Introduction: issues, debates and an overview of the crisis

In his celebrated *Manias, Panics and Crashes*, Charles Kindleberger (1978) predicted a historical average of at least one financial crisis per decade. Yet, in Gerard Caprio’s (1997, 79) memorable phrase, the 1990s have been a period of boom in busts. A financial crisis every twenty-four months – beginning in 1992–93 with the speculative attacks against several currencies in the Exchange Rate Mechanism (ERM) of the European Monetary System, followed by the sudden collapse of the Mexican peso in December 1994, and more recently, the Asian financial crisis that was set off when the Bank of Thailand devalued the baht on July 2, 1997. The unexpected meltdown of the Thai economy and the contagion (the so-called Asian flu) spread with unprecedented ferocity, and, by the end of August 1997, the currencies of three of Thailand’s neighbors, Malaysia, Indonesia and the Philippines, had all been devalued substantially (see Table 1.1), despite vigorous efforts by these governments to stop their currencies from falling.

During September and October, the currencies of Taiwan and Singapore came under intense pressure. While both countries managed to avoid

| Rate of currency depreciation 1997–98 (local currency per US dollar) |
|---|---|---|
| **2 July 1997** | **End Sept. 1998** | **Rate of dep. (%)** |
| Philippine peso | 26.38 | 43.80 | 66.10 |
| Indonesian rupiah | 2,341.92 | 10,638.30 | 354.30 |
| Thai baht | 24.40 | 38.99 | 59.80 |
| Malaysian ringgit | 2.57 | 3.80 | 47.80 |
| Korean won | 885.74 | 1,369.86 | 54.70 |

*Source: OECD (1999, 249).*
The Asian financial crisis

full-blown financial crises, both were, nevertheless, forced to engage in competitive devaluations by floating their currencies rather than losing reserves by trying to stabilize the exchange rate. Nevertheless, Singapore, in spite of its strong economic fundamentals (huge foreign exchange and fiscal reserves, and a solid financial sector), saw its currency depreciate by 15 per cent and its stock market fall by 13 per cent. Similarly, Taiwan, despite its strong economic fundamentals (consistent current account surpluses and large foreign reserves), saw its currency, the New Taiwan dollar, come up against strong speculative attack. Between 1989 and July 1997, Taiwan had pursued a de facto pegging of the New Taiwan Dollar to the American dollar, with the exchange rate being held within a narrow range of NT$26–27 to US$1. After the crisis broke, Taiwan’s central bank initially widened the band to about 28.7, with occasional interventions in the foreign exchange market to keep the rate steady. Yet, in the face of unrelenting battering, the Taiwanese central bank was forced to intervene extensively in the currency markets – spending some US$5 billion defending the value of the currency. However, the New Taiwan Dollar was abruptly floated on October 17, 1997 – after which it depreciated by 7 per cent. By October 20, the US dollar had broken through the NT$30 barrier for the first time in ten years.

Taiwan’s depreciation led to speculation that the Hong Kong SAR dollar would be devalued as well – since Taiwan and Hong Kong are competitors in export markets. Moreover, speculators reasoned that if Taiwan, with its enormous foreign reserves (about US$90 billion at the time), could not defend its de facto peg, neither could Hong Kong. Given this, even Hong Kong SAR, with its current account surpluses, budget surpluses that consistently averaged 2 per cent of GDP per year, large foreign reserves (US$92.8 billion at the end of 1997), and a currency firmly linked to the US dollar (at about 7.80 Hong Kong SAR dollars = US$1.00), since 1983 through a currency board, came under sustained attack. Indeed, the attack on Hong Kong’s seemingly impregnable currency board system came as a surprise to many.

