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Introduction

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First of all, let me thank the Monte dei Paschi Bank and Giovanni Ferri for helping to organize this conference. When I was approached with the idea of having this conference, the main reason I responded with great enthusiasm was that while there have been many discussions on the East Asian crisis – the number of conferences has probably increased supra-exponentially – the fact is that there have been relatively few serious academic conferences looking at the analytic issues that need to be addressed.

The East Asian crisis certainly raised a large number of issues for the economics profession. In terms of its consequences for the countries involved, it is certainly the most important event since the Great Depression. Therefore, if we consider it as an experiment – not an experiment without obviously enormous costs to the people involved – it is an experiment that is producing an enormous amount of data, raising an enormous number of questions, among which is the issue of the Global Financial Architecture. Alas, a huge number of conferences have focused mostly on theoretical issues and empirical evidence has often been either lacking or deficient. That is why I thought this conference, trying to focus on both theoretical and empirical issues, was potentially so important.

It is easy to notice that, as the crisis occurred and as the policy responses to the crisis were formulated, many statements were made, often with remarkable confidence, which were not based on much research or evidence. Indeed, there was perhaps almost an inverse correlation between the confidence with which the statements were asserted and the support provided to them by economic theory and evidence. As an example I have been involved in a couple of debates: one regards the assertion that we need to increase interest rates to stabilize the exchange rate; the other regards the assertion that devaluation would hurt the economy more than a rise in interest rates. In the first debate, there was enormous belief or faith that an increase in the interest rate would stabilize the exchange rate. As the experiment turned out, it did not work at all. What was particularly interesting was that theory and evidence available at the time both suggested that the belief was wrong, and yet, those policies based on wrong belief were pursued. My second example regards a very strong assertion made by some people, that devaluation would hurt the economy more than a rise in interest rate. Again, that question is subject to the validation of both economic theory and empirical evidence and, again, asser-

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tions were made with very little evidence. As events turned out and as the studies subsequently have shown, the assertions that were made, at least by a number of parties, were wrong.

At the beginning of the discussions on the East Asian crisis, many explanations were put forward as to why the crisis occurred: issues like transparency and chrony capitalism ranked very high. Again, what is remarkable is both how rapid the political leaders – as well newspaper journalists – were able to come forward with those explanations before doing very much research, and how weakly those explanations stood up to the scrutiny of more detailed analyses. Obviously, that raises the question 'Why were those explanations put forward with such alacrity and such conviction when the evidence for them seemed to be so missing?', and that brings us into the area – that we would not bring into this conference, but I think will occupy a lot of people going forward – which is that, obviously, there was some special interest that these kinds of explanations served and one would need to give more attention to the political economy of both policy and explanations of events. Thus, once more, it seemed to me that having a conference in which a number of the key issues raised by the East Asia crisis – that have to be addressed and have to be thought about – would be of enourmous value. Although the set of issues raised is enormous, this conference will be able to look at only a few of them. Let me just try to put into perspective three or four of the topics that will be discussed. Hopefully, the discussions in the next two days will shed some light on these issues.

The first topic has to do with the prediction of economic crises. One of the ironies here is that hours, or certainly days, after the crisis, you heard an outpouring of people saying: "Of course, the crisis occurred. Look at what was wrong with the countries. There's chrony capitalism, lack of transparency and so forth." Well, the first question is: "If it was so obvious, why didn't anybody predict it?" In fact, this raises the issue about prediction of crises, a task which is similar to that of journalists who, after the stock market goes up or down, have to explain why it went up or down. That is their job, they are paid for it. On the other hand, had they really had strong prediction powers, they would be rich; they would not be journalists, because they would have used that information *ex ante* to take a position in the market. Thus, to shed light on this crucial issue, we need to raise a few questions: "What do our models say about how likely were these countries to have crises?" "Were the crises predictable?" and "Is it a question that our models are bad?" or "Is there something *sui generis* involved in these crises?" These are clearly very important questions because, going forward, we would like to be able to predict crises, if we can. Accordingly, either our models are to be improved or we ought to recognize some of the unique features that were played in this crisis. On one of those sets of issues, Jason Furman and I have already written quite a bit, showing that, for instance, transparency, which is one of the variables that has most frequently been invoked, is clearly not the cause of the crisis. Let us just recall

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that the last set of crises were in Scandinavia, probably the countries with the most transparent set of institutions and so, while transparency may have contributed to the depth of the East Asian crisis, it clearly cannot be ascribed to as its cause and one can use econometric models to verify that concern. One of the papers that is going to be presented here argues that, in fact, not only did the credit rating agencies do a bad job in predicting the crisis, the way they revised their ratings may have actually caused the crisis to be worse than otherwise it would have been. So, here we have an outside private sector agency not only failing to do a good prediction job, but actually being a player within the crisis and contributing to it. What implications that has for policy, I think, is something that we will go on to ponder.

