The Asian financial crisis, which erupted in 1997 in Thailand, awoke the world to "contagion," a new peril inherent to highly interconnected financial markets. Spreading quickly within and outside the region, the crisis brought the world's 11th largest economy, Korea, to the brink of bankruptcy and led to the defaults by Russia and Brazil.

Was the international response to this crisis sufficient? And have the right lessons been learned for future crisis management—or, better, prevention?

Lawrence Summers

President of Harvard University; U.S. Secretary of the Treasury, 1999-2001

Assistant secretary of the U.S. Treasury during the Asian crisis, Larry Summers felt that unless vigorously checked, the "virulence" and "global and pervasive nature" of the crisis could be a permanent threat to the globalized world.

A Phenomenon of Globalization

LAWRENCE SUMMERS: Contagion has become very much a phenomenon, and it's a phenomenon of globalization. Contagion is very much a feature of this new world. It's a reflection of globalization; it's a reflection of information technology. When bad things happen in one place, it affects other places for any number of reasons. People who are in financial trouble have to sell other assets. Countries whose currencies fall in value put pressure on the currencies of other countries. People who look at one situation wonder whether something similar couldn't happen in another situation. So I think it's very important to recognize the phenomenon of contagion, and that will often mean that the best forward defense with respect to a problem is prevention by stopping the initial impulse. That's part of why we put such emphasis on the capacity to deploy resources quickly based on tough [conditions] as part of the response to financial crisis.

INTERVIEWER: When you had a sense that Thailand was in trouble, what did you do?

LAWRENCE SUMMERS: We convened with other countries and were part of working out a large IMF support program and an extensive dialogue between Thailand and its creditors to ensure that Thailand was able to maintain its financial solvency.

INTERVIEWER: And as the crisis began to spread elsewhere, was it of a different nature from other crises?

LAWRENCE SUMMERS: I think the global and pervasive nature of the 1997-98 crisis was something new, and it was not something that we fully foresaw. I think it is a reflection of technology and globalization that the crisis happened in the way that it did.

INTERVIEWER: As you were living through it, did you have a sense that you were seeing something [different]?

LAWRENCE SUMMERS: We had a sense that this was a new phenomenon, [that] this was probably the way the world was going to be, with markets increasingly interlinked, even if it had not been the way markets had always been. That was one of the things that encouraged us to take bolder kinds of responses, of not being prepared to allow—because we frankly feared it would throw us so far into the unknown—a moratorium on Korea's debt, which looked like a very real possibility at the end of 1997.

INTERVIEWER: What would have happened had you not have been there, say, for Korea? What were the stakes involved for the global economy?

LAWRENCE SUMMERS: Oh, I think the stakes could well have been an enormous erosion in capital flows to all of the Third World, very substantial consequences for financial institutions in the major countries, substantial interference in the pattern of global growth, not to mention the security consequences for the United States of upheavals in South Korea. I think all those things were on the line.

INTERVIEWER: And as it spread to Russia and ultimately [elsewhere], was it a sense that it was moving faster and quicker and around the world in a way that we've never really seen before? Did that catch you by surprise at the time?

LAWRENCE SUMMERS: I think the virulence of the crisis was a surprise and was not something that observers expected, but it was something that we came to deal with. And it was part of what shaped our decisions to pursue more aggressive rather than less aggressive approaches.

The Role of Information Technology

INTERVIEWER: Was technology affecting the speed of contagion?

LAWRENCE SUMMERS: Certainly technology and globalization make that possible. For example, because they both had currency boards, there were close connections between what happened in the markets in Argentina and what happened in the markets in Hong Kong—two markets that would have been completely separate 20 years ago [and] which would have had very little influence on each other.

INTERVIEWER: Just on the contagion, we interviewed William McDonough [president of the Federal Reserve Bank of New York], and he said that he didn't think we'd seen the final effects of that. What's your sense of the long-term impact of that crisis?

