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# The Asian Economic Crisis

This paper considers the economic crisis that began in the financial markets of South East Asia in 1997 and the consequences for the economies of the region and the rest of the world.

The paper provides a chronology of and explores the factors that led to the crisis.

An overview is given of the policy measures that the international financial institutions (IFIs), such as the IMF, have taken to deal with the crisis. Some of the arguments and policy proposals made to try to avoid future crises are also covered.

Eshan Karunatilleka

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# Summary of main points

During 1998, the world economy has entered a slowdown, which originated in South East Asia. The Asian Crisis has caused severe economic turbulence in the economies of South East Asia since the summer of 1997. There have been two distinct phases to the Asian Crisis: the first from July 1997 to December 1997, when the first international assistance was provided, and the second since mid-1998, when the turbulence has spread beyond the region as Russia, China and Brazil have shown signs of contagion. This crisis was initially a financial one as speculation caused funds to drain out of Thai and Korean currencies and stock markets. The crisis eventually caused economic growth rates to collapse in several South East Asian countries.

Even before the summer of 1997, there had been doubts about the sustainability of certain economic policies followed by the South East Asian countries, especially the policy of unofficially fixing their exchange rates to the US dollar. The appreciation of the US dollar that began in 1995, in particular against the Japanese yen, caused the South East Asian currencies to also appreciate against third-party currencies. This resulted in lost competitiveness in export markets and worsening current account deficits. Many countries found it increasingly difficult to fund their current account deficits.

Events came to a head when, following an intense period of speculation in foreign exchange markets, the Thai baht was devalued in July 1997. Subsequent speculative attacks and devaluations followed in Malaysia, Korea, the Philippines, Indonesia, Taiwan and Singapore. The financial crisis severely undermined public finances in a number of countries and prompted the IMF to organise a rescue package totalling $112 billion for Thailand, Korea and Indonesia. Despite this support, interest rates rose sharply, causing many companies to become bankrupt as the cost of borrowing rose. Foreign and domestic investors withdrew funds. The region experienced a collapse in the level of economic activity while the number of bankruptcies and level of private sector debt escalated.

After a period of apparent stability in world markets in early 1998, the crisis was re-ignited in mid-1998 and spread to markets in advanced economies, beginning with Japan. The threat to the rest of the world economy became more obvious to western governments. The repercussions of the financial crisis in South East Asia have led to falls in export orders, lower equity markets and cancelled inward investment. The crisis has prompted concerns about the health of the international financial system and the threat of systemic risk.

In addition to managing the rescue package, the IMF has played the leading role in encouraging change in the South East Asian economies, especially by developing plans to restructure banks. However, the Asian Crisis has also led to proposals for longer-term measures to prevent such events in future. These proposals include agreeing global standards for banking regulation, enhancing the quality of economic statistics and improving the levels of information available to investors in emerging market economies.

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# I Introduction: South East Asia Before the Crisis

> The economies of east Asia at the centre of the recent crisis have been some of the most successful emerging market countries in terms of growth and gains in living standards. With generally prudent fiscal policies and high private saving rates, these countries had become a model for many others. That this region might become embroiled in one of the worst financial crises in the post-war period was hardly ever considered - within or outside the region - a realistic possibility. What went wrong? Part of the answer seems to be that these countries became victims of their own success. This success had led domestic and foreign investors to underestimate the countries' economic weaknesses.[1]

During 1998, it became increasingly apparent that the global economy was heading towards a period of slower growth, with a quarter of the world economy in recession and world trade growth set to fall by two-thirds.[2] These trends began with the Asian Crisis. The countries at the heart of the Asian Crisis are the same countries that had, for the previous two decades, shown spectacular economic growth that was the envy of the world: Korea, Singapore, the Hong Kong Special Administrative Region (SAR), Taiwan, Thailand, Indonesia, Malaysia and the Philippines.

Until the advent of the crisis in 1997, these 'Asian Tigers' had been held up to developing nations as prime examples of how to progress. Any doubts about their economic policies were easily dismissed, given their spectacular record of economic growth. For example, in 1997 the World Bank commented:

> East Asia's capacity to sustain rapid growth is without precedent. The only significant group of countries to close the gap with the industrialised economies over the past few decades, their growth has averaged 7 percent per year in real terms since the mid-1970s, accelerating to 9 percent per year in the 1990s.
>
> While the region continued to be a major recipient of private capital flows and a growing world trade player, a slowdown of exports and macroeconomic performance in 1996 raised questions about whether the East Asian "miracle" is over. After years of double-digit growth, export growth slowed, and some countries experienced large current account deficits. Although this highlighted some structural issues, it mostly reflected one-off, or cyclical events, and the successful cooling of overheated economies rather than an end to sustained economic growth. Indeed, exports and overall economic growth recovered in the first half 1997, albeit below past levels. The large current account deficits, driven by high private inflows rather than low domestic savings, reflect some short-run vulnerabilities. And although there are some concerns about the fragility of the region's banking systems, the risks of loss of confidence in banking systems would be easy to overstate, since most East Asian countries have a more robust external and fiscal position than countries that have faced banking crises elsewhere. The prospects for continued high growth in coming years remain sound, provided countries undertake the necessary important reforms.[3]

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1 International Monetary Fund, *World Economic Outlook*, May 1998 p 3

2 Pre-Budget Statement by the Chancellor of the Exchequer, HC Deb 3 November 1998 c682

3 "East Asia & Pacific", *World Bank Annual Report 1997*, 19 September 1997

Traditionally, the main problem for policy makers in the region was how to avoid 'overheating':

> Growth in the late 1980s was export-led and resulted in severe labour shortages that, in turn, fuelled sharp rises in real wages. Average nominal wages in manufacturing doubled between 1987 and 1991 in Korea, and they rose 60% in Taiwan. These rapid wage increases spurred the growth of private consumption.[4]

The problem for these countries was therefore to accommodate rapid increases in consumption as well as rapid increases in investment and to alleviate the consequential inflationary effects. Before the crisis, they had been relatively successful in curbing inflation, as shown in table 1 below.

Table 1

**Key Variables in 1996: The Asian Tigers Before the Crisis**

| | Investment as a Proportion of GDP (a) | Gross Savings Rate | Trade as a Proportion of GDP (b) | Share of World GDP | Real GDP Growth | Consumer Inflation |
|---|---|---|---|---|---|---|
| Hong Kong | 31.3% | 30.6% | 122.9% | 0.6% | 4.9% | 6.0% |
| Indonesia | 32.1% | 31.2% | 20.4% | 0.8% | 8.0% | 7.9% |
| Malaysia | 42.2% | 42.6% | 78.9% | 0.4% | 8.6% | 3.5% |
| Philippines | 23.2% | 15.6% | 31.2% | 0.3% | 5.7% | 8.4% |
| Singapore | 36.5% | 50.1% | .. .. | 0.3% | 6.9% | 1.4% |
| South Korea | 36.8% | 35.2% | 28.9% | 1.8% | 7.1% | 4.9% |
| Taiwan | 21.2% | 25.1% | 40.1% | 1.0% | 5.7% | 3.1% |
| Thailand | 42.2% | 35.9% | 34.9% | 0.7% | 5.5% | 5.8% |

Notes: (a) GFCF plus inventories (GFCF only in the cases of Hong Kong and Singapore)
(b) Average value of exports plus imports as a proportion of GDP (including re-exports in the case of Hong Kong, given its status as an entrepôt)

*Sources: Goldman Sachs, "International Economics Analyst", February/March 1998 p xii; IMF, "World Economic Outlook", May 1998 tables 5 & A2; BIS, "68th Annual Report", 1998 table III.2; IMF, "World Economic Outlook: Interim Assessment", December 1997 table A1; ROC Council for Economic Planning and Development, Taiwan Statistical Data Book 1998, June 1998 tables 3.1, 3.14a, 3.9 & 11.4; Government Information Services Department, "Hong Kong 1997", appendix 6*

Because of the semi-authoritarian governments in these countries, the maintenance of political stability also required that economic growth be rapid. There seemed to be an implicit pact between the populace and leadership that some political liberty could be sacrificed in order to pursue economic objectives.[5]

Policymakers would swing between imposing austerity packages to prevent overheating and reflationary packages to stimulate growth. The most difficult combination of all

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4 OECD, *OECD Economic Outlook No. 54*, December 1993 p 119

5 Peter Montagnon, "Needed: Another Miracle", *Financial Times*, 23 December 1997

would prove to be to sustain high levels of consumption simultaneously with high levels of investment without running into a balance of payments problem.

# II The Chronology of Events

It is convenient to consider the events surrounding the Asian Crisis in two phases. The first phase covers events from 1996, through the onset of the crisis, and the provision of IMF emergency funding. The second phase covers the period from May 1998 to the present, when a brief period of stabilisation was followed by a renewed bout of financial turbulence as the crisis spread to Russia and Brazil.

| Date | Event | Follow-Up Commentary |
|---|---|---|
| 1996 and Early 1997 | The Thai baht is under speculative attack during 1996 and early 1997. | Thai stock markets fall throughout 1996 and early 1997. |
| Early 1997 | There are seven high-profile bankruptcies of Korean conglomerates, such as Hanbo Steel and Kia Motors. | Korea's economy is very dependent on manufacturing-based enterprises, especially large industrial conglomerates known as chaebol, which dominate the economy. |
| May 1997 | Thailand is forced to impose certain exchange controls. | On 27 June, the largest non-bank financial institution in Thailand becomes bankrupt. By the end of the year, fifty-six such finance houses are closed down. |
| 2 July 1997 | The baht's peg against the dollar is officially abandoned. | Hedge funds play a major role in this first devaluation of an Asian Crisis currency. |
| July 1997 | The Philippines abandons its dollar-peg and imposes certain foreign exchange controls. Malaysia also abandons its pegged exchange rate. | Overnight interest rates are raised in the Philippines to 32% at one point, whereas Malaysia introduces capital controls. |
| 14 August 1997 | Indonesia raises interest rates but lowers them from late August, as it devalues the rupiah on 14 August. | |
| 20 August 1997 | The IMF puts together a $17.2 billion Thai rescue. | The letters of agreement with the IMF have since been re-negotiated five times. |
| August 1997 | The Hong Kong dollar comes under speculative attack. | |
| Mid-October 1997 | Devaluations vis-à-vis the dollar average 20% to 30% in Thailand, Indonesia, Malaysia and the Philippines. | Stock markets in the western economies are still setting new highs. |

| Date | Event | Comments and References |
|---|---|---|
| 17 October | The New Taiwan dollar is forced to devalue; the Hong Kong dollar is attacked again. | Hong Kong overnight interest rates rise to 280%, the Hang Seng index fall 23% in three days. The crisis worsens when Korea's sovereign credit rating is downgraded. |
| 27 October | The Dow Jones Index on Wall Street falls by 7% in one day. | Latin American stock markets fall in tandem with the Dow Jones index and Brazil doubles overnight interest rates to 43%. |
| November 1997 | President Clinton calls the developing crisis "a few small glitches in the road". | For most of late 1997, Western stock markets fall, before recovering to new all-time highs in 1998. However, the fourth largest investment bank in Japan, Yamaichi Securities, goes bankrupt on 24 November. |
| 5 November 1997 | Indonesia finalises a deal with the IMF for funding that could total up to $42.3 billion. | Although the Indonesian authorities close 16 insolvent banks on 1 November, the IMF deal is re negotiated three times as the government is unwilling to meet all the conditions it imposes. |
| 4 December 1997 | The IMF organises a $58.2 billion rescue for Korea. | The Korean won is eventually allowed to float on 16 December. |
| December 1997 | Talks led by the US Federal Reserve lead to $22 billion of Korea's private-sector debts being re-negotiated. | In April 1998, Korea manages to re-negotiate $24 billion of sovereign short-term debt as well. |
| 12 January 1998 | The largest investment bank in Hong Kong, Peregrine Securities, goes bankrupt. | |

