The package did not provide for social safety nets for the vulnerable sections. (e) The prescriptions are based on influencing market-behaviour at a time when the markets had collapsed. (f) Fiscal adjustment and high interest rates made the situation worse, especially for local banks which are life-blood for the revival of economy. (g) The response put the whole burden of adjustment on the borrowers or host country and let off the creditors and investors relatively free.

It is essential to recognise that the IMF which, in a way led the international response, had to face inherent handicaps at this stage such as the inadequacy of mandate as well as resources, initial reluctance on the part of affected countries to implement corrective measures and non-availability of institutional architecture to advance a better package. There is also evidence to show that Western Europe and the USA had underestimated the gravity and were slow to respond and support the IMF. There were also reservations about providing a workout with attendant moral hazard problems. Finally, unlike its predecessors, this was essentially a market failure and hence, the governments were reluctant to pay for such failures, either directly or indirectly through multilateral bodies. Overall, therefore, the dimensions of the crisis as well as approaches to meet the crisis were difficult to comprehend by all concerned.

At the same time, it may be inappropriate to conclude that no losses were borne by the private investors as a result of the international response. The Institute of International Finance estimates that investors in stock markets have lost US $ 80 to 100 billion, though some amounts may have since been recouped; foreign banks made provision of US $ 9 to 10 billion and foreign bonds holders lost US $ 10 to 15 billion. This extraordinary and unprecedented situation led to international initiatives on designing appropriate architecture – to which I will turn at a later stage.

Outlook for Asia

The outlook for Asia should not be viewed entirely in terms of the current crisis or turmoil, but in a slightly longer perspective. The questions that ought to be asked are : a) How did the Asian economies perform before the crisis ? b) Now that they are going through the crisis, what is the immediate outlook ? What would be the medium-term prospects ?

Performance

The crisis in Asia occurred after three decades of unprecedented strong growth which raised per capita income levels several fold, and close to those in industrial countries. The region accounted for a fifth of world exports. In 1996, nearly half of global private capital flows to developing countries went to Asia. This growth performance was set in an environment of macro economic stability characterised by fiscal prudence and modest inflation.

Underlying the record of sustained high growth in Asia were remarkably high investment rates. Throughout the 'eighties, the evidence suggests that the high investment rates were financed mainly through domestic saving which kept pace with the rise in investment rates except in Indonesia and Thailand. As fiscal imbalances were modest or in surplus, the high saving rate was essentially in the form of private saving. Thus, the investment boom in Asia was not on account of any decline in private saving. On the other hand, the shortfall in private saving was due to unusually high and accelerating investment rates which ultimately brought the growing macro economic imbalance to the sudden downturn. Although the ratios suggest that investment efficiency as measured by ICOR was somewhat on the high side (attributable to heavy investment in infrastructure) in the Asian region in relation to 1977-86, the ratios had further risen in the 1993-96 period relative to the 1987-92 period suggesting that the efficiency of investment had been declining prior to the crisis. The widening gap between investment and saving was reflected in large and persistent current account deficits in the Asian countries during the 'nineties. By contrast, in the 'eighties current account deficits were modest. An assessment of the sustainability of current account deficit typically takes into account the composition of financing. The Asian countries reveal a wide diversity in financing patterns. Yet, a common feature of all these economies was that net capital inflows excluding foreign direct investments were large relative to the current account deficit resulting in large accumulation of foreign exchange reserves between 1990 and 1996.

The most important positive feature of the ASEAN model of development is the emphasis on human capital formation. Stabilisation and structural reform programmes were accompanied by large investments in social security, health and education. Most of the Asian economies, in particular Indonesia, experienced declines in poverty levels and in unemployment. Similar commitment is found in South Korea where the Government expanded and upgraded social services leading to a substantial improvement in literacy rates, life expectancy and mortality.