The second topic that we need to address is the policy response to the crisis. There is, by now, widespread agreement that the magnitude of the fiscal contractions engaged in were excessively contractionary and that they contributed to the magnitude of the downturn. There is, however, remaining controversy over at least two issues. First, were the monetary policies appropriate? This relates to some of the fundamental issues referred to earlier. The conference will not have time to consider those in much detail, but I hope the discussion will partially remedy this. The second issue, though, is a more profound one from the point of view of economic theory and empirical models: should there have been a better job at forecasting? To put it in the context, when I was Chairman of the Council of Economic Advisors, we regularly monitored a whole range of forecasting models, we brought in all the forecasters – from private and public sector – for the US economy, looking forward three months, six months and up to five years. We were very careful in trying to compare the models to understand the reasons for the difference in forecasts, their weaknesses, their strengths, their bases, and which prediction we would have the greatest confidence in as the basis of our economic recommendations. I can state with some confidence that this kind of exercise of open comparison of models has not been done extensively in the international arena. Perhaps, therefore, this has put those involved in making and formulating advice in a less well-prepared position to formulate policy recommendations appropriate to the circumstances that prevailed in these economies. I would go even further and suggest that good economic modelling should have predicted the severity of the economic downturns facing the East Asian crisis countries. If that is the case – and certainly many of us felt that it was going to be that case – then, what is wrong with the models that have led to the wrong kinds of predictions, and what can be done in the future? Indeed, I believe we should focus mostly on the future, and on what needs to be done, to avoid similar kinds of mistakes. We will be facing new crises and will have to make economic decisions, and those economic decisions will have severe consequences: the magnitude of the recessions and depressions in East Asia are testimony to a failure of economists of a first order of magnitude.

As a consequence of the severe economic downturn – partly resulting from

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bad policy formulations – there has been a plethora of bankruptcies: our third topic. By some estimates, the number of bankrupt firms in Indonesia is somewhere around 75 per cent; in other countries, it is between 30 per cent and 75 per cent. This level of economic disorganization has seldom been seen in the past. The nature of the problem – the fact that it was not government debt but private debt, that raising interest rates to the level that they reached would likely result, given the high level of corporate leverage, in systemic bankruptcy – certainly calls for a different approach to economic policy. Thoughts about bankruptcy have not played a central role in macroeconomics. Over the past fifteen or twenty years, an enormous amount of work focusing on the importance of bankruptcy has been done. Its results have been integrated into microeconomic models but, unfortunately, not yet into macroeconomic analyses to the extent that they ought to be. One of the ironies is that, while many of these East Asian countries worked years to reduce their public debt, suddenly, as a result of the corporate and financial sector crisis and the governments assuming these private debts, public debt is once again at very high levels. The idea that governments having spent ten years privatizing national assets, decided to nationalize private liabilities seems to me one of the ironies of the recent crisis. Thus, one of the major issues that this conference is going to address is the view about this whole set of bankruptcy, corporate reorganization, the effect of economic policy on default and on corporate disorganization in the manner that has worked out in East Asia. Let me indulge in just one of the important asides for which, again, important empirical research has provided evidence. We normally think of bankruptcy as a mechanism of sorting good from bad firms. However, with this kind of systemic bankruptcy that has occurred, bankruptcy as a sorting mechanism completely falls apart and you have good firms just as likely to die as bad firms. So, the whole impact on the structure of the economy going forward is completely disrupted.