LAWRENCE SUMMERS: I think that the history of Indonesia 15 years from now will be very much affected by the tragedies of that crisis. I think that that crisis may well represent an important change in direction and a beneficial direction for Brazil. So I think those events are going to cast a very, very long forward shadow for any number of economies, and they really remind one of the overwhelming importance of finance in shaping what happens in history.

Robert Rubin

U.S. Secretary of the Treasury, 1995-1999

Looking back at Korea's near bankruptcy in December 1997, Robert Rubin, then U.S. Treasury secretary, believed that had Korea been allowed to default, the global effects would have been catastrophic.

Korea, 1997: Verging on a Global Crisis

INTERVIEWER: When did you begin to worry about "contagion" during the Asian crisis?

ROBERT RUBIN: We began to worry very greatly about contagion in the Mexican crisis in [1994-95]. Our concern was that if Mexico was going to default [on its debt], that default could rapidly spread to other emerging-market countries. So when we faced the [1997] Asian crisis, starting with Thailand, we were concerned not only about Thailand, but also about the effects it might have elsewhere. For us, the concern about contagion was integrally part of our concern about the individual countries in the Asian financial crisis.

INTERVIEWER: Talk about the economic stabilization in Korea in late 1997.

ROBERT RUBIN: I think that the world may have been very close, far closer than almost anybody realized, to a very severe crisis in the last week of December of 1997, when Korea had approximately $4 billion of reserves, and was using [those] reserves at the rate of about $1 billion a day [to protect the value of its currency]. Had there not been an international effort at that point, I think there was a very real chance you could have had a default in Korea, the 11th largest economy in the world. And that, I think, could have had far broader and more dangerous effects around the world.

INTERVIEWER: How bad could that have been?

ROBERT RUBIN: Well, there's no way of telling how bad such a thing could be, but I think that if an economy of that size defaults, it has the potential to create a crisis that could, at least conceivably, involve all the countries of the global economy.

Eisuke Sakakibara

Professor, Keio University; Minister of Finance for International Affairs of Japan, 1997-1999

Eisuke Sakakibara led Japan's international economic policy between 1997 and 1999. He drew from the crisis was the lesson that global capitalism was "inherently unstable."

An Unexpected Crisis

INTERVIEWER: [The crisis] began in Thailand. Did you think it was likely to be contained there? Did you think that the baht crisis had serious implications for the whole region? Did your thinking about the crisis change as you watched it move from country to country?

EISUKE SAKAKIBARA: Thailand's prices erupted in May of 1997. Of course, there was a sense of a bubble bursting in Thailand in late '96 and early '97, but at the time the Thai crisis erupted nobody, including ourselves, thought that it would proceed to a crisis in Korea, for example. It was unbelievable that the crisis spread as quickly as it did to Indonesia and Korea, within a matter of six months or seven months. We realized that the world was much more globalized that we had thought at the time.

INTERVIEWER: What was your own personal worst moment at that time?

EISUKE SAKAKIBARA: Well, I have lots of recollections during that time, but one meeting I remember very clearly was in September 1997. It was the annual meeting of International Monetary Fund, which was held in Hong Kong. That was during the time of the return of Hong Kong to China. I remember meeting with George Soros [the hedge-fund specialist and philanthropist] in Hong Kong. During our meeting Soros said Korean banks owed very heavily to Indonesia, and Indonesia was now entering the crisis, so that the problem will eventually proceed to Korea. So as early as September, George Soros was predicting that the crisis would spread to Korea. After that meeting I checked the numbers and realized it was true. The American and European banks had been withdrawing their money from Korea beginning in the middle of 1997, and in September the Japanese banks—they were the last ones to get out of there. It was a very rapid withdrawal of money by European, American, and Japanese banks, which resulted in the Korean crisis in December of 1997.

INTERVIEWER: It must have been nerve-wracking to watch that money that had flowed in such huge amounts flow out so quickly.

