

Taking stock : Ten years after the Asian financial crisis

The Asian financial system could become a full-fledged partner in the global triad of economic powerhouses, alongside Europe and the United States—but only if its regulatory systems, economic ministries, and financial institutions improve dramatically.

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This year marks the tenth anniversary of the beginning of the Asian financial crisis, a collapse brought on by macroeconomic imbalances that exposed fundamental weaknesses in Asia's corporate and financial sectors. The sequence of events that began with the Thai baht's collapse in July 1997 ultimately cost the region tens of billions of dollars and led many observers to speculate about an impending "lost decade" in Asia.

Today, after a remarkable ten years of transformation, Asia's financial system is substantially deeper and more robust than it was in 1997. Sitting atop an enormous rising economic tide, it is poised to benefit from a host of factors, including the rise of China and India, the reemergence of Japan, robust intraregional trade, enormous infrastructure-financing needs, and the opportunities presented by increasingly powerful Asian sources of capital. Asia appears set to play an important role in the world's financial system over the coming decade—a true third partner in the global triad, along with Europe and the United States.

But it would be foolhardy to believe that Asia has been immunized against imbalances, shocks, and dislocations. The sheer pace of growth and financial innovation across the region makes it inevitable that imbalances will build and shocks occur. Asian risk-management systems may have improved, but they have not become fully mature in just a decade. Asian regulators and CEOs of financial-services companies have concerns about the coordination of central banks, regulators, and government ministries—both within and among the region's countries. Asian financial institutions face ever-stiffer competition for talent at a time when their activities are becoming increasingly complex. And worrying signs of asset bubbles are emerging in China, Hong Kong, Indonesia, Singapore, and Vietnam.

The Asian financial system will achieve truly global stature only if a number of critical improvements and initiatives, which should put the region on a stable path for the next decade, are implemented over the next two or three years. It has a very good chance of maintaining its momentum and emerging as a global leader, but it will take concerted effort to build on the progress of the recent past.

Yesterday and today

During the next ten years, the region is poised to rival Western Europe as a pool of financial-services revenues. From 2005 to 2015, Asia could contribute more than 27 percent of projected global growth in financial services, up dramatically from the 13 percent of 2000 to 2005. Asia's share of global revenues could easily rise from 20 percent in 2005 to more than 25 percent by 2015.

Given the blow the region suffered in 1997 and 1998, this is a remarkable outlook. But to achieve it, Asia's executives and policy makers must recognize the value of the reforms left unfinished from the Asian crisis—and work to complete them.

The contours of the Asian financial crisis are broadly understood. In the years leading up to 1997, enormous short-term foreign funds flowed into a variety of longer-term investment opportunities, with the assumption that exchange rates were essentially fixed. Much of that funding passed through structurally weak and underdeveloped banking systems into equally weak corporate sectors.

This flood of relatively cheap foreign funds generated speculation in real estate and other sectors, fueled by strong direct and indirect links between banks and corporations. Net foreign reserves were largely negative or just barely positive in many Asian countries. When the baht collapsed, it quickly became clear that linkages among them were much denser than regulators understood. Few, for example, realized that South Korean merchant banks, guaranteed by South Korean commercial banks, had been providing significant loans to Thai property developers and buying Indonesian derivatives.

Ten years later, many of Asia's key micro and macro metrics have improved dramatically. Exchange rates, once mostly fixed, are now mostly flexible or floating. (China remains the significant exception.) Ratios of foreign-exchange reserves to short-term debt are better in all Asian countries. The composition of foreign funding in Asia has shifted and improved: short-term lending from foreign banks has been halved as a percentage of GDP—to 4 percent, from 8 percent—and the proportion of loans in local currencies has risen from 16 percent in 1995 to 42 percent in 2006. Economic growth is strong across the region, and interest rate differentials are on the whole lower than or similar to those in the United States.

At the micro level as well, there has been broad improvement. Banks are considerably more profitable and efficient than in the

years before the crisis. Since the late 1990s, the proportion of national banking assets owned or tightly controlled by the state has decreased. In many countries, national banking systems have become much more open to foreign competition. In South Korea, for example, foreign banks control more than 10 percent of total assets, up from 2.7 percent in 1997.