Immediate Outlook

As a result of the crisis, there has been a serious disruption in most of the economies, affecting output and employment. In this respect, it should be treated as global crisis and not merely Asian crisis. Overall, no growth is expected this year in the combined output of the five countries that were most affected – Indonesia, Korea, Malaysia, Philippines and Thailand. The aggregate current account is now expected to be in surplus by US $ 14 billion compared with deficits of US $ 26 billion in 1997 and US $ 55 billion in 1996. This estimate could be somewhat on the optimistic side. Much of the initial adjustment appears to be through import compression rather than export growth. While inflationary pressures are noticed in view of the large element of intra-regional trade especially in basic goods, the price increase appears less than anticipated. The global impact of the crisis is still adverse to growth prospects in output – especially among emerging and perhaps in transition economies. These countries are affected by increased interest spreads on foreign borrowing, lower stock market prices and policy tightening to reduce vulnerability.

The growth prospects for Asia would depend on many factors, especially: (a) the restoration of confidence and resumption of capital flows; (b) the correction in exchange rates which have in most cases been overcorrected; (c) the growth prospects of Japan; (d) the exchange rate of Yuan and (e) the sustained growth without protectionist trends in Western Europe and North America – particularly, USA.

On balance, the prospects appear to be stagnated in 1998, moderate rebound in growth in 1999 and solid recovery by 2000.

Medium-Term Prospects

In brief, while the crisis has brought out some weakness in Asian economies, and disruptions in what could have been a continuing miracle, the overall prospects for the longer term, under normal circumstances, should not be overlooked. To recall:

(i) the high growth has only been temporarily disrupted and is likely to be resumed;

(ii) the gains in terms of human development, literacy, health, population control, etc. are lasting and self-perpetuating;

(iii) the organisational and skill capabilities that the population and the system has acquired to compete globally are permanent assets;

(iv) the quantity and quality of physical infrastructure, almost on par with industrialised countries, will be of continued significance;

(v) with the reorientation of policies and restructuring, after what may be termed as the worst being over, the economies are bound to emerge stronger and more resilient. There is already evidence of return of capital to Asia;

(vi) the Asian economies as well as the world at large might have avoided or minimised the costs of the crisis, even after the crisis commenced, if it had been possible to have an effective lender of last resort because, on most counts, the Asian crisis was a liquidity crisis and not a solvency crisis.

To conclude, was the Asian miracle a mirage? Most likely no; and there are many positive aspects of their management that should be noted. A temporary setback should not blind us to their achievements and inherent subsisting strengths.

Future Crises

In the light of this experience, both about crisis and response, is there a continuing, perhaps even a growing potential for such crises?

First, there is a trade-off between stability and efficiency. In the search for higher efficiency gains risks could be taken on the stability front and over a period the economy may be better off. There is no guarantee that in view of the recent experience, choice would, in future, favour stability at the cost of efficiency.

Second, the process of globalisation brings into existence new products, new situations and perhaps new risks. Recent experience has shown that strong fundamentals cannot explain or provide immunity from the crisis. It is clear that we cannot easily anticipate what factors in the short-term trigger a crisis. The market participants will continue to be risk-averse and subject to herd-behaviour. The exchange rate and interest rate regimes are critical in the market response, but choice of instruments available with national authorities to deal with markets is getting increasingly restricted. Moreover, the authorities find it difficult to judge the scale of intervention that would be affordable and effective.

Third, financial markets are, by their very nature, much more mobile than product-markets.

Fourth, technology has added enormous speed to the transactions. This means that along with information, rumours and panic are also spread, with great speed, high intensity and in large magnitudes. In fact, huge forex reserves did not help the Asian economies.

Fifth, there is no system of what could be called global governance of monetary and financial arrangements – except the IMF. Apart from limitations on the IMF to which I will refer later, there are 'gaps' since off-shore financial markets account for some transactions. The role of non-bank financial transactions is increasing and their activities are not subject to the type of regulation that banks are. Some of them can be as much a threat to the system as transactions through large banks are. In fact, debt workouts are easier to handle when banks are involved.

Finally, in the absence of a credible lender of last resort facility or provider of liquidity, there is a greater chance of crisis. At the same time, if arrangements are made to 'bailout' and meet a crisis, there could be moral hazard aggravating chances of future crises. In fact, there is an opinion that argues that the Mexican bailout was the main culprit in encouraging international investors and lenders to rush capital into Asia without regard to risks involved.