After a short period of some stabilisation in world markets in the early part of 1998, the Asian Crisis seemed to be settling. However, by May 1998 it seemed that a second phase was starting, as the situation worsened in South East Asia itself and the crisis spread to Russia, Brazil and the West

| Date | Event | Comments and References |
|---|---|---|
| 21 May 1998 | Riots in Indonesia lead to the resignation of President Suharto. | There is a change of government in the Philippines, as President Estrada is elected. |
| June 1998 | The second phase of the crisis, 'Asia II', begins with another speculative attack on the Hong Kong dollar. | Prompted by the Japanese economy contracting in the first half of 1998, the Bank of Japan cuts short term interest rates to 0.25% from 0.50%. |

| Date | Event | Comments and References |
|---|---|---|
| 17 June 1998 | The United States begins to intervene in the foreign exchange markets, attempting to support the Japanese yen for the first time since 1987. | The weakness of the yen causes additional pressure on Asian Crisis currencies because of the linkages between these economies. |
| June 1998 | The Hong Kong dollar peg is defended by the authorities with market intervention. | Concurrently, Hong Kong authorities instigate a plan to intervene in the stock market with public funds to stop it falling. In Singapore, the government introduces measures to curb property transactions to stop prices falling. |
| 12 July 1998 | Poor results in the Upper House Elections causes Japanese Prime Minister Hashimoto to lose power. | |
| June and July 1998 | Latin American countries are forced into a series of knock-on currency devaluations. | Brazil attempts to prevent a devaluation by pre-emptively imposing economic stringency; the authorities intervene the foreign exchange markets to defend the real and raise short-term interest rates in two stages, from 19% to almost 50%. |
| July 1998 | Sharp falls in western stock markets of approximately a quarter of their value | The cause is the emergence of problems in Russia, a recipient of investment inflows from Western Europe. |
| 20 July 1998 | The IMF agrees to a $5.6 billion Russian rescue deal. | The Russian monetary authorities raise overnight interest rates to over 100%. |
| August 1998 | The Hong Kong dollar is attacked again and $8.8 billion is spent defending it. | In Taiwan, slowing growth leads the government to enact a two-year, $5.7 billion, economic stimulus package. |
| 17 August 1998 | There is a de facto devaluation of the Russian ruble; exchange controls are imposed. | Western markets fall as Russian authorities declare a ninety-day moratorium on the payment of private sector foreign currency debt. |
| 1 September 1998 | Malaysia imposes more capital controls; the ringgit is fixed at RM3.80 to the dollar. | |
| 2 September 1998 | The Russian central bank stops defending the currency. | Russian Government defaults on its sovereign obligations later in September. |
| September 1998 | As real economic activity contracts, Korea lowers short-term interest rates. | |
| 15 January 1999 | Brazil is forced to allow its currency to float freely. | |

# III Factors Behind the Asian Crisis

The explanation for the Asian Crisis has been the subject of much argument. There is no easy consensus to be reached on what lay behind the problems of these afflicted economies. As noted in the introduction, not so long ago, many aspects of their economies had been thought praiseworthy. It is possible, however, to make a distinction between underlying weaknesses in the South East Asian economies and the initial triggers that brought events to a head.

## A. Underlying Causes of the Asian Crisis

This section seeks to identify some of the underlying factors that made South East Asia susceptible to financial crisis. A number of 'structural' weaknesses in these economies have been suggested: South East Asia's current account deficit, over-inflated asset prices, excess lending, corruption and macroeconomic policy mistakes.

### 1. Unsustainable Current Account Deficits

Most of the South East Asian economies in crisis had large current account deficits (see table 2 below), in some cases exceeding 5% of their GDP. These deficits were financed by attracting inflows of capital from abroad, often short-term capital.

Table 2

**Current Account Positions of the Asian Crisis Economies**

| | | 1995 | | 1996 | | 1997 | |
|---|---|---|---|---|---|---|---|
| | | % of GDP (%) | US dollars ($ billions) | % of GDP (%) | US dollars ($ billions) | % of GDP (%) | US dollars ($ billions) |
| Hong Kong | (a) | -3.9 | -5.5 | -1.1 | -1.6 | -3.2 | -5.5 |
| Singapore | | 16.8 | 14.3 | 15.7 | 14.6 | 15.4 | 14.8 |
| Malaysia | | -10.0 | -8.7 | -4.9 | -4.9 | -4.8 | -4.8 |
| Indonesia | | -3.3 | -6.8 | -3.3 | -7.6 | -1.8 | -3.9 |
| Taiwan | | 2.1 | 5.5 | 4.0 | 11.0 | 2.7 | 7.7 |
| Korea | | -2.0 | -8.5 | -4.9 | -23.0 | -2.0 | -8.2 |
| Thailand | | -7.9 | -13.2 | -7.9 | -14.4 | -2.0 | -3.0 |
| Philippines | | -4.4 | -3.3 | -4.7 | -3.9 | -5.2 | -4.3 |

Notes: (a) Includes only goods and value-added services

*Sources: IMF, "World Economic Outlook", May 1998 table 10 & October 1998 table 2.11*

Inflows from overseas on such a large scale were a new phenomenon. Many governments, especially in developing countries, had previously resisted full capital mobility, as one academic has noted:

> The apprehension regarding the opening of the capital account - or at least its rapid opening - goes beyond traditional nationalistic views, and is based on both macroeconomic and microeconomic arguments...It is often argued that under capital mobility the national authorities lose (some) control over monetary policy, and that

> the economy will become more vulnerable to external shocks...Moreover, sometimes it has been argued that full capital mobility will result in 'overborrowing' and, eventually, in a major debt crisis as in Latin America in 1982. Other concerns regarding the liberalization of capital movements relate to increased real exchange rate instability, and loss of international competitiveness. Still other analysts pointed out that the premature opening of the capital account could lead to massive capital flight from the country in question.[6]

During the 1990s, following financial deregulation and capital liberalisation in the West, international institutions began to encourage developing countries to move towards free capital markets as well. It was particularly welcome in South East Asia, because the foreign capital was ostensibly for investment:

> With fiscal positions healthy in most cases, the sizeable external current account deficits being run up persistently in some cases - most notably in Malaysia and Thailand - reflected not public sector dissaving but shortfalls of private saving relative to private investment; and such deficits, it could be argued, were not a matter for policy concern if monetary policy was set appropriately and private sector decisions were not subject to significant distortions.[7]

The idea that a country's current account deficit is of no concern provided it is the result of the private sector and not the public sector (and is used for investment not consumption), has been referred to as the 'Lawson Doctrine'. It was proposed by the then Chancellor, Nigel Lawson, in a speech to the IMF and World Bank in September 1988.[8] The problem is not that the free movement of capital is a danger for developing economies per se, rather that a country could become excessively dependent on foreign short-term capital flows.

Table 3 below provides an indication the size of the capital inflows into the Asian Crisis economies. Capital inflows from the private sector are shown, broken down between foreign direct investment (FDI) made for the purposes of ownership (for example in factories) and portfolio investment in financial markets.

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6 Sebastian Edwards, *Capital Controls, Exchange Rates and Monetary Policy in the World Economy*, p 2

7 IMF, *World Economic Outlook: Interim Assessment*, December 1997 p 3

8 The IMF has also noted that the limitations of the Lawson Doctrine were exposed by the experience of the United Kingdom itself in 1988, when the policy of shadowing the deutschemark was abandoned by the government as sterling appreciated above a value of DM3.00 (see IMF, *World Economic Outlook: Interim Assessment*, December 1997 p 3).

Table 3

**Asian Economies' Capital Flows as a Proportion of GDP** (%)

(a)

| | | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 |
|---|---|---|---|---|---|---|---|
| Indonesia: Net Private Capital Inflows | | 4.6 | 2.5 | 3.1 | 3.9 | 6.2 | 6.3 |
| *of which:* foreign direct investment | | 1.2 | 1.2 | 1.2 | 1.4 | 2.3 | 2.8 |
| portfolio investment | | 0.0 | 0.0 | 1.1 | 0.6 | 0.7 | 0.8 |
| Taiwan: Net Private Capital Inflows | (b) | -1.2 | -3.2 | -2.1 | -0.6 | -3.6 | -3.2 |
| *of which:* foreign direct investment | | -0.3 | -0.5 | -0.7 | -0.5 | -0.4 | -0.7 |
| portfolio investment | | .. .. | 0.2 | 0.5 | 0.4 | 0.2 | -0.4 |
| Korea: Net Private Capital Inflows | | 2.2 | 2.4 | 1.6 | 3.1 | 3.9 | 4.9 |
| *of which:* foreign direct investment | | -0.1 | -0.2 | -0.2 | -0.3 | -0.4 | -0.4 |
| portfolio investment | | 1.1 | 1.9 | 3.2 | 1.8 | 1.9 | 2.3 |
| Malaysia: Net Private Capital Inflows | | 11.2 | 15.1 | 17.4 | 1.5 | 8.8 | 9.6 |
| *of which:* foreign direct investment | | 8.3 | 8.9 | 7.8 | 5.7 | 4.8 | 5.1 |
| portfolio investment | | n/a | n/a | n/a | n/a | n/a | n/a |
| Philippines: Net Private Capital Inflows | | 1.6 | 2 | 2.6 | 5 | 4.6 | 9.8 |
| *of which:* foreign direct investment | | 1.2 | 1.3 | 1.6 | 2 | 1.8 | 1.6 |
| portfolio investment | | 0.3 | 0.1 | -0.1 | 0.4 | 0.3 | -0.2 |
| Singapore: Net Private Capital Inflows | | 1.7 | -2.7 | 9.4 | 2.5 | 1.3 | -10.1 |
| *of which:* foreign direct investment | | 8.8 | 2.1 | 5.5 | 4.8 | 4.9 | 4.3 |
| portfolio investment | | -2.1 | 3.3 | 0.5 | 1.1 | 0.9 | -16.2 |
| Thailand: Net Private Capital Inflows | | 10.7 | 8.7 | 8.4 | 8.6 | 12.7 | 9.3 |
| *of which:* foreign direct investment | | 1.5 | 1.4 | 1.1 | 0.7 | 0.7 | 0.9 |
| portfolio investment | | 0.0 | 0.5 | 3.2 | 0.9 | 1.9 | 0.6 |