EISUKE SAKAKIBARA: That's right, that's right. Within a matter of two to three months, Korean foreign reserves were very quickly depleted, so at the beginning of December 1997, the U.S. government, the Japanese government, myself, and the European governments knew that the Korean foreign reserves might be [exhausted] any day. We were watching day by day what was happening in the Korean short-term capital market. This was the time when Kim Dae-jung had just won the election. It was a transition period, but it was a very difficult time. We were being sent information on daily basis.

A Crisis of Global Proportions

INTERVIEWER: At the time you were talking to Secretary Rubin and Larry Summers in the U.S. What do you remember from those conversations?

EISUKE SAKAKIBARA: There were a lot of things taking place during that period. As early as late August and early September of 1997, the Japanese government proposed the establishment of an Asian Monetary Fund. Larry Summers was furious. He was very strongly opposed to the idea. so we had heated discussions over the phone and at various meetings about whether we should proceed to establish an Asian Monetary Fund. That kind of heated debate continued for two months, and in the end, Larry prevailed, but it was an interesting period. We remained friends, but we had very different views of the world at that time. I was saying from the outset that this was a crisis of global capitalism. But in 1997 Larry's view and Bob Rubin's view was that it was an Asian crisis, and, essentially, Asian policy management was the problem—Asian governments and Asian corruptions and collusions and the Asian structured economic system, which is quite close to the structure of the Japanese. I admitted that was a part of the problem, but I said that the problems had arisen both on the part of the borrowers and lenders, and the lenders were mostly Wall Street, so it was a problem created by both the borrowers and lenders; it was a problem of global economy. I think I was right. Rubin recognized that later when the crisis spread through Russia to Brazil and eventually to Wall Street itself. Wall Street was in crisis in September and October of 1998, so what started as an Asian crisis in 1996-97, and what started as an Argentinean and a Mexican crisis in 1994-95, eventually spread to Wall Street in '98. And so in September and October of 1998 the Rubin-Summers team was very tense. They then initiated a very aggressive policy to intervene when the American hedge fund Long Term Capital Management collapsed. They succeeded in staving off the crisis in the U.S. Their sense of urgency, their sense of crisis was very strong by then, but they didn't have that urgency in '97. They thought it was simply a regional crisis.

INTERVIEWER: What do you take as the most important lessons to come out of the Asian crisis and its global consequences?

EISUKE SAKAKIBARA: Well, one thing is that global capitalism we now have is inherently unstable, and we need to be prepared for the recurrence of this kind of global crisis. We don't have an international mechanism to really prevent a crisis or to manage them when they occur; although we have tried to create [such a mechanism] as much as possible after the crisis, it is not here. We have global markets, [but] we don't have a world central bank. It's very simple: If you have a global market, you've got to have a world central bank which can be a lender of last resort. In the domestic markets we have that; in internal markets we have a central bank which is a lender of last resort. So theoretically you have only two choices: One is to create a global lender of last resort; the other is to control, to limit the flows of capital in and out of individual countries. The latter turns out to be extremely difficult. And the creation of a world central bank is politically very difficult, so we have to tread a very difficult middle way, which is full of risks and problems.

Stanley Fischer

First Deputy Managing Director, International Monetary Fund, 1994-2001

The former second-ranking official of the IMF, Stanley Fischer believed that the global financial contagion of 1997-1998 was unlikely to repeat, but that other crises were inevitable.

The Roots of Contagion

INTERVIEWER: [The contagion that we observed in the Asian financial crisis was a new phenomenon.] What created the contagion?

STANLEY FISCHER: Some of the contagion was caused because [Asian] economies had certain similarities; some of it was caused because in the minds of investors, there were certain similarities; some of it was caused because there are mutual funds that invest in "emerging markets," so they treat emerging markets as a group; and some of it was caused because the things that happened to these economies, the real things, were reasonably similar. They were almost all hit by a decline in electronics exports at the end of 1996. They all had a weakness there, they all had stock markets which got overvalued and began to decline, so it was a mixture of valid reasons and some which relate to the structure of international capital flows that you wish you could change.