Banking systems have also consolidated dramatically, and if recent trends continue the region is likely to become home to a greater proportion of the world's most significant financial institutions. Already, four of the top ten banks, by market capitalization, come from Asia. Over the next ten years, we believe that the underlying growth of Asian markets will propel even more into the top ranks. (We should recall that Japanese banks were dominant globally in the late 1980s. The difficulties they subsequently encountered at home and abroad offer lessons to Asia's emerging financial leaders. Some are taking steps to avoid such difficulties: certain Chinese banks, for example, have formed joint ventures and partnerships with foreign institutions and are focusing on building up their capabilities.)

Financial markets have developed somewhat more slowly. Across Asia, the banking sector still accounts for 30 percent or more of the financial system's assets (55 percent in China), compared with less than 20 percent in the United States and 25 percent in the eurozone. Although equity markets are soaring, effective markets for corporate bonds and other debt securities—important to provide lower-cost, longer-term capital to companies; to create competition for banks; and to give banks opportunities to shed credit risk through securitization—are largely absent.

Today, according to the latest City of London Index, four Asia-Pacific cities rank among the world's top ten financial centers: Hong Kong (three), Singapore (four), Sydney (seven), and Tokyo (nine). Still, they remain far below the top two—London and New York—in significance. Asian stock exchanges outside Japan represent 14 percent of global market capitalization, up from 4 percent in 1998, but many Southeast Asian exchanges still have high trading costs, low turnover velocity, and higher equity risk premiums than do their counterparts in more developed markets.

Capital flows within the region remain surprisingly small, particularly in the light of growing trade links and integration of supply chains. Asia is likely to see greater intraregional capital flows in the years ahead as powerful Asian pools of capital emerge. But for the moment, the majority of cross-border holdings are distributed among the three big global financial centers: the United States, the United Kingdom, and the eurozone. The cross-border capital linkages of Asian countries are mainly with those three centers. Control of the flow of funds is different: Asia's central banks, which invest primarily in long-term dollar- and euro-denominated assets, account for roughly 65 percent of all capital outflows from the region. By contrast, private investors account for the majority of capital outflows from Europe and the United States.

If this balance changes and private capital becomes a greater part of investment into foreign markets, more capital will probably stay in the region—an important boost for its aspiring financial centers. Assuming that countries continue to open up, as China has just started to do, to deregulate vital support activities (such as legal services), and to attract leading global talent, some of them should become more significant global hubs. Hong Kong, Shanghai, and Singapore are particularly well placed to do so. This transition will be made easier if Asia develops as a more integrated financial market, with a degree of coordination and specialization (for example, bond markets and the consolidation of regional exchanges). If these things do come to pass, there is no reason Asia's hubs shouldn't eventually challenge London and New York.

Recommendations and imperatives

Private- and public-sector institutions have undertaken a number of important improvement initiatives across the region. But to entrench the progress of the past decade, more remains to be done.

1. Embed and deepen risk-management processes, capabilities, and culture in financial institutions.

In many banks, the organizational chart has been drawn, boxes have been filled, and the discussion has moved from theory to practice, yet risk management doesn't permeate the organization. This must change. CEOs and corporate boards should consider establishing an annual, independent, enterprise-wide audit of risk-management processes and practices. The compliance function must be seen as one of the top three roles in a bank. Supervisors and regulators should focus their scrutiny not only on top-level executive decision making but also on activities two or three levels down. Branch visits should be a regular part of the regimen.

The importance of managing credit risk was one of the important reform themes arising from the 1997 crisis. The instability that recently emanated from the US subprime-mortgage market is a reminder that managing market risk and liquidity risk are equally important.

2. Ensure that top management, both in the private sector and in regulatory bodies, conducts annual scenario- and contingency-planning exercises.