Notes: (a) As well as foreign direct investment (FDI) and portfolio investment, official financing and private sector borrowing contribute to a country's capital inflows

(b) A negative sign indicates an outflow of capital from the country

*Source: IMF, "World Economic Outlook: Interim Assessment", December 1997 table 1*

## 2. Over-Dependence on Short-Term Foreign Funds

The problem in the South East Asian countries was not merely allowing deleterious current account positions to build up, but of the form that they took. Driving a large part of their capital inflows were lending booms, which led domestic banks in a number of these economies to actively seek foreign funds from the West to finance the lending. The banks were motivated by the prospect of large profits, especially as they could take advantage of fixed exchange rates in order to reduce the cost of this borrowing. However, as the IMF has noted, the borrowing from foreign sources became excessive:

> In Korea, in particular, substantial difficulties accumulated in the financial sector as a result of a combination of weaknesses both in that sector and, more generally, in the financial structure of the Korean economy. Large corporate conglomerates (**chaebol**) became heavily dependent on debt as opposed to equity

> finance, with much of the corporate debt supplied directly by, or guaranteed by, Korean financial institutions...[9]

The same motives led blue chip companies to borrow excessively from overseas, rather than pay higher domestic interest rates. Even Asian borrowers with sound businesses would raise capital abroad to finance industrial development. Excessive leverage in financial markets is most often the cause of extreme booms and crashes:[10] in South East Asia, the excessive leverage was in foreign liabilities. For example, foreign liabilities amounted to 24% of all bank liabilities in 1996 in Thailand just before the crisis erupted (this compares with only a 6% proportion in 1992).[11] As can be seen in table 4 below, lending to South East Asia by western banks was considerable, with Japanese banks the largest lenders.[12]

Table 4

**Exposure of Banks from Western Countries to Asia: June 1997** (a) ($ billions)

| Exposure to: | | Japanese Banks | French Banks | German Banks | UK Banks | US Banks | Other European Banks (b) | Total |
|---|---|---|---|---|---|---|---|---|
| China | | 18.7 | 7.3 | 6.9 | 6.9 | 2.9 | 7.0 | 57.9 |
| Hong Kong | (c) | 87.4 | 12.8 | 32.2 | 30.1 | 8.8 | 24.4 | 222.3 |
| Indonesia | | 23.2 | 4.8 | 5.6 | 4.3 | 4.6 | 7.8 | 58.7 |
| Malaysia | | 10.5 | 2.9 | 5.7 | 2.0 | 2.4 | 2.1 | 28.8 |
| Philippines | | 2.1 | 1.7 | 2.0 | 1.1 | 2.8 | 2.0 | 14.1 |
| Singapore | (c) | 65.0 | 15.4 | 38.4 | 25.2 | 5.2 | 34.3 | 211.2 |
| South Korea | | 23.7 | 10.1 | 10.8 | 6.1 | 10.0 | 9.3 | 103.4 |
| Taiwan | | 3.0 | 5.2 | 3.0 | 3.2 | 2.5 | 3.0 | 25.2 |
| Thailand | | 37.7 | 5.1 | 7.6 | 2.8 | 4.0 | 4.3 | 69.4 |
| Total | | 271.3 | 65.3 | 112.2 | 81.7 | 43.2 | 94.2 | 791.0 |

Notes: (a) Data are for total lending as of June 1997
(b) Banks from Austria, Belgium, Denmark, Finland, Ireland, Italy, Luxembourg, Netherlands, Norway, Spain and Sweden
(c) Includes large amounts of funds on-loaned from these two off-shore banking centres

*Sources: Bank for International Settlements, "The Maturity, Sectoral and Nationality Distribution of International Bank Lending, First Half of 1997", reproduced in "Picking Up the Pieces", The Banker, April 1998 p 58*

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9 IMF, *World Economic Outlook: Interim Assessment*, December 1997 pp 12-13

10 Following the near collapse, in the first week of October this year, of the well known LTCM hedge fund (a hedge fund is a speculative investment vehicle) in New York, it was reported that the fund had borrowed up to forty times the amount of capital it actually possessed. Similarly, an unusually severe US Government bond market crash in 1994 is now widely thought to have been exacerbated by the unwinding of various speculative financial derivatives trades.

11 IMF, *World Economic Outlook: Interim Assessment*, December 1997 p 9

12 The amounts of lending shown table 4 represent, respectively, some 3¼% of European Union GDP, 5% of Japanese GDP and 1% of United States GDP (see IMF, *World Economic Outlook*, May 1998 p 25).

An additional problem was the short-term nature of the foreign debts. Short-term borrowing (i.e. loans of less than a year's duration) meant that there was a need for the banks' accounts always to be liquid. In Thailand, which had the weakest position of the Asian Tigers in this regard, short-term capital inflows formed the majority of all capital inflows and hovered between 7% and 10% of GDP in each year from 1994 to 1996.[13] Given their overseas origin, such short-term obligations left the banks searching for rollover funds if existing loans were ever called in. One academic commentator has pointed out the consequences of such a strategy:

> The final lesson to be learnt is that the composition of foreign borrowing matters a good deal for crisis vulnerability. As suggested earlier, while borrowers can reduce the cost of borrowing by assuming rollover and currency risk, there is accumulating evidence that this strategy is penny wise and pound foolish for most emerging economies. Heavy reliance on short-term, foreign-currency denominated borrowing makes it easier to get into a crisis and tougher to get out of one, and when the true costs of this borrowing strategy are included in the overall calculus, the true cost of this borrowing strategy can be expensive indeed.[14]

Data from the Bank for International Settlements show that, as of June 1997, 66% of outstanding loans to Thailand were short-term, 68% of outstanding loans to South Korea were short-term,[15] 59% of outstanding loans to Indonesian banks were short-term and 56% of loans to Malaysia were short-term.[16]

South East Asian banks apparently overlooked problems as they were developing, causing the crisis to erupt suddenly. Existing loans collateralised with stock/property assets were already failing. Banks, both domestic and western, and regulators all seemed to overlook the risk that a high proportion of loans were becoming valueless, i.e. ceasing to receive interest payments. The central bank in Thailand has revealed that 8% of major commercial banks' loans were non-performing[17] at the outbreak of the Asian Crisis, a figure that would have worsened considerably since then.[18] The Korean Office of Bank Supervision has said that non-performing loans amounted to approximately 6% of total lending when the Asian Crisis erupted (although private sector analysts think the actual figure is likely to have been three times this level).[19] The corresponding figure for the Philippines in June 1997 was something over 3%.[20]

The noted economist, Paul Krugman, has argued that such behaviour by South East Asian banks amounted to more than a mere carefree attitude. He has theorised that the liabilities

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13 IMF, *World Economic Outlook: Interim Assessment*, December 1997 p 4

14 M. Goldstein, "Early Warning Indicators of Currency and Banking Crises in Merging Economies", *Financial Crises and Asia*, pp 51-52

15 "Japanese Banks Lead Lending to Asian Countries: BIS Survey", *The Nikkei*, downloaded from the newspaper at http://satellite.nikkei.co.jp/enews/SPECIAL/market/news21.html#gen91

16 "Picking Up the Pieces", *The Banker*, April 1998 p 58

17 Non-performing loans (NPLs) are those for which interest payments are more than six months overdue.

18 Data as of June 1997, quoted in "Asian Meltdown", *The Banker*, December 1997 p 40

19 "Beware of Recession", *The Banker*, April 1998 p 55

20 "Asian Meltdown", *The Banker*, December 1997 p 43

of the financial sector were perceived to have an 'implicit guarantee' attached to them.[21] Frequently, the failure on the part of investors, as well as lenders, to subject lending decisions to a true test of risk and return was due to this implicit protection. The process has been explained as follows:[22]

> Banks also financed (sometimes with official guidance) corporate investment plans that were focused on increasing market share with inadequate attention to the returns generated…
>
> …This extraordinary expansion took place not primarily because of new and highly profitable opportunities, but because banks in the countries where credit expanded fastest accepted increasingly narrow interest margins even as riskier business was being undertaken...The less efficient banks were not forced to leave the industry or to merge with more efficient banks; instead, government guarantees, implicit or explicit, kept such banks afloat...[23]

## 3. Poor Regulation of the Economy

A third contributory factor to the Asian Crisis has been the absence of an adequate regulatory framework for businesses, especially the banks, in South East Asia. This omission allowed unsound and possibly corrupt relationships to develop. In Korea, for example, it was not unusual that one division of a chaebol would be a bank, lending to other divisions of the same chaebol. With easy access to funds, it is no surprise that some investments were made in dubious ventures, as pointed out by *Financial Times* columnist Robert Chote:

> These institutions [banks] were essentially unregulated - loan classification and provisioning practices were too lax; there was too much 'connected lending' to bank directors, managers and their related businesses; there was excessive government ownership or involvement in the institutions; and the quality of public disclosure and transparency requirements was also poor. The institutions were also not required to hold sufficient equity in their balance sheets. As a result, they were subject to a severe moral hazard[24] problem in which the owners

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[21] P. Krugman, "What Happened to Asia?", January 1998, available online at his website @ internet address http://web.mit.edu/krugman/www/DISINTER.html

[22] During 1995 and much of 1996, international bank lending to non-banks in Asia rose sharply, with flows to Indonesia, Korea, Malaysia, the Philippines and Thailand reaching an annual rate of $15 billion. In addition, BIS estimates suggest that international interbank borrowing by banks in the five countries most affected by the crisis was running at an annual rate of about $43 billion during the same period. About 40% of total lending were denominated in yen and the remainder mainly in dollars; two-thirds had a maturity of less than one year. European banks, whose involvement in the early stages of the boom had been relatively modest, accounted for more than half of lending to this group of countries between the beginning of 1995 and mid-1997. Banks in Asia on-lent these funds to domestic borrowers, often to finance essentially local business.
The country in which foreign currency denomination of local loans went furthest was Indonesia, where about one-third of domestic banks' balance sheets was denominated in foreign currency. See Bank for International Settlements, *68th Annual Report*, 1998 p 123.

[23] Bank for International Settlements, *68th Annual Report*, 1998 p 118

[24] Moral hazard is the term applied in economics to the idea that providing aid to organisations in distress will cause them to behave in a less than optimal moral way, i.e. the provision of insurance against a risk encourages behaviour that makes the risk more likely to come to pass (because lenders know they will be bailed out if lending decisions prove to be incorrect).