Logically, the next question relates to the adequacy of existing arrangements. This matter is being considered in a variety of fora and three broad areas have been identified for strengthening the international financial system.

(i) Enhancing transparency and disclosure of information by identifying relevant types of information, methods of generation of such information from both public and private sectors, nature of incentives to use of such information by market participants, and by advocating the transparency needed to boost the accountability of national authorities and multilateral institutions.

(ii) Strengthening financial systems in national economies and globally, encompassing supervisory/regulatory regimes, institutional infrastructure, corporate governance and, enabling orderly sequencing of capital account liberalisation.

(iii) Appropriate burden-sharing in case of occurrence of international financial crisis, to include assessing role and obligations of different debtors, encouraging pricing of risk and devising new mechanisms for orderly workouts.

Lender of Last Resort

While the approaches indicated above are being worked out, the future role of the IMF in this regard has become a matter of debate. There are some who feel that a new organisation is needed, while others feel that the IMF is still the most acceptable one which may be in need of some change in mandate as also outlook. A major issue relates to the scope for the IMF to function as a lender of last resort or provider of liquidity. I will highlight the salient features of the debate.

(a) A lender of last resort (LOL) should have the necessary resources. In any country, the central bank operates virtually on behalf of the sovereign which has, in a way, command over resources/surplus of the central bank. To be a 'LOL', IMF should be able to command adequate resources when warranted.

(b) A 'LOL' requires knowledge of the entities it is supposed to support and hence the significance of supervision/surveillance, whether directly or indirectly. The IMF should be able to strengthen its surveillance and may need to overcome the present asymmetries as between North and South in the degree of surveillance.

(c) A distinction has to be made between illiquidity and insolvency, and LOL provides support to get over illiquidity. Often, a judgment is involved in making such a distinction and mistakes are made (in fact, one seldom knows *ex ante*). While a sovereign or a central bank can afford to make judgments, a multilateral body may find it difficult to obtain authorisations for decision based on judgments.

(d) It is argued that a 'LOL' is expected to insist that it is not a lender and more importantly not have rules governing lender of last resort for reasons that are self-evident. At the same time, 'LOL' should be prepared to provide support when it is inevitable. So 'LOL' facility can seldom be rule-bound. An international body created by governments may have problems in operating a non-rule-based regime.

(e) It must perhaps be recognised that the extent of globalisation and capital account liberalisation by developing countries would necessarily depend on the effectiveness of the facility of a lender of last resort. Should both responsibilities be cast on the IMF?

Impact, Outlook and Lessons for India

Now, let us look at the issues of intimate concern to us. What has been and what is likely to be the impact of Asian Crisis on India?

India has been spared from the "Contagion". The fact that we have successfully weathered the storm of the Asian crisis can be evidenced from the performance of a number of macro-variables. Apart from the GDP growth of 5 per cent and containment of inflation at 5 per cent during 1997-98, the performance in the external sector was also satisfactory. The RBI reference rate which was US $ 1 = Rs.35.82 on July 1, 1997 moved down to Rs.40.36 on January 16, 1998 before appreciating to Rs.39.50 on March 31, 1998. Foreign currency assets also increased by US $ 3.6 billion from US $ 22.4 billion on March 31, 1997 to US $ 26.0 billion on March 31, 1998.

It may be useful to recognise the background that saved India from the contagion. Management of our external sector was governed by parameters indicated by the High Level Committee on Balance of Payments (Rangarajan Committee). The Report, which guided us, recommended, *inter alia,* flexible exchange rate, sustainable current account deficit, preference to non-debt creating flows, limits on the quantum, use and costs of external debt, and highly restrictive approach to short-term debt. The importance of monitoring of external debt was also recognised and transparent disclosure system was mounted on the basis of the Report of a Policy Group on External Debt Statistics constituted by RBI Governor Shri S. Venkitaramanan. It is my good fortune that I was Member-Secretary of the former and one of the two members of the group.