INTERVIEWER: Could we see crises like this in the future, or is this a once-in-the-century storm?

STANLEY FISCHER: There were elements of this set of crises that will probably not be repeated. Almost all those crises were related to fixed exchange rates, and they took the form of a tax on fixed exchange rates. We have, among the major emerging-market countries, very few fixed exchange rates now. The exchange rate can move, so the first shock absorber of any change is a movement in the exchange rate that was not possible in these countries at the time. So I think we've got much less reason to have that sort of crisis. We've also done a great deal of work, the IMF has, the international community has, to strengthen financial systems. And there was another source of weakness. That work goes on, but you can still have crises which come because countries have overborrowed, and you can still have crises because companies in countries have overborrowed. The markets can be very confident about country X one day, and then there's a recession in the United States or a change of government in that country, and the markets change their mind. Money could pour out, and they could need help again. I don't think we'll see a collection of crises on that scale any time soon, and I think we'll see fewer and fewer because we're getting more flexible exchange rates, but we will not be rid of crises.

Lessons from the Asian Crisis

INTERVIEWER: What are the lessons that we should take away from the Asian crisis?

STANLEY FISCHER: The first lesson of the Asian crisis is prevention is better than cure. Much of the work that we're doing now, much of the work that countries ought to be doing, is about strengthening their systems of corporate government—their financial system, their accounting standards, how their central banks operate, simple things which we in the industrialized world take for granted.... Those fundamentals need to be taken care of. That's the prevention element. You'll see all the Asian countries have built up their reserves, their foreign exchange reserves. Countries that have a lot of reserves were less badly hit by the crises. They've changed their exchange rate systems, as I've mentioned. The lessons I take away from the IMF, beyond prevention [being] better than cure, is [there is a necessity for] much closer surveillance, as we call it, much closer relationships with these countries, trying to stay on top of things; helping them; being very close to them, which we are in some countries, in order to try to anticipate things; being ready when the crisis comes to move very fast.... We're a much more limber institution than we used to be. To give you one example, in 1994, there were no news screens in this organization.... There were no Bloomberg [terminals] in this organization. They're all over the place now. Nothing happens now that we're not aware of the next moment. We didn't used to be like that seven years ago.

William McDonough

President, Federal Reserve Bank of New York

As president of the Federal Reserve Bank of New York, William McDonough was the central bank's link to private lenders to East Asia. He reflected on the psychology of investors during the crisis.

The Momentary Myth of Riskless Investment

INTERVIEWER: Let's talk about the events leading up to the Asian financial crisis. From your perspective in New York, what was your sense of what was going on [in Thailand], and how was it impacting on you?

WILLIAM McDONOUGH: In July of 1997, a world that had appeared to be deceptively calm became much less so when Thailand began to be the first pebble in the ongoing stream of problems, which came to be known as the Asian financial crisis. It spread throughout Asia. That had not been anticipated initially. It was thought to be more a problem specifically of Thailand, but it began to spread to its neighbors, and I think we all became especially concerned when it spread to South Korea, a country that had been thought to be very powerful, with a very resilient economy. At the end of 1997—in fact, in this very room on Christmas Eve, December 24, 1997—the major financial institutions of the world gathered at a meeting which I called, and we decided that it was not going to be possible for additional public-sector money from the International Monetary Fund or the World Bank, or certainly from bilateral governments putting taxpayers' money in, to continue to help Korea if the private sector was pulling its money out of Korea. That meeting led to a decision by the private banks that they would reschedule the bank debt of Korea. That took place, the decision was really made on December 24th. The actual details were resolved within the next two to three weeks.