Specifically, Hong Kong’s currency board system is based on a linked exchange-rate system that requires the monetary base (the sum of banknotes in circulation and bank balances with the central bank) to be fully backed by the foreign currency to which the domestic currency is linked. Thus, any change in the monetary base has to be matched by a corresponding change in the amount of US dollar reserves held by the Hong Kong Monetary Authority (HKMA). In effect, under Hong Kong’s currency board system, the currency issued was fully (i.e. 100 per cent) backed by foreign reserves, and the exchange value of the Hong Kong dollar vis-à-vis the US dollar was fixed at the intervention/official rate. The 100 per cent back-up requirement meant that one could not use the existing Hong Kong dollar currency to exhaust the official reserve. Thus not only was the money supply disciplined and demand-determined, but the monetary and exchange-rate system in
Hong Kong was far more stable than the “fixed” exchange rate system in the crisis-affected countries.

Yet these impressive fundamentals failed to provide immunity to Hong Kong. In the week beginning October 20, hedge funds and other speculators mounted a massive onslaught on the Hong Kong dollar. To pre-empt an all-out assault on the Hong Kong dollar, the HKMA raised its interest rate.\(^6\) By October 23, the HIBOR (Hong Kong Inter-Bank Offered Rate) was pushed to an unprecedented intra-day high of 280 per cent, while the three-month inter-bank rate shot up to 37 per cent (Yam 1998). This in turn prompted local banks to raise their prime lending rates. The sharp rise in interest rates allowed speculators to amplify the impact of their short selling of shares and speculative selling of stock futures on the stock index. That is, speculators were engaged in “double play” by selling short both foreign exchange and stocks.\(^7\) This caused the Hang Seng Index to plunge 1,700 points, or 14.6 per cent – the largest point drop and the third largest percentage loss in its history. Overall, the Hang Seng Index fell steadily from a high of 15,447 points in July 1997 to 7,225 points by August 1998 (Tan 2000, 131). Although Hong Kong managed to maintain its exchange rate peg to the dollar (despite strong speculative attacks), it suffered a 20 per cent drop in share prices, a sharp decline in property prices, and a precipitous fall in the stock market – triggering a worldwide fall in stock prices.\(^8\)

The depreciation of the Taiwan dollar also drew attention to the vulnerability of South Korea, which is closely competitive with Taiwan. Since Taiwanese products compete closely with Korea’s in the global markets, the move in undercutting the price competitiveness of Korean goods would sooner or later put enormous pressure on the Korean currency, the won. In fact, by early November 1997, the crisis had spread to Republic of Korea – the world’s eleventh largest economy. The Korean won came under increasingly heavy selling pressure, with the US dollar exchange rate rising from 870 in the first quarter of 1997 to over 1,100 in the fourth quarter of 1997. With the won under growing pressure, foreign banks ran down their claims on Korean banks and on their foreign branches – forcing these banks to buy dollars with which to repay their debts. The central bank came to their aid by selling them dollars directly and by depositing dollar reserves with their foreign branches. As a result, Korea’s foreign reserves, net of deposits, began to deplete rapidly: from US$30 billion to less than US$15 billion by the third week of November. Moreover, the sharp depreciation of the won not only greatly reduced Korea’s competitive edge, but also exacerbated its credit crunch problem in the international capital markets.\(^9\) This crunch in turn caused a currency crash and a liquidity crisis in an economy with unhedged and short-term foreign liabilities. Since the Korean economy is the third largest in Asia, the fall of the won implied a real depreciation that negatively affected the competitive position of the other countries in the region. Indeed, the fall of the won resulted in further competitive devaluation throughout...
The Asian financial crisis

Table 1.2 Changes in real GDP (%)

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<td>Indonesia</td>
<td>8.0</td>
<td>4.5</td>
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<tr>
<td>Korea</td>
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<td>8.6</td>
<td>7.5</td>
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<td>Philippines</td>
<td>5.8</td>
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<td>Singapore</td>
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<td>Thailand</td>
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<tr>
<td>China</td>
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<td>Hong Kong (SAR)</td>
<td>4.5</td>
<td>5.3</td>
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<td>Taiwan</td>
<td>5.7</td>
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<tr>
<td>Japan</td>
<td>5.0</td>
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<td>−2.5</td>
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<td>USA</td>
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East Asia. Faced with such mounting problems, the Korean government initially approached Japan for financial aid, but the request was turned down. In desperation, the Korean authorities (on November 20) widened the band in which the won was allowed to fluctuate – and the won fell quickly to the edge of the new band. The very next day, the Korean government turned to the IMF for help. On December 4, an IMF-led support package of US$57 billion was announced, and two days later the won was allowed to float.10 However, in spite of all these measures, Korea was, nevertheless, plunged into a deep recession.