> of the institutions were encouraged to engage in excessively risky lending in the expectation that they would be bailed out if things went wrong…[25]

Often, lending to the corporate sector by banks was actually taken out of the hands of the banks and administered by governments:

> ...The vulnerability of the banking system was increased not only by large exposures to chaebol, but also by directed lending (with banks required to allocate a certain proportion of marginal loans to small and medium-sized enterprises), politically influenced lending, and regulations and institutional factors that combined to encourage the channelling of international borrowing through the financial system for on-lending to corporations.[26]

A further insight into these weakly regulated economies is highlighted by the fact that it was only in 1993 that Korea passed a law, which was contentious at the time, that all financial transactions had to be conducted with parties using their real names rather than pseudonyms.[27]

Such practices have been dubbed 'crony capitalism'. They have been defended by some as a continuation, in a modern guise, of a tradition in the region of allowing networks of inter-related corporations to act together, which saw family-owned businesses wield considerable influence. It is debatable whether such 'Asian Values' have contributed to South East Asia's success in the past or ultimately exacerbated the present crisis. For example, in Indonesia banks would never refuse to lend to businesses owned by branches of the ruling Suharto family: the lenders could not conceive that the borrowers would allow debts to go unpaid, even where a particular investment failed.

### 4. Over-Inflated Asset Prices

Another weakness of the South East Asian economies that made them vulnerable to a sharp downturn, if not crisis, was the unrealistically high asset values in most of the South East Asian countries. The cause was that the money supply was growing too quickly for the real economy to absorb. Excess credit was used to fuel speculative booms in real estate, factories and the stock market;[28] the consequences have been noted by Robert Chote:

> …In Asia this excessively risky lending fuelled asset price inflation, creating a virtuous circle: risky lending drove up the prices of risky assets, which made the

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[25] Robert Chote, "Financial Crises: The Lessons of Asia", *Financial Crises and Asia,* pp 10-12. Chote notes that once the crisis had begun, in Korea in August 1997, the government guaranteed the liabilities of all Korean financial institutions and their overseas offices.

[26] IMF, *World Economic Outlook: Interim Assessment,* December 1997 pp 12-13

[27] Tong Whan Park, "South Korea in 1997: Clearing the Last hurdle to Political-Economic Maturation", *Asian Survey,* Vol. XXXVIII No. 1, January 1998 p 2

[28] In the eight countries considered in this paper, nominal money supply was increasing at up to 20% on average between 1994 and 1997 (Robert Chote, "Financial Crises: The Lessons of Asia", *Financial Crises and Asia,* p 6)

financial condition of the intermediaries seem sounder than it was, which in turn encouraged and allowed them to engage in further risky lending.[29]

In Korea, the chaebol would invest in inefficient factories. In Thailand the property market was the main weakness of the financial sector. Thai banks had loaned funds to non-bank financial institutions, which in turn advanced loans to property market investors. It is estimated that a quarter of bank loans in Thailand, Indonesia and Malaysia was ultimately made, sometimes through intermediaries, for property-related investments.[30]

As with all speculative bubbles, the fallout when the bubble bursts can have severe effects on the real economy. The Bank for International Settlements has noted:

> …In a number of centres, unsold or unused properties are being held off the market in order to prevent a collapse in prices; moreover, current construction plans in some cities imply further additions to supply in an already depressed market. However, several large-scale projects – notably in the public sector – have been postponed or cancelled in recent months. The experience of industrial countries has been that property price bubbles were followed by protracted and substantial declines in prices: average falls of almost 70% in real terms for commercial property and 30% for residential property spread over about five or six years.[31]

## 5. Macroeconomic Policy: Fixed Exchange Rates

Whereas the factors outlined above have been recognised as probably contributing in one way or another to the crisis, there is less agreement amongst economists over the question of whether the governments of the Asian Tiger economies made basic errors of policy in running their economies. The policy most intensely discussed is the decision to unofficially fix the value of their currencies to the dollar.[32]

The previous fifteen years had seen the global debate over exchange rates move in favour of some type of pegged or fixed exchange rate.[33] In Europe, the quest for a zone of stability is well known; an interest in fixing exchange rates in developing economies was also evident:

> In the late 1980s and early 1990s, a number of observers and experts - including prominent members of the IMF executive board - began to argue that the enthusiasm for an active and flexible exchange rate policy in developing countries had gone to far. It was pointed out that by relying too heavily on exchange rate adjustments, and by allowing countries to adopt administered systems characterized by frequent small devaluations, many adjustment programs had become excessively

29 Robert Chote, "Financial Crises: The Lessons of Asia", *Financial Crises and Asia,* p 10

30 Robert Chote, "Financial Crises: The Lessons of Asia", *Financial Crises and Asia,* p 11

31 Bank for International Settlements, *68$^{th}$ Annual Report*, p 140. The BIS cites, as an example of the scale of property market falls, Hong Kong, where commercial property fell 28% in the second half of 1997.

32 Only Korea did not have a pegged currency, having been forced into devaluation in 1996.

33 See for example, D. Burton and M. Gillman, "Exchange Rate Policy and the IMF", *Finance and Development,* No. 28, September 1991 pp 18-21

> inflationary…Indeed, the arguments used to promote a return to greater fixity in the LDCs were very similar to those used to support systems such as the ERM.[34]

Pegging domestic currencies to the dollar had important effects. In the early 1990s, the dollar fell against most currencies, especially the Japanese yen. By maintaining the peg with the depreciating dollar, the governments of the Asian Tigers also effectively depreciated their currencies against third-party currencies. The cost of imports for the South East Asian nations increased whereas their export prices fell in the Japanese market (their major trading partner). However, at the same time the Asian Tigers became a favourite target for foreign direct investment by Japanese companies,[35] who were themselves under competitive pressure from the over-valued yen and wished to shift production abroad.

These effects were reversed from 1995 when the dollar appreciated, yet again especially sharply against the Japanese yen. Maintaining the fixed dollar-rate amongst the South East Asian economies effectively caused their currencies to appreciate also. Although primary import costs fell, the price of exports of the semi-manufactured goods in which the Asian Tigers specialised increased.[36] The IMF has pointed out the consequences of this price increase:

> …with the dollar recovering most markedly against the yen, these countries suffered substantial losses in competitiveness, with adverse effects on net exports and growth. That Japan is the largest or second-largest trading partner of these countries meant that their competitiveness was particularly sensitive to changes in the yen/dollar exchange rate.[37]

When the crisis was brewing, the appreciation of the dollar magnified perceptions of trouble. It was evident that not only were these countries running large deficits, but that their strong currencies would make it harder to fund them.

As well as leaving the South East Asian nations vulnerable to changes in competitiveness, a further problem with fixed exchange rates is that in these countries with poor institutional structures, they:

> …came to be viewed as implicit guarantees of exchange value, encouraging external borrowing - often at short maturities - and leading to excessive exposure to foreign exchange risk in both the financial and corporate sectors…[38]

The implicit guarantee theory states that banks followed risky borrowing strategies because they could not believe there was any danger of a devaluation relative to the dollar taking place (and suddenly increasing the relative size of their borrowings). Furthermore, it meant that the banks did not hedge their foreign currency borrowing. Whether or not

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34 Sebastian Edwards, *Capital Controls, Exchange Rates and Monetary Policy in the World Economy,* p 7

35 The phenomenon of Japanese companies moving low-value added production facilities abroad, particularly into South East Asia, is known as 'hollowing out' in Japan.

36 One particular element contributing to the slowdown in export growth in South East Asia during 1996 was the contraction in the world semi-conductor market, caused by global over-supply.

37 IMF, *World Economic Outlook: Interim Assessment,* December 1997 pp 5-7

38 IMF, *World Economic Outlook,* May 1998 p 3

banks explicitly used such logic, some have argued (for example, the noted academic Joseph Stiglitz) that it is possible to excuse their over-borrowing from overseas as being the result of rational market conduct:

> As it was, the **incentives** created by macroeconomic policy were much more important than the **stance** of macroeconomic policy. Government exchange rate policies, either pegging to the dollar or managing the float, encouraged investors to build up unhedged debt. At the same time, the sterilization of capital inflows raised domestic interest rates, encouraging people to borrow from abroad, and possibly causing adverse selection effects that led to more risky investments.[39]

## B. Initial Triggers of the Events in South East Asia

The weaknesses described above indicate that the afflicted South East Asian economies were becoming increasingly vulnerable to a financial crisis. The onset of a financial crisis is often triggered by a specific event. For example, a letter to the *Financial Times* by George Soros, in which he questioned the sustainability of the Russian financial position, is thought by some to have triggered the run on the rouble that led to the Russian default earlier this year.

However, it is not always possible to identify any particular event as triggering a crisis. A financial crisis may simply develop from a small downturn that gathers pace and turns into a rout. This section outlines those factors that have been suggested as triggering the Asian Crisis: changed sentiment amongst domestic and foreign investors, excessive speculation and 'contagion', all of which are inter-related.

### 1. Changed Sentiment Amongst Investors in South East Asia

In the increasingly free global market for international funds, sentiment clearly plays a critical role in sustaining the values of currencies and other assets, especially when values seem difficult to justify in terms of underlying economic fundamentals. At some point, investor sentiment begins to waver and the effects may be fast and cumulative. The scale of effects caused by sudden shifts in investor sentiment were last witnessed during a similar crisis in Mexico in 1994.[40]

### 2. Speculation by Participants in the Currency Markets

Excessive speculation is also blamed as a trigger. Some argue that speculation by currency markets acts as a discipline on government policy. However, the damaging

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[39] Joseph Stiglitz, "Macroeconomic Dimensions of the East Asian Crisis", *Financial Crises and Asia*, p 54

[40] A number of commentators have drawn parallels between the two events. The response of policymakers to the Asian Crisis has been similar to the response to the Mexican situation. Immediately after the Mexican peso's collapse, the government needed financial support from the US and the IMF, as dwindling reserves threatened to drive the government into debt default. The U.S. and other foreign governments, along with a small number of private sector banks, put together a $50 billion bailout. The Mexican economy suffered a severe 6% contraction in 1995, but expanded again by early 1996. Recovery was so strong that within eighteen months of the beginning of the crisis, the Mexican government was able to repay its debt to the US.

effect that speculation, beginning in Thailand, may have had in the lead up to the Asian Crisis should not be underestimated according to the IMF:

> …International investors - commercial banks, investment banks, and hedge funds[41] - appear to have played a role alongside domestic investors in taking short positions against the baht, which they viewed as providing a one-way bet given the exchange rate peg, weak fundamentals, and relatively low funding costs.[42]

## 3. Contagion

A third factor initiating such a widespread crisis was 'contagion' or 'spillover' effects between markets. For example:

> …developments called attention to the importance of financial linkages, whereby the deteriorating economic situation in the region could, directly or indirectly, further weaken the financial position of Japanese banks…[43]

The idea of contagion within and between financial markets is not new, but the scale of such spillover effects during the Asian Crisis has been unprecedented. The conventional rationale for the events in South East Asia, in the wake of the attack on Thailand's currency, is that market participants re-assessed the 'risk factors' associated with countries in similar positions. They looked at countries neighbouring Thailand and saw similar symptoms afflicting them. Financial markets, being inherently volatile, are prone to over react to changes in underlying variables. So, while the volatility of the markets' reaction may have been excessively severe, the crisis spread for entirely rational reasons.[44]

An alternative to the financial linkages-view is a school of thought that sees the crisis spreading due to the 'competitive dynamics' of devaluation. For example, Robert Chote has noted that market pressures cause successive currency devaluations because:

> …What is an equilibrium exchange rate against the dollar before the competitor countries devalue is unlikely to remain one afterwards.[45]

The Asian Crisis has led to a new focus on a third explanation, that financial crises are not rational, but driven by unstable sentiment, which is ultimately self-fulfilling:

> …Self-fulfilling crises occur when the weakness [in an economy] is sufficiently moderate that a crisis is possible, but not necessary. When the crisis occurs, however, the weakness becomes very serious and justifies ex post the crisis.[46]

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[41] Hedge funds are highly leveraged, speculative funds which operate on a large scale within the financial markets. Unlike funds designed for individual investors, they specifically follow a very risky strategy.