Then a very, very strange thing happened. From about the first of February 1998 until August, when Russia defaulted on its debt, there was a period in which financial markets essentially decided that risk didn't exist anywhere, so the spread—the additional amount of interest that emerging-market countries had to pay or that junk-bond issuers had to pay to sell their debt in relation to the ultimate benchmark, the U.S. Treasury, the riskless security—became so small that it became very clear that investors everywhere had decided risk had disappeared.

Now, obviously that couldn't endure, and so when I look at the August default by Russia, essentially you were looking at an accident waiting to happen, and the only question is where would the accident take place, and at which street corner would cars collide with a bang? It happened to be Russia, and I think the reason that the Russian default was taken so seriously and just convulsed financial markets is that investors had decided Russia is an ex-superpower, and it has lots of missiles and lots of atomic warheads for them, and certainly you could not have a financial accident in Russia, because the rest of the world, the rich countries, would bail Russia out.

Well, it turned out that that was wrong. The international community had tried to help Russia through an International Monetary Fund program. It didn't work, wasn't working, and so Russia defaulted on its debt, and then there was a massive devaluation of its currency. All these people who, in the previous seven months, had decided there was no risk anywhere literally panicked and decided there's got to be massive risk everywhere. Behind each fence and barnyard wall there must be a risk that we hadn't though of, you know, like the redcoats retreating from Lexington. And that, I believe, led to the circumstance of the near collapse of Long Term Capital Management [LTCM]. The situation could well have happened in any event, but it required a triggering event, and the triggering event was the Russian devaluation and default.

Laura Tyson

Chair of the U.S. National Economic Council, 1993-1995

Senior economic advisor to U.S. President Clinton in 1995, Laura Tyson confronted the risk of contagion firsthand with the Mexican peso crisis. But Thailand, at first, seemed different.

We Didn't Expect "Spillover" to Become "Contagion"

INTERVIEWER: I know you were out of the government at the time, [but let's] talk about Asia, Russia, [Latin America]—[their financial] crises.

LAURA TYSON: In 1995 we thought that we had actually done something to prevent spillover. At that moment in time we [thought that way] because if you looked, there had been a few signs in Latin America and in Central Europe that there were going to be some spillover effects from a default in Mexico. Having precluded the default, we reined in the spillover effects. I think that the problems in '97-98 in the rest of the world show how our concerns were justified in the sense that I think everyone widely agrees that what we were worrying about and calling spillover effects in 1995 became contagion effects in '97 and '98, and they were extremely powerful. There were no particular reasons to expect Malaysia or Indonesia to be brought down by financial difficulties in Thailand. Thailand is a very small economy. It didn't have a lot of links to Malaysia or Indonesia. It's in the same general region of the world, but actually the links between those countries are primarily with developed countries, and not with one another. Malaysia and Indonesia absolutely had a political problem, but Indonesia didn't have any obvious sort of macroeconomic imbalances; nor did Malaysia. So you have a crisis in a small country, and it's not exactly in your backyard the way Mexico is.

Furthermore, the administration, and particularly the Treasury, had come under enormous criticism for the way in which the Mexico intervention had been financed through this stabilization fund of the Treasury. So the Treasury could not—and this tends to be forgotten—have done in the summer of 1997 what we chose to do in the winter of 1995, because the U.S. Congress had put a limitation on the use of the Treasury's funds to intervene in this way. In any event, the United States chose not to intervene in Thailand, thinking it was not going to spill over. Why would it? What effects the contagion would have were not apparent to anybody. And the administration didn't really have the capability to do much because it had one arm of discretion tied behind its back by congressional legislation that was due to expire in another year. So in this case, the contagion effects became very powerful, very, very fast. And it was really only when Korea became a serious issue toward the end of '97 that the United States really became engaged in trying to work both through the IMF and through the Treasury Department to try to get Korea's debt rescheduled. That was really the first major item of business.

Moises Naim

Editor, *Foreign Policy* Magazine; Minster of Industry and Trade of Venezuela, 1989-1990

Editor of Foreign Policy *magazine, Moises Naim believed that the financial crises of the 1990s at least showed the need for better rules and institutions.*

Averting Contagion: Is It the Architecture or the Plumbing?