Indeed, the crises turned out to be so severe that, in a matter of weeks, East Asia’s high-performing “tiger economies,” accustomed to annual growth rates of anywhere between 6 per cent and 10 per cent were reduced to “whimpering kittens.”11 As Table 1.2 shows, Indonesia’s economy (measured in real GDP) contracted by 13.7 per cent in 1998 and Thailand’s by 10 per cent and Hong Kong, Malaysia, and South Korea each contracted by between 5 per cent and 8 per cent. Such sharp swings in GDP are of the same order of magnitude as what occurred in the United States during the Great Depression in the 1930s (Gilpin 2000). Indeed, like the Great Depression, the financial crisis took a heavy socioeconomic toll. A fall in output of the severity described above was invariably accompanied by massive job losses, as bankruptcies and cutbacks in production multiplied. This led to a sharp rise in both unemployment and underemployment. According to the World Bank (2000, 103), at the end of 1998, unemployment in Indonesia, Thailand and Korea had reached some 18 million, compared to 5.3 million in 1996. Moreover, the rise in inflation in the context of a greatly weakened labor market extracted a further toll in terms of falling real wages and incomes.
The combined effects of growing unemployment, rising inflation, and the absence of a meaningful social safety-net system, pushed large numbers of displaced workers and their families into poverty.

In economic terms, 1997 began on a positive note for the long-beleaguered Russian economy. The gradual decline in inflation and successful exchange-rate management were promising signs. Moreover, the stock market was on the rebound, and output actually rose slightly (by 0.8 per cent) for the first time in over a decade. While the budget deficit remained uncomfortably high, at 7 per cent of GDP, the domestic and foreign attractiveness of government bonds led the Yeltsin administration to conclude that Russia would need no further IMF funds after the full disbursement of the current loan (Gould-Davies and Woods 1999, 16). However, by October 1997 Russia began to feel the first waves of Asian contagion. As Asian banks with losses on lending at home sold their holdings of Russian high-yielding bonds to improve their liquidity position, this placed great pressure on the ruble and on the bond market. According to one account roughly US$2 billion invested by Southeast Asian businesses fled Russia between January and March 1998 (Illarionov 1999, 69). Furthermore, a sharp drop in the price of the country’s biggest export commodity, gas and oil (a drop of 31 per cent between January and July 1998), coupled with Russia’s inadequate (and grossly unfair) tax base, a large and growing fiscal imbalance financed by short-term ruble-denominated T-bills (or GKOs), widespread corruption and the failure of the authorities to come to grips with the longstanding fiscal problems made Russia particularly vulnerable to changes in investor sentiment.

Russia responded to the growing economic pressure by raising interest rates. However, this only increased the already heavy burden of interest repayments on loans – inexorably pushing the country further into debt. In an effort to stop this deadly downward spiral, the government redoubled its effort at revenue (tax) collection, including empowering the authorities to seize and sell off assets of tax debtors. Such measures (supported by the IMF), only served to bring stiff opposition from the entrenched vested interests, especially the powerful business interests of the oligarchs. The continuing revenue shortfalls, the high debt-service burden and the international flight to quality finally pushed the authorities to appeal for foreign assistance. Under pressure from the United States Treasury, the International Monetary Fund on July 20, 1998 approved its portion (US$11.2 billion) of a US$22.6 billion loan package to strengthen Russia’s economic program and help stabilize the ruble. Although US$4.8 billion was spent almost immediately to defend the ruble, this failed to bolster confidence in the financial markets. As asset prices and foreign currency reserves continued their free fall, the government devalued the ruble by 34 per cent on August 17 and unilaterally imposed controls on capital flows and a 90-day moratorium on the repayment of Russia’s foreign financial liabilities. Such arbitrary actions
The Asian financial crisis led to further depreciation of the ruble, bringing in its train Russia’s loss of access to international capital markets, a virtual collapse of the banking sector and the accumulation of large external arrears. The widespread expectation among market participants that Russia would receive a rescue package because it was “too big to fail” turned out to be wrong. Indeed, the speed of the Russian collapse brought home the message that no country (not even a nuclear power) was too big to fail.