[42] International Monetary Fund, *World Economic Outlook: Interim Assessment*, December 1997 p 17

[43] IMF, *World Economic Outlook: Interim Assessment*, December 1997 p 21

[44] Academic research has found that currency crises which spread through contagion have a regional structure. The fact that the Asian Crisis spread to other, non-Asian emerging market economies and eventually affected the West is unusual and highlights its severity compared to other crises of recent times. See M. Goldstein, "Early Warning Indicators of Currency and Banking Crises in Merging Economies", *Financial Crises and Asia*, p 48

[45] Robert Chote, "Financial Crises: The Lessons of Asia", *Financial Crises and Asia*, p 14

[46] Charles Wyplosz, "Currency Crisis Contagion and Containment: A Framework", *Financial Crises and Asia*, 16 March 1998 p 39

The Asian Crisis was made worse by the contagion of one market by another. For example, the Harvard economist Jeffrey Sachs argues that irrational reactions in financial markets led to the crisis spreading and to it being unnecessarily severe in all the countries, whatever distinctions existed in their individual situations. The initial contagion from Thailand to Indonesia, Malaysia and the Philippines appears to have mainly reflected the fact that foreign investors grouped these countries together, and did not deflect the differences in their underlying economic situations. A commentary by an international investment bank even stated that:

> The turmoil in Asia has now taken on a new, sinister, dimension. Whereas before one could argue that the currency and financial market moves were related in some way to macroeconomic fundamentals, the current selling pressure seems more divorced from economic reality…Outside hyperinflations, this kind of currency depreciation is very unusual.[47]

[47] Tim Condon, "Non-Japan Asia: What Happened to Asia?", *Morgan Stanley Global Economic Forum,* 15 January 1998 (online at http://www.ms.com/GEFdata/digests/latest.html)

# IV Effects of the Crisis on Economies in the Region

This section looks at the effects that the crisis would be expected to have on the economies of the region and some of the consequences that have actually emerged. Falls in equity markets, foreign exchange markets and rises in interest rates are the most notable financial effects. These changes then have an impact on the real sector of the South East Asian economies. Table 5 below gives an indication of the extent of these changes.

Table 5

**Exchange and Interest Rates During the Asian Crisis**

| | 3-month Interest Rates | | | Change in Dollar | Change in Real | Move in |
|---|---|---|---|---|---|---|
| | Average in 1996 | Peak Level (a) | Date of 1997 Peak | Exchange Rate Jun. 1997 to Sep. 1998 (b) | Exchange Rate Jun. 1997 to Sep. 1998 (c) | Stock Market During 1997 |
| Hong Kong | 5.5% | 25.0% | October | 0.0% | 16.1% | -18.7% |
| Indonesia | 13.8% | 27.7% | October | -77.7% | -56.3% | -37.0% |
| Malaysia | 7.3% | 8.8% | November | -39.8% | -27.2% | -52.2% |
| Philippines | 11.7% | 85.0% | October | -38.3% | -26.0% | -40.3% |
| Singapore | 3.0% | 10.3% | December | -17.6% | -2.7% | -31.7% |
| Korea | 13.3% | 25.0% | October | -33.8% | -19.8% | -42.6% |
| Taiwan | 5.5% | 9.8% | October | -19.4% | -12.4% | 9.3% |
| Thailand | 13.0% | 26.0% | December | -36.7% | -19.1% | -55.2% |

Notes: (a) Based on 3-month interbank interest rates
(b) Change from 2 July 1997 to 21 September 1998
(a) Change in the bi-laterally trade-weighted real exchange rate index

*Sources: BIS, "68th Annual Report", 1998 table VII.10; IMF, "World Economic Outlook", October 1998 table 2.13; IFC, "Emerging Stock Markets Factbook", 1998 various tables; FT, various editions*

## A. Equity Markets

Stock markets serve as a barometer of opinion on the health of an economy. The concerns about the South East Asian economies were reflected in sharp falls in the stock markets in the eight countries affected (see Appendix I for graphs of the region's stock market movements since the Asian Crisis began). The greater the degree of concern over a particular country's plight, the greater was the consequent correction of its stock market.

The level of any stock market is ultimately dependent upon the prospects for continued earnings/profits of the companies listed on the market. In periods when economic problems are taking place, or even anticipated, stock markets would tend to fall to reflect the lower expected profits. However, when investors lose confidence in the economic health of an entire economy or a government to meet its foreign debts, they will seek to move funds abroad into more secure assets. Financial companies which invest in large portfolios will switch from holding stocks to holding hard currency or bonds issued by the governments of the industrialised economies, particularly the United States. During periods of financial turmoil, such government bonds are viewed as 'safe havens'. This 'flight to quality' tends to exacerbate the anticipated problems.

## B. Competitive Currency Devaluations

One of the most notable effects of the Asian Crisis has been the rapid fall in the value against the dollar of many of the region's currencies. As noted earlier, devaluations can be very contagious as 'matching' devaluations are made, moving from country to country.

In the early 1930s, Professor Charles Kindleberger first described the phenomenon of countries, led by France and the US, pursuing 'beggar-thy-neighbour' policies of competitive currency devaluation, which was labelled the 'Kindleberger Spiral'. In South East Asia in 1997, there also seemed to be an element of 'beggar-thy-neighbour' devaluation,[48] which added to the uncertainty, as the BIS has acknowledged:

> At least three different mechanisms helped to spread currency strains across East Asia and beyond. A familiar mechanism works through competition in international trade. If a competitor's currency depreciates, an economy's competitiveness suffers from an effective currency appreciation that can slow economic activity and thus lead to pressure for a depreciation. A second, less familiar, mechanism is the demonstration effect of profits and losses on speculative positions. Finally, in the third mechanism foreign investors seek to withdraw their funds from markets and instruments deemed in some way to be similar.
>
> Despite the differences across Asian economies in export composition - textiles and shoes in one country, electrical components and machine tools in another - each competes closely with at least two others…Broadly speaking, close competitors have shown similar depreciations against the dollar, and thus limited exchange rate movements against each other.[49]

## C. Interest Rates

The third symptom of the financial crisis was that interest rates increased significantly. The market reaction to a decrease in the money supply (in this case because of capital flight overseas) is an increase in market interest rates and the prospect of a so-called 'credit crunch', in which funds for borrowing diminish throughout the economy.

In addition to this market response, the monetary authorities may raise rates further in an effort to prevent further, continuous depreciation of the currency. For example, Indonesia raised overnight interest rates to 300% in August 1997, but this failed to stop the exchange rate from collapsing. On the other hand, in Thailand during the initial pressure

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48 See Marcus Noland, *The Financial Crisis In Asia*, 3 February 1998 (statement to the US Congress House of Representatives International Relations Committee, Subcommittee on Asian and Pacific Affairs, downloaded from the Institute for International Economics website @http://www.iie.com/)

49 Bank for International Settlements, *68th Annual Report*, 1998 p 106

on the baht, the central bank resisted tightening monetary policy. As a result overnight interest rates peaked at 20%, before falling back to 10% in August 1997.

Although they may be necessary to prevent stricken currencies going into free-fall, one effect of higher interest rates is to reinforce the deflationary pressures squeezing the domestic economy.[50]

## D. The Real Economy

These factors in combination have initiated a severe contraction in real economic activity in South East Asia, characterised by increased corporate bankruptcies and rising levels of unemployment. The best up-to-date statistics available (from the IMF) indicate that nominal GDP contracted in the first half of 1998 by 12% in Indonesia, by 8% in Thailand and by 5% in Malaysia and the Philippines.[51]

Economic theory predicts that a currency devaluation should lead to an overall expansion of output, as production for export increases. However, in the worst crises, if devaluation is slow in triggering an expansion of exports, a contraction in economic activity and deflation ensues. It is now clear that in the early aftermath of the Asian Crisis, there was little benefit to the export sector from the devaluation of South East Asian currencies:

> Several factors, some trade-related and others the consequence of financial fragility, may have played an important role in the lack of responsiveness of exports to sizeable competitiveness gains. First, the weak response of output, in particular of tradable goods, has reflected in part the importance of intra-regional trade. With exports to Japan and to each other accounting for about one-quarter to one-third of total exports in Indonesia, Korea, Malaysia and Thailand, exporters have faced particularly depressed markets in which to compete…Moreover, given the prevalence of processing activity in several Asian countries, export industries are highly dependent on intermediate inputs imported from elsewhere in the region. Thus, weakening imports and exports have been feeding upon each other.[52]

The level of activity was probably depressed further by businesses and consumers reining back spending, regardless of whether or not they were directly affected in the initial phase of the crisis. The combination of high levels of debt, rising interest rates and consumer caution reinforces weak economic sentiment. In such cases, international trading conditions also become blighted, further depressing confidence. Given the poor

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[50] For example, higher interest rates mean that the banking sector's funding costs (i.e. the cost of borrowing working funds in the global interbank money markets day-to-day), increases and causes banks to foreclose on loans. Even in the longer term, a country that has been through an economic crisis may have to pay higher interest rates because of the increased risk of bankruptcy. The 'Japan Premium' is a penalty added to ordinary interest rates, paid by Japanese companies regardless of any consideration except the fact that they are Japanese.

[51] IMF, *World Economic Outlook*, October 1998 table 3.12

[52] Bank for International Settlements, *68$^{th}$ Annual Report*, p 45

economic prospects globally, currency devaluations are unlikely to provide much relief in the medium term. This is a ‘debt deflation’.[53]

[53] Just as Kindleberger had described the macroeconomic causes behind the Great Depression, Sir John Hicks (following Keynes) outlined the domestic factors which prolong depressions, centring on the fact that individuals' and households' expectations of a depressed future can retard spending and therefore cause 'oversaving'. A recent example of this prolonged type of recession is in Japan, which has been stagnant since 1990, as consumers have been reluctant to increase consumption, instead raising their propensity to save.