Any threat of a speculative attack was effectively and determinedly countered by the preemptive and timely measures taken by Dr. Jalan, Governor of the RBI on January 16, 1998. It must be noted that one of the reasons to provoke speculative attack, viz., impending elections or political uncertainty did exist in India at that time. The measures which were meant to be failsafe succeeded primarily because they were not expected by the market and clearly timed to ward off a possible speculative threat.

That is about the past. What is likely to be the impact in near future?

First, the sharp devaluation in Asian currencies may not hurt our exports to any significant degree since the share of affected countries in our exports is only about 7 per cent. However, their exports especially in areas like gems & jewellery, textiles, etc. could, to some extent, displace our exports to third countries, but in the near term, the disruptions in banking and trading in the Asian economies will delay their export-thrust. Over a period, they would overcome the disruptions but their competitiveness may be eroded by some inflation and some adjustment of over-correction in their exchange rates. Even so, the indigenous industry could face some competition from cheaper imports from Asia, at least in select goods. As these economies are propelled to generate current account surpluses, we should expect them to push their exports with ruthless efficiency. Additionally, non-Asian countries including developed countries may look aggressively for markets to compensate for compressed demand originating from Asian economies under a process of adjustment.

Second, under invisibles, the impact could technically be due to lower exports of software and technology related services and lower remittances to India from the Asia region. From all accounts the impact would be negligible.

Third, in terms of capital flows there could be both a positive and negative effect. Positive effect would be due to more stable conditions relative to other emerging countries. Negative effect would be due to erosion of confidence in emerging markets in general. These effects operate in regard to both quantum and spreads or terms. Though India is a marginal player in world capital flows or Asian flows, the impact of higher cost of external funds could be felt. Overall, the strong fundamentals and prudent macro-economic management should ensure the continued capital flows at reasonable terms to finance the anticipated current account deficits comfortably.

Fourth, real estate and equity prices are expected to be depressed in the affected countries in the wake of the Asian crisis, but the channels of transmission of Asian effect to real estate markets and stock markets in India are weak.

What is the medium-term outlook for India, in terms of emerging concerns after the Asian crisis.

Broadly speaking, there are five major areas of concern today whenever one analyses an emerging economy. These relate to macro-economy, external sector management, regulation of the financial sector, the state of corporate sector and the broader issue of transparency in the system.

On macro-economy, the annual growth rate of Gross Domestic Product has been in the range of 7 to 7.5 per cent during the last three years (i.e. fiscal years 1994-95 to 1996-97). For the current year, estimates range between 5.0 to 5.5 per cent. Investments as a percentage of GDP has also been reasonably steady in the period at around 26 per cent on an average. We ensure sustainable current account deficit, restrict reliance on short-term external debt, limit access to external debt and emphasise productive use of such debt. We encourage Foreign Direct Investment as a main source of non-debt creating capital inflows. Also, exchange rate is market-determined though the RBI closely monitors and occasionally intervenes to avoid volatility as also ensure orderly conditions in forex markets. We undertook financial sector reforms, especially banking reform which included strengthening regulatory framework, imposing prudential norms and reducing non-performing assets. We discourage banks' investments in real estates and stock markets. Non-banking financial companies are currently subject to regulation. Corporates' exposure to debt, especially external debt is within reasonable limits, though growing. There is widely recognised transparency in operations of the RBI.

There is, therefore, reason to believe that our situation does not attract the serious concerns that recent developments in Asia seem to warrant.

Recent Initiatives by the RBI

It is necessary to learn from the experience of the Asian crisis despite the fact that we have weathered the crisis, the immediate impact has been manageable and the economy is not vulnerable in terms of major areas of concern. We have demonstrated that we continue to learn from experience. Let me illustrate with RBI Governor Jalan's Monetary and Credit Policy statement for the first half of 1998-99 which addresses some of the related matters.

First, with a view to encouraging banks to mobilise long-term deposits, and discouraging short-term deposits, the interest rate ceiling on FCNR (B) deposits of one year and above has been increased by 50 basis points and that on such deposits below one year has been reduced by 25 basis points.

Second, as part of risk management, banks are being advised to monitor unhedged exposures of their clients by building adequate risk evaluation procedures in their credit appraisal system.