The Russian default was particularly traumatic, sending investors throughout the world scrambling for cover and inflicting heavy losses on a number of large financial institutions. In fact, so severe was the impact of the Russian crisis that interest rate spreads widened significantly, seriously straining the financial markets in the United States and other industrialized countries. With the Russian experience still fresh, investor confidence made another sharp volte-face in perception of sovereign risk. Inevitably, this triggered a new round of large-scale capital outflows from emerging markets, including Brazil, the world’s ninth largest economy (after the G-7 and China), and the other country once deemed too big to fail.

Although Brazil’s ambitious inflation stabilization program, the Plano Real (introduced in July 1994), had made exemplary progress towards restoring price stability and productivity growth and reducing inflation between 1994 and 1998 (after decades of out-of-control inflation), it failed to contain the fiscal deficit adequately. The fiscal deficit, estimated at 8 per cent of GDP in 1998, also contributed to a widening of the external current account deficit to 4.5 per cent of GDP in 1998.

These substantial fiscal and trade deficits and the structure of public debt (which makes the government’s finances extremely sensitive to changes in short-term interest rates and the exchange rate), made Brazil highly vulnerable to changes in investor sentiment – in particular, the widespread sentiment in financial markets that Brazil’s crawling peg was simply not sustainable. To stem the huge outflows of US$12 billion in August and another US$19 billion in September 1998, the Brazilian authorities increased official interest rates to more than 30 per cent in September 1998 and to more than 40 per cent in October, and announced several fiscal measures, including substantial spending cuts, to stabilize the real (IMF 1999, 49). However, this brought only temporary relief. By late September, Brazil’s foreign reserves had dwindled to US$45 billion, below the level of its short-term debt. As the real came under renewed pressure from speculators the Brazilian government sought external assistance. In November the IMF announced a US$41.5 billion multilateral loan package (with the IMF contributing US$18.1 billion under a three-year Stand-By Arrangement), to sustain the value of the real and help Brazil with its balance of payments problem.

However, the calming effects of the IMF program were short-lived. The failure by the authorities to reach political agreement on the fiscal adjustment program prevented Brazilian congressional approval and further undermined
Investor confidence. In December 1998 the Brazilian congress again failed to pass a critical component of the fiscal package (pension reform legislation), and in early 1999 the important state of Minas Gerais threatened to suspend servicing its debt to the federal government. Market concerns were immediately reflected in increased capital outflows, and spreads on Brazil’s external debt rose to about 1,000 basis points. By early January 1999 Brazil had about US$36 billion in reserves compared to US$70 billion in August 1998. The Standard and Poor’s ratings agency downgraded Brazil’s foreign debt rating, and the Bovespa, Brazil’s leading stock index, fell by 27 per cent in a week. As reserves continued to decline, the government was forced to abandon its exchange-rate policy and float the beleaguered real on January 15, 1999 – just two weeks after President Cardoso’s second inauguration.

For the G-7 nations and their OECD partners, acting in concert with the IMF, the World Bank and other multilateral financial institutions, managing the crises has been both frustrating and extremely costly. If the Mexican rescue package cost an unprecedented US$52 billion (with the IMF and the United States contributing US$17 billion and US$20 billion respectively), between August 1997 and December 1998 the G-7 and its partners had already pledged just over US$200 billion to support Indonesia, South Korea, Thailand, Russia and Brazil – with the IMF contributing an unprecedented US$65.3 billion. This amount does not include the additional US$30 billion pledged by Japan under the Miyazawa Initiative.