# V The IMF and its Handling of the Asian Crisis

As the International Monetary Fund was able to inject liquidity into markets, it naturally took the lead in trying to handle the crisis. The IMF's policy had a number of key elements: financial assistance, a package of austerity measures and re-structuring of the economy. The following section considers these elements.

## A. Financial Assistance

The rescue funding for the Asian Crisis economies was organised by the IMF over the course of the second half of 1997.[54] The need for international assistance to stricken economies is usually only triggered when there is a danger of sovereign default. In trying to defend their currencies from speculation, the Thai, Korean and Indonesian governments were in danger of defaulting on their repayment commitments by late 1997 and thus needed aid. Details of the financial assistance are set out in table 6.

Table 6

**IMF Funding of Asian Nations** ($ billions)

| | | Global Pledges | | | | IMF-Administered |
|---|---|---|---|---|---|---|
| | | IMF | Multilateral (a) | Bilateral (b) | Total | Disbursements |
| Indonesia | | 9.9 | 8.0 | 18.7 | 36.6 | 4.0 |
| Korea | | 20.9 | 14.0 | 23.3 | 58.2 | 17.0 |
| Thailand | | 3.9 | 2.7 | 10.5 | 17.1 | 2.8 |
| Total | | 34.7 | 24.7 | 52.5 | 111.9 | 23.8 |
| Comparisons: | | | | | | |
| Mexico | (c) | 17.8 | - | 33.0 | 50.8 | n/a |
| Philippines | | 1.0 | 0.0 | 0.0 | 1.0 | 1.0 |

Notes: (a) Funding promised jointly by the World Bank and ADB
(b) Funds promised from individual countries
(c) The 1994 Mexico crisis saw a rescue only in February 1995

*Source: "Asian Meltdown", The Banker, December 1997 p.43 and IMF website @* ~~http://www.imf.org~~

Although the IMF co-ordinated the rescue, contributions were made available from a variety of sources such as the World Bank and the Asian Development Bank. These rescue packages were notionally for the public sector in the affected countries. At $112 billion, the total value of the rescue packages for Indonesia, Malaysia and Thailand was

[54] A comprehensive overview of the IMF strategy can be found at its website; see IMF, *The IMF's Response to the Asian Crisis,* October 1998 @ http://www.imf.org/External/np/exr/facts/asia.HTM

more than twice the size of the $50.8 billion aid that was arranged for the Mexican bailout in 1994.

## B. The Austerity Programme

In return for the international aid, all receiving nations invariably agree to conditions about macroeconomic policies to be followed and structural reforms to be implemented. Of course, recipients may not always fulfil these conditions. The IMF's macroeconomic proposals consisted of setting targets for the permissible size of future budget deficits and tightening monetary policy. Such contractionary policies are considered necessary following devaluation, to prevent higher import prices being translated into higher export prices and thus causing the erosion of competitiveness gains.

### 1. Fiscal Policy

Fiscal policy is tightened to limit the need for inflows of capital from overseas. In Thailand, for example, the first IMF agreement called for a reduction in the budget deficit (especially by cuts in social spending), so that money could be diverted to pay some of the costs of bank restructuring. IMF staff in Washington had apparently wanted a fiscal contraction of 3-4% of GDP, but the staff in Thailand found the authorities reluctant to see a contraction of more than 2%.[55]

In Indonesia, the November 1997 IMF agreement sought to impose cuts equivalent to about 1% of GDP in the 1997/98 fiscal year and 2% in 1998/99, with the aim of creating budget surpluses of 1% of GDP in both years. Measures proposed included postponing/rescheduling major state infrastructure projects, removing government subsidies and certain VAT exemptions and adjusting government-controlled prices such as the prices of electricity and petroleum. However, against a background of continuing declines in the value of the rupiah and slower growth reducing tax revenues, in January 1998 the government was forced to adjust the 1998/99 budget so that a deficit of about 1% of GDP would result.[56]

As it became apparent that the economic impact of the Asian Crisis was deeper than had been expected, fiscal targets in all three countries were relaxed to take account of falling government tax revenues (although the targets were reviewed quarterly).

### 2. Monetary Policy

A high interest rate policy has the twin effects of reducing the need for external capital inflows and helping to maintain export competitiveness by controlling domestic prices. If monetary policy is not tightened, the 'benefit' of the devaluation is lost:

> Korea failed to increase interest rates significantly until the crisis was well under way. In many countries, subsequent bouts of renewed downward pressure on the exchange rate finally forced substantial increases in interest rates, often in the

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55 See Robert Chote, "Financial Crises: The Lessons of Asia", *Financial Crises and Asia,* pp 16-17.

56 For more details of the various IMF programs agreed with the three countries which borrowed funds, see the IMF website athttp://www.imf.org/External/np/exr/facts/asia.HTM.

context of an IMF programme. In most cases, interest rates reached a peak only in the later stages of the crisis, and exchange rates did not touch bottom until January 1998.

One notable exception to this pattern of interest rate policy was Hong Kong, where there were sharp and sustained increases. Interest rates rose along the maturity spectrum (with three-month rates reaching 25% at one point). This served to successfully defend the dollar peg, in the face of steep declines in asset prices.[57]

## C. Restructuring

Accompanying the rescue package and the macroeconomic prescriptions described above, the IMF also tried to correct a number of structural weaknesses in the South East Asian economies. There is widespread agreement that in the long term “the main task facing governments in the countries most affected by financial turmoil [is] to ensure that adjustment policies to tackle problems at their roots be implemented as rapidly and effectively as possible”.[58]

The aim of such structural reforms is to remove features of the economy that had become “impediments to growth”, such as monopolies, trade barriers and “non-transparent corporate practices.”[59] Immediate action was taken to correct the weaknesses in the financial system. While tailored to the needs of individual countries, the IMF programs arranged for:

- The closure of unviable financial institutions, with the associated write down of shareholders’ capital;
- The re-capitalisation of undercapitalised institutions;
- Close supervision of weak institutions;
- Increased potential for foreign participation in domestic financial systems.[60]

In Thailand, for example, the most significant element of the structural reforms introduced was that fifty-six out of fifty-eight insolvent finance and non-bank institutions were shut down (despite great resistance from some members of President Chavalit’s six-party coalition). The government was required to set up the Financial Sector Restructuring Authority, to force restructuring on the financial sector. In Indonesia, sixteen of the 240 private banks in existence were forced into bankruptcy at the behest of the IMF, as the first step towards change, in November 1997. However, talks with the IMF broke down twice in the following six months, until an agreement on major structural changes was reached only in April 1998. As part of the Korean bailout, 17 banks were closed down immediately, despite particularly strong opposition to bank closures.

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57 Bank for International Settlements, *68th Annual Report*, 1998 p 136

58 "The OECD Economic Outlook Highlights", *The OECD Observer 210*, February/March 1998 p 50

59 IMF, *The IMF's Response to the Asian Crisis*, October 1998 (downloaded from the IMF website athttp://www.imf.org/External/np/exr/facts/asia.HTM)

60 IMF, *The IMF's Response to the Asian Crisis*, October 1998

Although some financial restructuring may have been welcome, the initial effect of such measures was to exacerbate the shortage of liquidity in these economies, by forcing the closure of banks.

The international community's rescue efforts, although large, would not have had any effect on private sector debt per se. Another facet of the structural changes attempted by the IMF has thus been the promotion of private sector solutions to the debt problem. For example, in Korea a voluntary restructuring of short-term debt was agreed in December 1997. In June 1998, Indonesia and a steering committee of its foreign bank creditors agreed on a framework for the voluntary restructuring of interbank debt, trade credit and corporate debt.

## D. Criticisms of the IMF

There has been severe criticism of the IMF policy prescriptions applied after the first phase of the crisis, led by Jeffrey Sachs, especially of the imposition of large interest rate increases, which are said to have exacerbated the effects of the credit crunch. The IMF measures raised real interest rates sharply in an attempt to stabilise the problem currencies. However, the difficulty with this policy is that at some point high interest rates may simply become counter-productive:

> The goal of higher interest rates is to increase the rate of return, persuading people to keep their capital in the country. But in a crisis situation we need to ask the deeper question, why are people pulling their money out of the economy in the first place? Often it is because they do not believe that they will receive the promised rate of return, that is, they are worried about the possibility of default.
> Higher interest rates increased the **promised** rate of return, but in many circumstances they will also create financial strains, leading to bankruptcies and thus increasing the expectations of default. As a result, the **expected** return to lending to the country may actually fall with rising interest rates, making it less attractive to put money into the economy.[61]

While high interest rates may be ineffective in stabilising a currency, they nevertheless can have a damaging effect on fragile businesses on the brink of solvency. The argument of critics of the IMF's handling of the crisis, such as Jeffrey Sachs, is that by deliberately increasing interest rates the IMF exacerbated the monetary contraction that was already in place.

The IMF has defended its monetary tightening policies in the first phase of the crisis during the summer of 1997:

> **Monetary policy** must be kept sufficiently firm to resist excessive currency depreciation, with its damaging consequences not only for domestic inflation but also for the balance sheets of domestic financial institutions and non-financial enterprises with large foreign currency exposures. Excessive depreciation, by weakening the competitiveness of partner countries' currencies and contributing

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[61] Joseph Stiglitz, "Macroeconomic Dimensions of the East Asian Crisis", *Financial Crises and Asia*, p 59

to downward pressure on them, also adds to the risk of a downward spiral of competitive depreciations, which bring no benefit to any country and monetary instability to all. As fundamental policy weaknesses are addressed and confidence is restored, interest rates can be allowed to return to more normal levels. Indeed, in Korea and Thailand some easing of monetary conditions has already been possible. But experience - including in the Asian crisis - shows that premature easing can be costly.[62]

[62] IMF, *World Economic Outlook*, May 1998 p 6

# VI The Global Impact of the Asian Crisis

> The loss of global financial wealth in the three months following peak in July [1997] was 2.3 trillion dollars - that is a lot of money by anybody's standards - which was equivalent to 19 per cent of OECD consumers' expenditure, so it was a big hit to world wealth. As far as I can see, there have only really been two episodes like this in the 20th century, the first being 1929 and the second 1987. Partly in response to this we have, like most others, revised our forecast down for world GDP very substantially.[63]

The financial effects on countries outside South East Asia was, for obvious reasons, the chief initial concern of governments outside the region. The Asian Crisis has already affected emerging economies such as those in Eastern Europe and Latin America extremely severely. Now its effects on the real sector of the western industrialised countries are being seen: reduced trade flows and lower foreign direct investment.

## A. The Wealth Effect: Falls in Equity Markets

When equity markets in South East Asia fell, they caused a negative 'wealth effect' on investors across the world, just as they had upon investors from South East Asia itself. Furthermore, these stock market falls directly initiated market declines across the globe.