INTERVIEWER: Was the global contagion of '97-98 a precursor to the kind of things we are likely to see?

MOISES NAIM: Yes. The financial crises of the '90s have had very positive effects. First, they showed that you can't have a crisis and not have its effect lingering for decades. When we had a financial crisis in the in 1980s, it [took] 10 years to play itself out and to get cured. In the '90s, we had crises that eventually got solved in two or three years, for the most part. But also it immediately created the need for rules and institutions that are now in place, [which] more or less ensure that that type of crisis we will not have [again]. We will have others for which we're not prepared, but the crisis of the '90s did create series of measures that, [though] not sufficient, created some progress in the creation of institutions that deal with this type of emergency.

INTERVIEWER: And what are the institutions that would prevent that [kind of contagion from] happening again?

MOISES NAIM: The 1990s contagion was very different, but there are all sorts of measures that have to do with accounting standards. There is a debate in these circles between the architects and the plumbers. The architects say you need to change the whole architecture of the global financial system. The plumbers say forget it—you're not going to get the... political will to do all of this; what we need to change is the wiring and the plumbing of the financial system. We'll deal with very technical, very specific things, that, while not being solutions to the problem, can be very effective in creating early warnings, in creating better remedies, in trying to anticipate some of these things before they happen and reacting better when they [do] happen. That doesn't mean that the world is immune to a widespread financial crisis, because we don't know, by definition, what form it will take, but we know that the types of problems that triggered the crisis of the '90s are not going to generate similar types [of problems] because some remedies are in place. We will have others, however, for which we are not prepared.

Dr. Mahathir bin Mohamad

Prime Minister of Malaysia

For Malaysia's prime minister Mahathir, a sound economy with good "fundamentals" was little comfort against the financial crisis.

Currency Speculation Puts Even "Safe" Economies at Risk

INTERVIEWER: The Asian crisis first hits Thailand. Were you watching from Malaysia? What was your first impression of it, and did you think it was going to expand? Did you have any idea it was going to reach this contagion level?

DR. MAHATHIR BIN MOHAMAD: No, I thought this is something that cannot happen to Malaysia. We have a very sound economy; we have good reserves; we have been very conservative in the management of our finances; and we have this currency that has been able to pull us through even in the worst times. So I did not think that it would come to Malaysia, certainly not on the scale that would eventually be experienced.

INTERVIEWER: Did the head of the IMF come here before the crisis and praise Malaysia on its extremely strong fundamentals?

DR. MAHATHIR BIN MOHAMAD: Yes, the IMF praised the governor of the Central Bank for his very good management of the finances of this country.... We really [did] believe [that we had] sufficient strength to weather any downturn.

INTERVIEWER: In Mexico, the crisis hits; America goes in to help. In Thailand, crisis hits; they ask America to help; nothing happened. What's your feeling about that?

DR. MAHATHIR BIN MOHAMAD: Maybe Thailand's economy is not so closely interlinked with that of America. The amount of American investments there may not be as big, so the interests are less as compared to Mexico.

INTERVIEWER: After the crisis in Thailand, why was Malaysia, Indonesia, Korea, why were not they not able to stop it [from] spreading to them?

DR. MAHATHIR BIN MOHAMAD: Because we have no say in controlling currency speculation. They can speculate with any currency, and their speculation is so designed that they can either revalue a currency or devalue a currency to any level. They hold this power, and they can literally make or break you by just by doing that. It has nothing to do with bad government or corruption or not being transparent, because if you are a bad government then long ago our currency would have collapsed. Long ago we would not be able to build up the country. But [it] is the same government, ... exactly the same government which has built up the economy of this country, and yet suddenly we are being told that is due to our bad government that the currency is collapsing. We don't believe that. We believe that it was due to people just selling off our currency, selling down our currencies. That's why it was devalued, not otherwise.