The frequency and severity of the crises, the enormous size of the rescue packages and the realization that such bailouts could not be continued indefinitely finally forced a reality-check on the complacent G-7 leaders. President Clinton, who in November 1997 dismissed Asia’s financial woes as “a few small glitches in the road,” a few months later characterized the Asian/global crises as “the greatest financial challenge facing the world in the last half century.” The urgent task facing the global community, President Clinton, the other G-7 leaders, their finance ministers and senior bureaucrats now argued, was to fix the potential flaws and to create a more equitable, sustainable and stable international financial and monetary system. Their collective esprit de corps was lucidly captured by the self-effacing, then United States Treasury Secretary, Robert Rubin, who in his inimitable manner stated that the task before the global community was to construct a “new international financial architecture” that was “as modern as the markets.”

Rubin’s pithy epigram has generated a veritable cottage industry. An ever-growing list of architects have come up with proposal after proposal on how to reform the existing economic regime and construct a new international financial architecture. Indeed, collaborative initiatives have already been unveiled to reduce susceptibility to financial crisis, and to deal with it more effectively when and where they occur. While there is broad consensus on the motherhood and apple-pie issues such as the need to strengthen the

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**Introduction: issues, debates and overview**

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The Asian financial crisis

global financial system via more intensive surveillance and monitoring of capital markets and country financial sectors (in particular, the banking system), timely dissemination of financial information under internationally agreed standards, greater transparency in both public and private sector activity, including greater private-sector burden-sharing in order to eliminate (or at least keep within permissible limits) the problems associated with asymmetric information and moral hazard, there is also much disagreement. Policy-makers, financial analysts, academic economists and others have been engaged in intense and usually instructive debates regarding the pros and cons of trade liberalization, capital controls, fixed versus floating exchange rate regimes, currency boards, dollarization, the role of the IMF, among other issues.

However, before much of the reforms envisioned in the new financial architecture had had a chance to be implemented, Asia was already in the midst of making a remarkable economic recovery – defying even the most optimistic predictions, which predicted the lapse of at least a decade before any meaningful recovery could take place. In this light, the IMF triumphantly noted that “the financial crises that erupted in Asia beginning in mid-1997 are now behind us and the economies are recovering strongly.” Major factors behind the recovery include strong exports (partly due to depreciated exchange rate levels), the rebuilding of foreign reserves (partly because of collapsing imports in 1998), fiscal deficits and low interest rates stimulating aggregate demand, reforms to the financial system resulting in foreign direct investment inflows, expansionary monetary and fiscal policy, and an improvement in the global economic environment – at least until September 11, 2001.

The focus and organization of the study

Why did an apparently localized currency crisis in Thailand soon engulf a number of countries long considered economic miracles? If the economic fundamentals were seemingly sound, why was the crisis so severe, and not a relatively mild correction? If the warning signs of an impending economic slowdown were there, why did no one predict the crisis? What has been the socioeconomic and political impact of the crisis? How effectively did the governments of Thailand, Indonesia and Korea respond to the crisis prior to the conclusion of agreements with the IMF? What were the deficiencies in domestic policies that contributed to the onset of the crisis? How did the international community, especially the IMF, respond to the crisis? What was the content of the IMF policies, and how did it affect the economies under the IMF programs? What has been the nature of the economic recovery in the crisis countries, and what explains the relatively quick recovery? How valid is the claim that the IMF policies are largely responsible for the
Introduction: issues, debates and overview

recovery? What explains why Hong Kong, Singapore and Taiwan came through such a severe region-wide economic contraction relatively unscathed? On the other hand, what explains why the People’s Republic of China (PRC), which suffers from many of the problems responsible for the crisis, remained conspicuously insulated from the turmoil raging around it? More conceptually, did the Malaysian capital controls work? What type of exchange regime is most suitable in this era of free capital flows? And last, but not least, what types of reforms are envisioned in the new international financial architecture, and what implications does it hold for emerging economies in Asia and elsewhere?