To a large extent, the size of any negative wealth effect on the major nations will depend on the size of their holdings in South East Asia prior to the crisis. In the UK, pension funds had about 5% of their assets, approximately $50 billion, in the Pacific region excluding Japan just before the Asian Crisis. Flows from the US into the region's equity markets amounted to $33 billion in the four years from 1993 and 1996.[64] Japan is the most exposed western economy to South East Asian markets. For a country already burdened by a domestic banking crisis, the impact of a negative wealth effect will be doubly severe.

Some investors managed, for one reason or another, to avoid some of the collapse in South East Asian markets by repatriating funds before the crisis emerged. It appears that some 'smart money' was withdrawn from the region's markets relatively early in 1997:

> Portfolio allocation data for pension funds from the Netherlands, the United Kingdom and the United States show that these fund managers had embarked on a reduction of their exposure to Asia as early as the last quarter of 1996, possibly responding to the emerging signs of strain. While arguably the withdrawal may partly reflect a retreat from an originally overweight exposure, it is consistent with survey evidence of declining market enthusiasm for the region.[65]

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63 Gavyn Davis (Chief International Economist of the investment bank Goldman Sachs), in oral evidence to the Treasury Select Committee of the House of Commons, 21 October 1998

64 "The Pacific's Grim Rim", *Financial Times*, 25 October 1997

65 Bank for International Settlements, *68th Annual Report*, p 92. Of course, this repatriation of funds by portfolio investors (though not the banks) may have contributed to the earliest stages of the crisis. For example, one report found that western fund managers caused foreign investment to decline by $100

Less prescient western financial institutions, having seen the value of their South East Asian assets decline once the crisis began, tried to get their money out of these countries. However, the dilemma in such a situation is that attempts to liquidate assets in themselves depress the markets further and prompt further sales.

The loss of wealth by western investors in South East Asia, even with such large holdings, will have been dwarfed by the losses incurred by their holdings in their own domestic markets. The direct financial effects of the Asian Crisis would have been limited, if they had not triggered falls in other equity markets, especially in Japan.

## B. International Trade

Another obvious effect on industrialised countries of the Asian Crisis is likely to be an 'income effect' caused by falling international trade. Because South East Asian currencies have devalued, there will be a weakening of demand for western goods in these countries, which are relatively more expensive. Western goods are likely to be relatively more expensive in third-party countries as well. There will therefore be a brake on the growth of exports from the major economies.

As with the other consequences of the Asian Crisis, different industrialised economies are exposed to different degrees. For example, in 1996, the combined value of imports from and exports to the Asian Tigers amounted to about 5% of GDP in Japan, but only on average 1½% of GDP in Europe and 3% in the US.[66] An indication of the importance of trade with South East Asia to the western economies is shown in table 7 below.

billion in the first half of 1997 (see Robert E. Litan, "A Three-Step Remedy For Asia's Financial Flu", *Brookings Policy Brief No. 30,* February 1998).

[66] IMF, *World Economic Outlook,* May 1998 p 8

Table 7

**Importance of Trade With South East Asia in 1996**

| | Share of All Trade Conducted with Asian Crisis Economies (a) | Merchandise Trade as a Proportion of GDP |
|---|---|---|
| United States | 16.3% | 13.2% |
| Japan | 30.4% | 12.0% |
| Germany | 5.5% | 27.0% |
| France | 4.3% | 29.7% |
| Italy | 4.3% | 22.6% |
| United Kingdom | 7.7% | 30.3% |
| Canada | 4.0% | 43.0% |
| Combined G7 | 12.2% | 19.9% |
| Russia | 3.3% | .. .. |
| Australia | 24.5% | 22.9% |
| New Zealand | 19.8% | 32.7% |

Notes: (a) The average value of exports plus imports

*Sources: IMF, "World Economic Outlook: Interim Assessment", December 1997 p 34; UN, "Economic Bulletin for Europe", Volume 49, 1997 tables 1.1.3 & 1.1.4*

Thus, although Europe is generally more dependent on trade than the US, the size of its trade with South East Asia is not as great in absolute terms, as table 8 shows.

Table 8

**Western Exports to South East Asia in 1997** ($ billions)

| To: | US | Germany | France | UK | Italy |
|---|---|---|---|---|---|
| Hong Kong | 15.1 | 4.6 | 2.9 | 5.3 | 4.0 |
| Indonesia | 4.5 | 3.0 | 1.5 | 1.0 | 0.9 |
| Malaysia | 10.8 | 2.8 | 1.3 | 2.0 | 1.2 |
| Singapore | 17.7 | 3.6 | 2.6 | 3.2 | 1.6 |
| South Korea | 25.1 | 5.3 | 1.9 | 2.0 | 2.2 |
| Thailand | 7.4 | 2.6 | 0.9 | 1.4 | 0.8 |
| South East Asia | 80.6 | 21.8 | 11.2 | 14.9 | 10.8 |
| All Exports | 688.7 | 511.6 | 289.0 | 281.4 | 238.2 |

*Source: IMF, "Direction of Trade Statistics Quarterly", June 1998*

It has indeed been the case that exports from the United Kingdom to South East Asia have fallen sharply during 1998. In October 1998, exports to Malaysia were 51% lower than in October 1997, exports to Hong Kong were 29% lower, exports to Singapore were 21%

lower than in October 1997 and exports to Thailand had declined 50% compared to October 1997.[67]

On the import side, although the full impact of South East Asian currency depreciations is yet to be passed on by producers, the fall in South East Asian product prices to global consumers are likely to be significant. South East Asian producers will be desperate to maintain demand as close to pre-crisis levels as possible by cutting prices. Western manufacturers may be pressurised into reducing their prices in order to maintain their competitiveness with these South East Asian imports.

## C. Foreign Direct Investment

While depreciating currencies give a competitive trade advantage to South East Asian companies, the cost of acquiring overseas assets will increase at the same time, just as the companies face a shortage of available funds. As a result, foreign direct investment projects are likely to be cut back severely.

The UK has been a particularly large recipient of foreign direct investment from South East Asia in recent years, and the announcements of delay or termination of projects by Korean companies, such as Samsung and LG Electronics, have been highly publicised. As table 9 shows, however, inward investment from South East Asia is actually a small proportion of the UK's inward investment.

Table 9

**Importance of UK Investment from South East Asia** (£ billions)

| | Levels of FDI [a] | | | | | Existing Stock of Investments [b] | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | World | EU | US | Asia [c] | Japan | World | EU | US | Asia | Japan |
| 1993 | 9.9 | 1.6 | 5.1 | 0.2 | 0.3 | 121.0 | 40.3 | 49.5 | 0.9 | 5.4 |
| 1994 | 6.0 | 3.4 | 2.1 | 0.1 | 0.0 | 121.3 | 40.0 | 49.8 | 0.7 | 5.1 |
| 1995 | 12.7 | 3.6 | 9.3 | 0.1 | -0.4 | 128.9 | 43.5 | 55.1 | 1.1 | 5.5 |
| 1996 | 15.7 | 4.7 | 6.7 | 0.1 | 0.2 | 134.7 | 43.8 | 56.0 | 0.9 | 5.9 |
| 1997 | 21.8 | 7.3 | 10.7 | 0.0 | 0.4 | 157.0 | 49.6 | 69.8 | 0.8 | 6.5 |

Notes: (a) Net direct investment in the UK, including unremitted profits
(b) Levels of investment in the UK according to net book value
(c) Excludes Near & Middle East and Australasia

*Sources: ONS, "Overseas Direct Investment 1997", First Release (98) 409, 14 December 1998*

The effect of the Asian Crisis on the advanced industrialised countries will be determined by the sum of these separate effects. Net exports and industrial production will be hit much harder than overall GDP.

67 ONS, *Monthly Review of External Trade Statistics*, Business Monitor MM24, September 1998 table B15

The vulnerability of an individual country will, in the first instance, vary depending on its degree of direct exposure to South East Asia. However, even a country with little direct exposure to the region through trade and foreign direct investment may still experience adverse repercussions via third-party countries. Although currency appreciation has affected all western nations, most analysts are agreed that the impact will slow growth more in the US than in Continental Europe.

## D. Economic Growth

Given the economic turmoil, it is inevitable that there will be some downturn in economic growth. A constant downward revision of economic growth forecasts has taken place since the crisis began. The IMF, at the centre of the Asian Crisis, noted in May 1998 that:

> …The impact of the Asian crisis on growth prospects for the **major industrial countries**, with the important exception of Japan, is expected to be modest. Exports to Asia are likely to fall sharply, but the declines in bond yields in most industrial countries since mid-1997 - reflecting reduced expectations of inflation and of monetary tightening as well as a portfolio shift away from emerging market investments - are likely to have an offsetting and stimulative effect on growth. Furthermore, equity prices in the most major markets reached new peaks in March.[68]

In the most recent edition of its *World Economic Outlook*, in October 1998, the IMF forecast for the growth of world real GDP in 1998 was revised down to 2%. In the May 1998 edition, the forecast for global growth had stood at 3% and in December 1997 it was 3½%.[69]

Differentiating the impact on a country's growth of the Asian Crisis from other influences on a slowdown is problematic. International factors and domestic factors are usually inter-linked. The UK economy has been slowing during 1998, and part of this slowdown has undoubtedly been the impact of the Asian Crisis. The slowdown has led to a re-evaluation of economic growth forecasts.

The Treasury publishes a survey of independent economic forecasts each month. In the January 1998 survey, the consensus forecasts for growth in 1998 and 1999 were 2.5% and 2.0% respectively. In the most recent, November 1998 survey, the consensus forecasts were 2.6% for 1998 and 0.9% for 1999.[70]

In response to the suggestion that western economies may enter a deflationary spiral, the IMF has played down any such threat:

> In assessing the risks of global deflation, it is important to distinguish **deflation**, a sustained fall in the overall price level, from **disinflation**, a decline in the rate of inflation. Disinflation has been an important achievement of macroeconomic

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68 IMF, *World Economic Outlook*, May 1998 p 28

69 IMF, *World Economic Outlook,* October 1998 p 1 (downloaded from the IMF internet website athttp://www.imf.org/external/pubs/ft/weo/weo1098/index.htm)

70 HM Treasury, *Forecasts for the UK Economy: A comparison of Independent Forecasts,* Nos. 129 & 139, January & November 1998

policy since the early 1980s, as central banks around the world have pursued low inflation as their primary policy goal. It is important also to distinguish deflation from relative price movements involving sustained price declines for particular assets, products, or commodities against a background of rising overall prices. Indeed, in a low-inflation environment, falling prices of individual products, stemming, in particular, from productivity gains and technological advances, are likely to be more common than when inflation is higher and relative price adjustments occur more through differences among **rates of price increase**, with fewer absolute price declines. Primary commodity prices must also be distinguished from the prices of manufactured goods and services that dominate the price indices of overall output or consumer purchases. Movements in primary commodity prices tend to be much more volatile than movements in the overall price level, and there have been several episodes of significant declines as well as sharp increases in world commodity price indices since the early 1980s, while consumer price inflation in the advanced economies has been on a fairly steady downward trend.[71]

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[71] IMF, *World Economic Outlook,* May 1998 p 35

# VII Preventing Future Crises

As with all crises, there are attempts to learn lessons for the future. A range of suggestions have been made, with an underlying theme among the mainstream of economists being to avoid prompting developing countries into embracing capital and exchange controls.