Finally, a very important topic is bank regulation. One emerging consensus – although not unanimity – is that capital market liberalization, particularly that of short-term financial flows, and excessively rapid financial market deregulation, without putting in place the appropriate safeguards, are factors that contributed very significantly to the crisis. In my opinion, this type of financial liberalization has contributed to the fact that, over the last quarter of a century, crises – financial and currency crises – have become more frequent and deeper. We now focus on the East Asia crisis, because such a big event drew a lot of attention but, in fact, if you look at historical records, there have been between 80 and 100 crises in the 25 years. Thus, these crises are not isolated events; they are not unique accidents in a road. To me, this is evidence that something is wrong with the basic financial architecture. Maybe people make mistakes, but if you have an economic system that is designed in a way that only perfect race drivers can drive on it safely, then it is not well designed. Fallible governments and even well-managed governments have faced enormous problems; this is one of the things that have become very clear after the

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events of August 1998. So, it is now easy to recognize that even good countries with good economic policies may be very adversely affected, and that capital market and financial market deregulation done in the wrong way has an essential part in causing the instability that we have witnessed. It is very interesting to notice that the evidence on the benefits of this capital liberalization has been at best scanty. I began my remarks by talking about statements made with an enormous amount of confidence, but very little evidence: this is a case in point. A few years ago, there was a big initiative to engage in capital market liberalization and you would have thought, given the conviction with which that initiative went forward, that there would be a plethora of evidence and theory, showing beyond the shadow of doubt that such policies would raise standards of living and improve economic growth, and yet, the level of evidence on this is very scanty. Perhaps the best study done to date is that by Dani Rodrik from Harvard, which shows no relationship between capital liberalization and economic growth. On the contrary, there is a large variety of literature – and also econometric studies – showing that excessive liberalization is systematically related to a higher probability of a crisis. This issue needs to be studied in depth; this is certainly not the last word that is going to be said about it. The point I would like to stress once more is that the large role that ideology, rather than science, has played in policy calls for a burden for conferences like this to look at the evidence and to engage in the debate on the real substance of the issue, a little bit set apart from the battles of the political process. Nevertheless, more fundamentally for the purposes of this conference, I hope this conference will discuss the following issues in the context of bank regulation. First, there is a growing recognition that excessive reliance on capital adequacy standards is neither sufficient, neither represents an efficient form of regulation, particularly for the less developed countries, which face greater risk and less capacity for risk management. Second, the way regulation and resolution of problems were implemented in the advent of the East Asian crisis probably contributed themselves to exacerbate the depth of the crisis. This is a very fundamental point which parallels the points made above on corporate reorganization. I mentioned that, in the context of the East Asian corporate reorganization, something like 50–75% of the firms are bankrupt. Dealing with bankruptcy on such systemic basis is fundamentally different from dealing with bankruptcy when only a few firms in the economy are bankrupt. Equivalently here, dealing with a financial system in which 50–75% of the banks are weak, is fundamentally different from dealing with a banking system in which only one or two banks are weak. Dealing with systemic financial sector problems is fundamentally different from dealing with isolated problems. There is a growing recognition of the failure to recognize what might be called in this context the 'fallacy of composition'. That is, when an isolated bank tries to correct its problems, it may be successful; when a whole banking system tries to restore its capital adequacy, it may lead to all firms looking even worse as each bank tries to reduce its asset base to meet the BIS

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standards. Intensifying credit constraints further weaken the economy. Thus, dealing with systemic consequences is the fourth topic that this conference will deal with.

What I have tried to do in these introductory remarks is to raise questions. I have also tried to put forward the fundamental hypothesis that, in fact – be it in recognizing the causes of the crisis, in predicting the crisis and, most importantly, in responding to the crisis – a lack of basic knowledge about economics and a lack of use of the available knowledge may have contributed to both the inability to anticipate and to deal with the crisis most effectively. The purpose of this conference, however, is not to go over the past – there have been a lot of debates over that; that is not the function. The function is to recognize that, as I said before, we will have crises in the future – no matter what we do, there will be crises – and we will have to face the challenge of how to deal with them. Thus, unless we can answer the kinds of questions that I have posed above, we will not be able to deal with future crises in the way which most effectively maintains the strength of these economies. As we move forward, we must remember that those policies formulated to respond to the crisis – if they have not contributed to aggravate it – have failed to stymie enormous recessions and/or depressions. Even worse, these policies have adversely affected, with disproportionate intensity, the workers and the small businesses who had not engaged in international financial market speculation. These were innocent by-standers who, in some sense, have borne a huge part of the brunt of the adjustment, without having themselves enjoyed any of the fruits of the economic policies that led to the crisis or being party to the packages to respond to the crisis.

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