The aim of the study is to provide answers to these complex and interrelated questions. Already a large and ever-growing body of literature (academic, policy-oriented and journalistic) has emerged addressing some of these issues – with the question dealing with why the crisis occurred receiving most of the attention. However, much of this literature remains either too general or too country-specific, with the country-specific usually being highly technical and specialized. This study moves beyond the existing literature by highlighting that it was the interactive conjunction of many factors – domestic political and macroeconomic policies, as well as international economic forces – that caused the crisis. Yet it is not always easy empirically to distinguish the various interrelated factors. This study will attempt to make sense of the causes by highlighting what I term the “vulnerability” and “precipitating” factors up to mid-1997. Such an approach requires a broad political-economic framework. Indeed, one of the major strengths of this study is that it adds substantially to the emerging scholarship by providing a broad comparative political-economic perspective on the Asian financial crisis and its aftermath.

Chapters 2, 3, 4 and 5 are detailed case studies of individual countries, Thailand, Indonesia, South Korea and the PRC in turn. The chapters on Thailand, Indonesia and South Korea not only examine the factors behind the crisis, but also highlight the underlying similarities and the fundamental differences between the individual cases. Specifically, the chapters illustrate that inappropriate macroeconomic policy responses to large capital inflows, weaknesses in domestic financial intermediation and poor corporate governance resulted in the build-up of vulnerabilities, while banking fragility, high leverage and currency and maturity mismatches made these economies highly susceptible to reversals in capital flows. However, these weaknesses remained unnoticed as long as these economies were growing. Despite these similarities, each country also suffered from its own unique sets of problems, and varied in its response to the crisis. Also, since the most common criticism of the IMF prescriptions was that they were indiscriminately applied, without taking account of the unique problems faced by each country, such detailed case studies provide a useful approach to assessing critically the validity of these criticisms and the overall efficacy of the IMF programs. Chapter 5,
The Asian financial crisis

with detailed illustrations from the PRC, documents why it escaped the worst of the crisis. The aim of Chapter 6 is twofold: first, to provide a review of the competing perspectives on the new international financial architecture; and second, to document the emerging consensus on a number of fundamental issues and its implications for emerging market economies. For example, a detailed review of the Malaysian capital controls is provided to discuss the pros and cons of capital account liberalization. The Conclusion examines the reasons behind Asia’s remarkable economic recovery, and the challenges that lie ahead.

Competing perspectives on the Asian crisis

As has just been noted, the Asian financial crisis was caused by many factors and the conjunctural interactions among them. These mutually overlapping and at times competing perspectives can be roughly divided into three broad categories, viz. those that see the crisis as mainly the result of: (1) investor panic coupled with the intrinsic volatility of international capital markets – which can quickly transform a modest liquidity problem into a full-blown financial crisis; (2) unanticipated exogenous shocks and unfavorable external economic developments; and (3) structural weakness and mismanagement of the domestic economies. Because no single variable is likely to have caused the crisis, the issue is the degree to which each of these different factors contributed to its onset and severity. The following section provides an overview of the various perspectives.

Investor panic and the instability of international financial markets

There are generally two strands to this argument. An asymmetric information view of financial crises defines a financial crisis as being a non-linear disruption to financial markets in which the asymmetric information problems of adverse selection and moral hazard become so severe that financial markets are unable to channel funds efficiently to those who have the most productive investment opportunities. According to Frederic Mishkin (1999), foremost among financial market imperfections is that there are endemic problems of asymmetric information (or differential information among different stakeholders) in international lending that reduce the efficiency of financial markets, and often contribute to overshooting and instability.\textsuperscript{30}

In particular, it is argued that international lenders have limited and poor information about local borrowers. Indeed, in emerging markets, information on the financial positions of banks and corporations is far less adequate than in the markets of advanced countries. Problems associated with asymmetric information are amplified in these economies, resulting in investor assessments that swing from periods of excessive optimism or euphoria to
Introduction: issues, debates and overview

periods of excessive gloom and panic. This, in turn, often leads to adverse selection, where lenders over-extend credit, often to unsound and poorly-managed local banks and companies, as well as to panic withdrawals at the first sign of trouble.