The Nobel prize-winning economist James Tobin proposed twenty years ago that there should be a universal tax on currency transactions to deter speculation by the markets. More recently, George Soros (the financier famed for leading the financial markets' speculation against sterling's position in the ERM in 1992) has suggested a fee-based system, in which private sector financial institutions pay for an insurance fund which would operate in parallel to the IMF. The organisation would be charged with preventing over-exposure to overseas capital by developing nations, but if it failed, it would pay out insurance to lenders who are the victims of default.[72]

The Chancellor, Gordon Brown, made a keynote speech in December 1998, laying out the UK Government's ideas on the reform of the world's financial system. He noted that:

> This year we have experienced events that were unthinkable just two or three years ago: free enterprise Hong Kong taking publicly owned stakes in all its private companies; Japan nationalising its banks; Russia going into default; in America, the mounting of one of the biggest ever emergency refinancings not for a bank, but for a hedge fund; most damaging of all, the biggest growth economies of the last decade in East Asia suffering larger contractions in output even than experienced in the great depression of the 1930s.[73]

The Chancellor's specific proposals for an updating of the system which established the IMF and the World Bank at Bretton Woods in 1948 were:

- Improving global regulation, which would involve the IMF, the World Bank and other regulators forming a new, permanent standing committee for global financial regulation;
- Creating a process of active and transparent surveillance of borrowing nations;
- Creating a Code of Best Practice on social policy issues, so that financial crises, if they do occur, do not result in disproportionate increases in poverty within developing countries.[74]

The IMF has made a similar case, that to strengthen the "architecture of the international monetary system", a framework is needed centred on five aspects of the system:

- Reinforcing international and domestic financial systems;
- Strengthening IMF surveillance;

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[72] George Soros, "Avoiding A Breakdown", *Financial Times*, 31 December 1997. See also George Soros's testimony to the Treasury Select Committee for the Second Report of the 1998-99 Session, *The World Economy and the Pre-Budget Report*, HC 91-II, 18 January 1999.

[73] Gordon Brown, "Rediscovering Public Purpose In The Global Economy", speech delivered at the Kennedy School, Harvard University, 15 December 1998

[74] Gordon Brown, "Rediscovering Public Purpose In The Global Economy", speech delivered at the Kennedy School, Harvard University, 15 December 1998

- Promoting more widely available and transparent data on member countries' economic situation and policies;
- Underscoring the central role of the IMF in crisis management;
- Increasing the involvement of the private sector in forestalling or resolving financial crises.[75]

Along such lines, the mainstream global organisations, led by the Finance Ministers of the G10, have stepped up their efforts to have global standards agreed for various aspects of the financial markets, from banking regulation to the presentation of economic data. This is a long-standing process and G7 communiqués from summits in Halifax, Lyon and Denver have given significant impetus to the process.[76] At the IMF/World Bank meetings in Hong Kong in autumn 1997, discussion about making fundamental changes to financial systems was already under way.[77]

More novel was an idea, given that the Asian Crisis showed that countries in a region could be severely affected by adverse developments in neighbouring countries, that similar events could be prevented by enhancing regional surveillance. Regional organisations such as ASEAN could warn a country heading for trouble via peer pressure from its closest neighbours. This strategy has borrowed from examples such as the European Union and G7.[78] Gordon Brown's version of this idea would see individual borrower nations and the banks lending to them exchanging a constant dialogue within 'country clubs', where each nation would be under the microscope.[79]

There have even been calls for the reform of the IFIs themselves, most notably by the Prime Minister. In a speech to the United Nations in September 1998, Tony Blair demanded reform of the IMF. He called for greater accountability and transparency from the IMF and other international financial institutions, and even proposed that the IMF's performance should be subject to external evaluation in future.[80] The IMF has also been

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75 IMF, *Annual Report 1998*, Chapter VII, 1998 pp 48-50

76 A report on preventing financial fragility in emerging markets was prepared for the G7 after the Mexican crisis and set out a strategy for establishing sound practices in markets (G10, *Financial Stability in Emerging Market Economies: A Strategy for the Formulation, Adoption and Implementation of Sound Principles and Practices to Strengthen Financial Systems*, 1997).

77 The Basle Committee presented a report in Hong Kong containing specific recommendations on banking regulations (see The Basle Committee on Banking Supervision, *The Core Principles for Effective Banking Supervision*, 1997). The G7 continued to ponder these issues at this year's meetings (see further reading IMF, *Toward a Framework for Financial Stability*, January 1997 and The Basle Committee on Banking Supervision, *Promoting Financial Stability*, March 1998, which were presented to the G7 Finance Ministers at the Birmingham G7 Summit). Most recently, on 30 October 1998 the G7 announced that it is to put in place $90 billion worth of precautionary credit lines for innocent countries caught up in a contagion. The funds would be on a stand-by basis, and though they would come from the G7, would be administered by the IMF. The funds would be for countries such as Brazil, where the developing crisis threatens to strike next and then overtake the whole of Latin America.

78 See S. Sugisaki's presentation at the IMF *Symposium on Capital Flows and Financial System Stability*, 8 December 1997 (from the IMF website @http://www.imf.org/external/np/speeches/1997/120897.htm)

79 Gordon Brown, "Rediscovering Public Purpose In The Global Economy", speech delivered at the Kennedy School, Harvard University, 15 December 1998

80 See David Wighton, "Blair Urges Big IMF Overhaul", *Financial Times*, 22 September 1998

criticised, by those agreeing with the Jeffrey Sachs school of thought, for being outmoded in the policies it imposes.[81]

The IMF, however, is of the view that the current structure of the international monetary system is sound; it is implementing existing polices in developing countries that is important:

> Serious financial crises are not a new phenomenon, and they will occur again in the future. With the in-creasing globalization of financial markets and the apparent tendency for investors to react exuberantly to success, belatedly to emerging concerns, and eventually to overreact as sentiment changes, it may well be that the risk of crises is rising, including the scope for international contagion. Countering the potential for new crises is a considerable challenge that needs to be met through increased vigilance of national policy-makers and private investors; the provision of fuller economic and financial information to the public by governments, financial institutions, and corporations; and enhanced international and regional surveillance of economic and financial developments and policies. Transparency in policy formulation and implementation is critical.[82]

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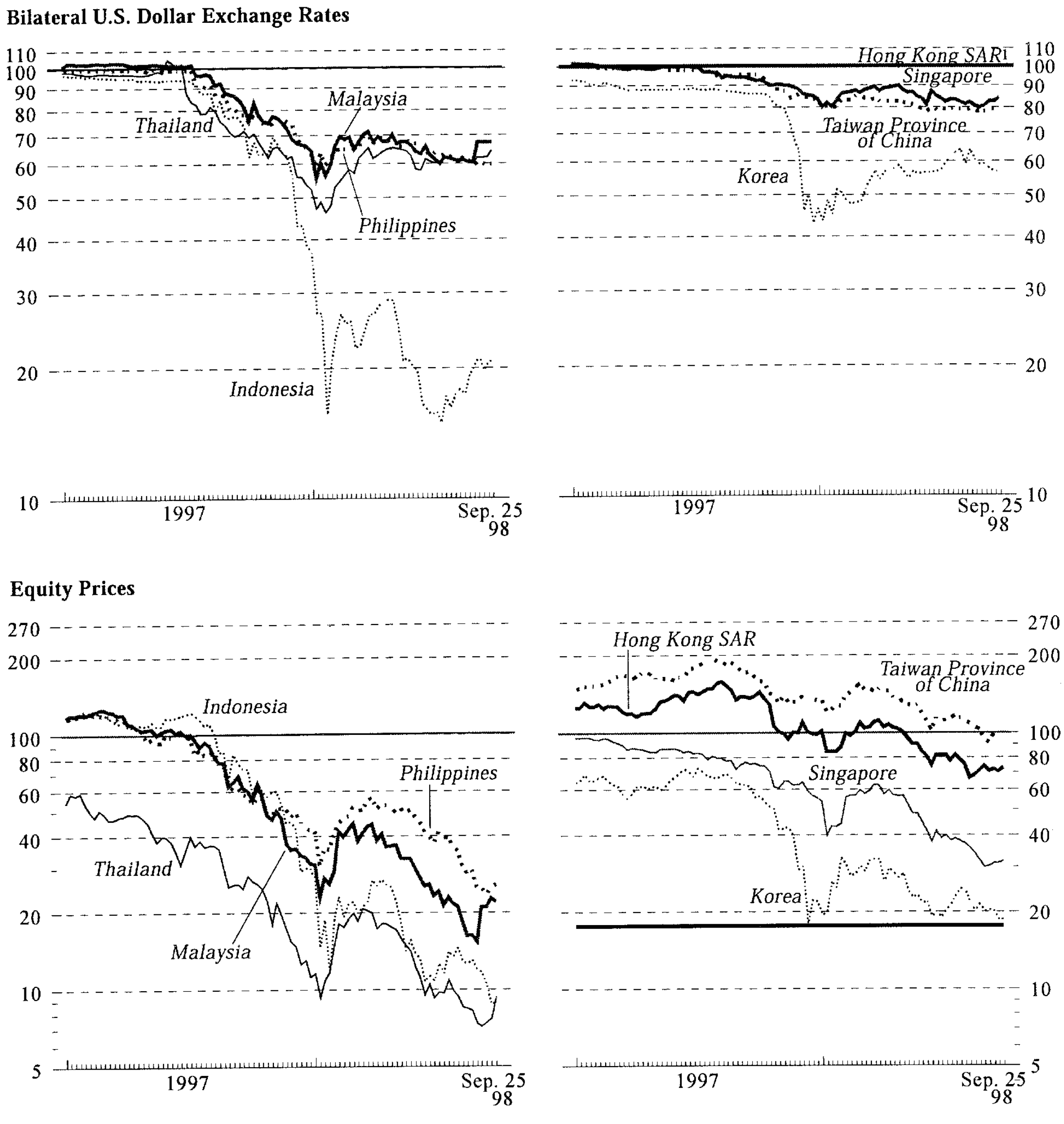
81 See Jeffrey Sachs, "Global Capitalism: Making It work", *The Economist*, 12 September 1998

82 IMF, *World Economic Outlook*, May 1998 p 7

# VIII Appendix I: Graphs of South East Asian Markets

**Figure 1. Selected Asian Economies: Bilateral U.S. Dollar Exchange Rates and Equity Prices**

*(In U.S. dollars per currency unit; logarithmic scale; January 5, 1996 = 100)*




Source: Bloomberg Financial Markets, LP; International Finance Corporation; and Reuters.
[1] Pegged to U.S. dollar.

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