Once a year, banks and regulators should stress-test the performance of their organizations against significant interest rate increases, liquidity and funding shortages, operational risks (such as disrupted payment systems and unexpected surges in trading and transactions), and external factors (like oil price fluctuations and bird flu). These exercises should expose weaknesses and improve decision protocols, approaches to internal and external communication, and information management. They should also highlight opportunities—for example, by exploring whether a bank ought to make acquisitions.

3. Shift the major banks' emphasis in corporate governance from "hardware" to "software."

Asia's financial institutions have made good progress in establishing well-structured corporate boards, but it is by no means clear that the mind-set and behavior required for effective governance are in place. Boards and management should agree to more explicit mandates and priorities, as well as more active discussion and questioning by independent board members, the greater involvement of the board in reviews of senior management, and better materials for meetings of the full board and committees. As with risk management, boards would be well advised to review their operations against best practices every year, with the corporate-governance and nomination committees leading the way.

4. Focus on developing talent.

Since the cost of a regional financial crisis runs to hundreds of billions of dollars, why is there any reluctance to invest in recruiting and developing skilled professionals to oversee the financial system? There is a strong case, across Asia, for doubling the money allocated to regulators and supervisors for hiring, training, and building the skills of the best people—and for retaining them.

The UK Financial Services Authority (FSA), for example, will spend about \$100 million over the next three years to train its 3,700 staff members—some \$9,000 per person a year.¹ While significant, the sums of money involved are hardly great when set against the costs of regulatory failure.

Banks themselves could do more to develop talented managers with a global perspective and specialist skills, especially in wholesale financial services and treasury operations. As more banks expand beyond their national borders, they will need executives who are comfortable operating and leading in a number of countries. Openness to external hires and disciplined globalization programs are highly desirable.

5. Increase and intensify the formal cooperation and interaction among government bodies with economic responsibilities.

Effective oversight of financial institutions and markets requires a systematic approach. All countries in Asia badly need better cooperation and coordination among financial-market regulators and government ministries with economic responsibilities—for example, the finance, economy, planning, and commerce ministries.

6. Formalize and greatly increase the interaction among regulators and supervisors across Asia.


A first step would be to promote training, the sharing of knowledge, and development by forging stronger links with established regulators—for example, the Bank for International Settlements, the International Organization of Securities Commissions, and the International Association of Insurance Supervisors. To ease the process, Asia may wish to implement an Asian forum for regional coordination, with the understanding that it must eventually integrate globally. The forum would have a threefold mission: improving the exchange (and standards) of information and making the structure, conduct, and performance of the entire financial system more transparent, within and across countries; conducting programs to share best practices; and developing regular regional scenario-planning and crisis-management exercises.

7. In each Asian country, launch master plans, developed cooperatively by both the public and the private sectors, for the financial system.

The next five years will be critical for the development of Asia's financial system. The region's higher growth rates, as well as the rising wealth and significance of its consumers and corporations in an increasingly linked global financial system, will create many strains on the world economy. Leading global institutions will be ramping up their focus on the Asian opportunity.

Banking consolidation within and across countries, the development of capital markets, and regional financial integration will create a rich menu of issues for market participants. It will be necessary to deal comprehensively with the role and approach of regulators: basing regulation on principles or on compliance with prescriptive rules, regulating whole businesses or specific entities, establishing information standards, and deciding whether to encourage local banks to become regional or global champions. Such issues can be addressed only if the private and public sectors work together.

One particular warning: perhaps the most important challenge for Asia is to avoid the arrogance or overconfidence linked directly to extraordinary success. Overconfidence was certainly evident in Asia during the early part of 1997, as it was recently on Wall Street and in London—and in the run-up to all the financial crises of the past century.

Financial institutions and regulators across Asia have done a tremendous amount of good work since 1997. Massive opportunities lie ahead, but to seize them Asia must not only consolidate its gains but also build for the future—informed by a keen sense of recent history and its own fallibility. 

About the Author

Dominic Barton is a director in McKinsey's Shanghai office. This article is adapted from a speech given by the author in the summer of 2007 at a conference at the Federal Reserve Bank of San Francisco.

Notes

¹ Financial Services Authority, Business Plan 2006/07.

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