Indeed, asymmetric information and the resulting adverse selection problem can lead to credit rationing, where some borrowers are denied loans even when they are willing to pay a higher interest rate. Moreover, the widely held belief that there are implicit guarantees by governments to maintain fixed exchange rates and to bail out local borrowers reinforces this process. At the same time borrowers are also encouraged by the same beliefs with regard to exchange rates and government bail-outs in time of crisis. As economic theory tells us: financial intermediaries who receive implicit guarantees will rationally choose investments that would otherwise be too risky. Moreover, implicit guarantees provide adverse incentives to international lenders to lend without implementing adequate supervisory, control and risk-management systems. These market failures not only increase the risks of international lending, but also make the market vulnerable to periodic crises. In such an environment it becomes rational for individual lenders to follow the herd when tell-tale signs of a crisis emerge. According to Mishkin (1999), in the case of Asia this herding phenomenon generated a self-fulfilling panic that led to market overreactions, which were not necessarily warranted by the economic fundamentals.31

The other related view, articulated by Furman and Stiglitz (1998), argues that although some macroeconomic and other fundamentals may have worsened in the Asian economies in the mid-1990s, the extent and depth of the crisis cannot be attributed to a deterioration in fundamentals, but rather to the panicky reaction of anxious domestic and foreign investors. In a similar vein, Radelet and Sachs (1998; 1998a) argue that in Asia the problem was one of liquidity rather than insolvency. That is, banks were not insolvent by any standard. Rather, East Asian financial institutions had incurred a significant amount of external liquid liabilities that were not entirely backed by liquid assets.32 Compounding this problem was the fact that a large proportion of foreign borrowings by corporates and banks were unhedged because of the prevailing expectations of stable exchange rates. When these expectations were disappointed, the scramble to repay these foreign currency loans created a massive market imbalance. In mid-1997, countries that relied on short-term capital inflows were caught in a liquidity crisis when investors refused roll-over lending. For example, in Indonesia, when available foreign exchange reserves were insufficient to cover short-term foreign liabilities, a sudden loss in investor confidence led to a rush for the exits by foreign investors, leading to a dramatic collapse of the rupiah. Many corporations, which would otherwise have been profitable, were made insolvent because over-depreciation of the rupiah increased the domestic value of their foreign debts to unsustainable levels.
The Asian financial crisis

Thus, the East Asian countries were victims of a shift in investor expectations that became self-fulfilling. Radelet and Sachs support their claims by showing that, up until the third quarter of 1997, optimism about the region was expressed by international bankers (as shown by low and falling risk premia attached to loans to East Asia), credit ratings agencies (as shown by ratings that remained unchanged throughout 1996 and the first half of 1997), and securities firms (as shown by their published forecasts). On the other hand, clear evidence of a collapse in investor confidence can be seen in the dramatic reversal of capital flows. In 1996, the capital inflow to the five Asian crisis economies (Korea, Thailand, Indonesia, Malaysia, the Philippines) was US$93 billion. In 1997, the figure was a minus US$12.1 billion, a swing of US$105 billion. This dramatic reversal represented 11 per cent of the combined GDP of the five countries (IMF 2000a). Similarly, quarterly Bank of International Settlements (BIS) data on banking flows show that international bank lending to the five crisis-affected countries was positive, at almost US$50 billion, in the first half of 1997, but swung to minus US$40 billion in the third quarter of 1997, thereafter averaging close to minus US$100 billion for the three quarters that followed (BIS 1999). For Radelet and Sachs (1998a), there is no other way to explain such a swift and massive outflow of capital once the crisis broke except as a classic bank run – where commercial banks and portfolio investors suddenly seized with panic demanded immediate payment, thereby forcing financial intermediaries to liquidate at great loss. Compounding the problem of investor panic were the overly harsh fiscal and monetary policies prescribed by the IMF. Radelet and Sachs note (1998a, 4–5):

The [Asian] crisis is a testament to the shortcomings of the international capital markets and their vulnerability to sudden reversals of market confidence . . . In this sense, the Asian crisis can be understood as a crisis of success caused by a boom of international lending followed by a sudden withdrawal of funds. At the core of the Asian crisis were large scale foreign capital inflows into financial systems that became vulnerable to panic . . . A combination of panic on the part of the international investment community, policy mistakes at the onset of the crisis by Asian governments, and poorly designed international rescue programs have led to a much deeper fall in (otherwise viable) output than was either necessary or inevitable.

