Preface

Financial crises have occurred for as long as financial markets have existed, but for emerging markets, the past seven years have been extremely turbulent. In December 1994 the 'Tequila' crisis erupted. In 1997 the Asian crisis started in Thailand and spread to South Korea, Malaysia, the Philippines and Indonesia. On top of this came the crises in Russia, Brazil, and more recently in Turkey and Argentina.

But what about the next seven years? Will these be rich years for financial stability in emerging economies, or will these be as meagre as the past seven? The outcome will depend on what policymakers and investors have learned from the events in the last seven years.

Let me summarise a few of the most evident lessons. A first lesson has been that – although much depends on a country's specific circumstances – fixed exchange rate regimes are more demanding and maybe more dangerous than flexible regimes. Mexico, all of the Asian crisis countries, as well as Turkey and Argentina pursued fairly rigid exchange rate regimes in the run up to their crises. In the face of adverse external shocks or unsound domestic budgetary and wage policies, fixed exchange rates can more readily lead to ill-suited monetary policies and to an overvaluation of the exchange rate. The strengthening of the dollar against the yen in 1996, for instance, squeezed the competitiveness of the Asian emerging markets and led to substantial current account imbalances. Argentina's currency board may have helped the anti-inflation programme, but at a very high cost. If such a fixed exchange rate policy is not based on sound macroeconomics, a crisis may become inevitable.

A second lesson has been that sound debt management is crucial. In both Mexico and the Asian crisis countries, short-term foreign borrowing was excessive. The crisis in Argentina shows that the burden of foreign currency debt gives the government an incentive to remain with a regime with an overvalued exchange rate for too long.

A third lesson has been that investors and policymakers need

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access to reliable and accurate information on a country's state of play. In South Korea in 1997, for example, international investors had no idea that the central banks' liquid foreign currency reserves were actually depleted. Once the actual figures became available to the markets, the crisis was triggered. This point has been well taken by the international financial community, which has invested vast resources in developing international standards and codes and other transparency initiatives.

A fourth lesson has been the importance of a strong and well-supervised financial sector. In most of the crisis countries, banking supervision was poor, giving banks scope to act irresponsibly, for instance by borrowing heavily from abroad and then speculating on favourable exchange rate developments while profiting from interest rate differentials. We know from the experience in Asia that it takes a lot of time to clean up banks' balance sheets once they have become messy. In my opinion, to enhance the financial system, emerging countries, especially in Asia, should more vigorously stimulate the entry of foreign-owned banks. This can help improve banking practices relatively quickly, while avoiding the dangers of large cross-border borrowing. A significant presence of foreign banks is one of the characteristics of financial markets in European emerging countries.

Will the future be spared of crises? That is idle fantasy. It is my hope, however, that we will see fewer crises and, maybe more importantly, less contagion of crises between emerging markets. The Argentine crisis has not seriously spilled over into other economies, with the exception of Uruguay that has close banking system links through Argentine branches and deposit holders.

This lack of contagion can indeed, at least in part, be attributed to the initiatives by policymakers. First, macroeconomic policies in emerging economies have generally improved since the Asian crisis. Fewer countries pursue fixed exchange rate policies and current account imbalances are smaller, especially in Asia. Debt management has also improved, as indicated by smaller shares of short-term debt in total foreign borrowing. The transparency initiatives, moreover, seem to have given investors a greater ability to discriminate between countries. A positive development is that although capital flows to emerging markets have declined, foreign direct investment, with its potentially larger positive spill-over effects on economic growth, has continued to increase.

Stability in emerging markets is not only important for these countries themselves; it has a global dimension as well. Indeed, economic developments in emerging markets have an increasing impact on developments in the industrialised world as our trade and especially financial flows have grown much faster than our economic production. Multinational investors can make handsome profits by taking appropriate risks in emerging markets and diversifying their portfolios, but can also face large losses if a crisis occurs. The impact on developed countries can be large: wealth, trade, bank lending and even general confidence may be depressed. Nonetheless, at the same time, we need to recall that there is a mutual interest in sustaining this interdependence. Actually, if anything, this interdependence will increase in step with the ageing populations in the developed world. From an economist's viewpoint, there seems to be a certain logic to increasing capital flows toward the younger emerging markets, and repatriating these flows in due course as the share of retired workers in the developed world rises.

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