Third, the policy explicitly states that we would be constantly watchful of developments that may adversely affect exchange markets.

Fourth, the RBI is proposing to further strengthen the prudential regulations to cover all risks, keeping in view the international best practices and our country specific requirements.

Fifth, the recent experience of Asia has made it clear that a distinction needs to be made between access of banks/financial institutions to short-term cross broader financing and other forms of long-term funds. RBI is preparing a Discussion Paper which will contain the RBI's draft proposals for bringing about greater clarity in the respective roles of banks and financial institutions and for greater harmonisation of facilities and obligations applicable to them.

Sixth, the RBI will keep a close watch on liquidity conditions and ensure that sufficient credit is available to permit the growth potential to be realised. By implication, neither excessive credit expansion nor lending to unproductive purposes will be allowed.

Seventh, the RBI policy recognises that while the long-term objective of the monetary policy is to reduce the average level of CRR for improving the allocative efficiency of the banking system, the pace of change as well as intra-year variations in CRR would have to reflect short-term developments in financial markets including forex markets.

Finally, in order to monitor the channels of transmission of effects of monetary policy, the RBI has recognised the necessity of adopting a multiple indicator approach wherein interest rates or rates of return in different markets along with such data on currency, credit extended by banks and financial institutions, fiscal position, trade, capital flows, inflation rate, exchange rate and transactions in foreign exchange are juxtaposed with output data for drawing policy perspectives.

Incidentally, we have taken a number of steps of operational significance. For example, recognising the critical importance of collecting timely and accurate information from the market, the RBI constituted a Sub-Group on Reporting of Foreign Exchange Transactions. The Sub-Group has recommended electronic reporting of details of foreign exchange transactions by selected bank branches and streamlining of the existing reporting arrangements. The RBI has already implemented these recommendations.

Further, though we have a fairly well-laid out framework for collection and periodical dissemination of external debt statistics, we still find that some international agencies are presenting conflicting magnitudes of our external debt. In order to clarify these aspects both for ourselves and for the concerned institutions, we have set up a Technical Group on External Debt comprising members of the RBI and Government. The Group is expected to submit its Report shortly.

Broader Issues

To conclude, I submit that we should urgently deliberate further on some broader fundamental issues that have been thrown up by the recent experience.

First, in the balance between State and Market, Government action to ensure that markets perform well is critical. Governments may not succeed in avoiding market failures or in minimising costs of market failures when they do occur. Regulatory framework, particularly in more complex areas like financial sector needs attention; and such a framework should ensure information and transparency. How do we combine this with liberalisation and deregulation? In other words, we need to have a relook now at the nature of balance between State and Market.

Second, private sector failures, beyond the point when they impose systemic risks, will become the responsibility of the public sector. The private institutions may be too large to be allowed to fail and in the process they may even become too expensive to save. That markets bear the total risk of failure may not be true beyond a point. We should, therefore, review the balance between public and private sector.

Third, globalisation has immense advantages, but there are accompanying risks. If there are no credible international systems to minimise unbearable risks, the relationships between national policies and international obligations need to be reviewed. The outcome of the current search for new international architecture should be addressing this issue. The nature and extent of capital account liberalisation will be dictated by this outcome. More specifically, the relationship between national regulations and international obligations need to be reviewed in the light of this outcome, especially, on the issue of lender of last resort.

Fourth, macro-policy changes could bring immediate gains but they could easily be threatened by failure to address institutional factors. The link between macro policies and micro as well as institutional factors (the latter being less glamorous and more onerous) need to be addressed. The relative emphasis and attention between macro and micro and institutional factor needs to be reviewed. How do we put in place institutions that are right and effective?

Fifth, Asian policies or institutional structures in combination with external factors might have led to the current crisis and that would undermine Asian values. But as we have seen, the Asian economies have achieved a lot and will continue to do so after this setback. Asian values – family values of hard work, high savings and investing in children – should continue to guide all developing economies.

Perhaps, we should debate as to whether the Asian crisis itself was an aberration due to unfortunate combination of circumstances or was it an inevitable consequence of domestic policies in the existing global financial system.