Radelet and Sachs make a compelling argument. Certainly, the revolutionary advances in computing and other communications technology have enabled investors to access information on macroeconomic data, asset prices and exchange rates at the push of a button. Today, global capital markets operate around the clock searching for the highest rate of return, and financial transactions can occur instantaneously. Among other things, this has made bank and currency runs both easier and faster. Large depositors and other banks can withdraw funds almost instantaneously. Indeed, the highly
competitive and globalized financial world has created individual market participants that are huge enough to mobilize, often with the help of leverage, financial resources larger than the GDP of smaller economies. They can build up dominating positions in the markets of smaller economies and influence short-term market movements singly or through acting in concert. Even small depositors no longer need to line up physically at banks to withdraw their funds. They can transfer their funds to other banks by telephone, computers and automatic transaction machines (ATMs). Not only can funds be withdrawn faster and more cheaply; runs can start upon the receipt of any adverse news about the financial health of financial institutions and countries. Thus, in a world of integrated, securitized and electronically linked capital markets, where in-depth information is expensive to obtain, it may be rational for investors to react to even small news — and move funds in and out of markets with a click of the computer keyboard. Arguably, relatively small bad news can lead to a major speculative attack, even if the news is not related to any important change in economic fundamentals. Thus Calvo (1996) argues that emerging markets are vulnerable to a herd mentality among investors. Since it is too costly for investors to address the state of each economy, it is optimal for them to pull out of a group of related markets simultaneously when they spot signs of trouble in any one of them. Similarly, Masson (1998) argues that small triggers can be precipitating factors for investors, leading to across-the-board loss of confidence and a higher perceived risk of holding investments in a set of countries. As investors follow each other and pull out their funds, the herd behavior pushes these countries into financial distress.

The comprehensive study by Kaminsky and Schmukler (1999) analyzes the twenty largest one-day swings in stock prices (in US dollars) in Hong Kong, Indonesia, Japan, South Korea, Malaysia, the Philippines, Singapore, Taiwan and Thailand since January 1997 to see what type of news moves the markets in days of extreme market jitters. Of special interest was whether news in one country would affect markets in another, and if so, what type of news. The authors classified news into seven different categories: news related to agreements with international organizations, the financial sector in each country, monetary and fiscal policies, credit-rating agencies, the real sector and political announcements. Their study found that some of the biggest one-day downturns cannot be explained by any apparent substantial news, but seem to be driven by herd instincts of the market itself. Similarly, Goldfajn and Baig (1998) construct dummy variables to represent good and bad news. They find that news in one crisis country affects exchange rates and stock markets in the others, suggesting contagion. Thus there appears to be an element of pure contagion effect at work — that is, a sudden and massive shift in market sentiment unrelated to market fundamentals. Their study reinforces the view that, in this era of mobile capital, even countries with otherwise exemplary macroeconomic environments
The Asian financial crisis

(in Asia, countries such as Singapore, Taiwan and Hong Kong) can become victims of market contagion.

There is no doubt that a currency crisis in one country can worsen market participants’ perception of the economic outlook in countries with similar characteristics and trigger a generalized fall in investor confidence. Since financial market turbulence can spread from one country to another via three main channels – monsoonal effects, spillovers and pure contagion effects – the study by Goldfajn and Baig (1998) of financial market developments in Malaysia, Indonesia, the Philippines, Thailand and South Korea from July 1997 to May 1998 provides evidence of high correlations between sovereign spreads across the five countries. This indicates that markets felt that the probability of private debt default increased dramatically in these countries, and nervousness about one market was transmitted to other markets readily. As a consequence, global investors demanded higher risk premiums for all countries. Moreover, in Asia, the rapid downgrading of the region’s sovereign ratings by international rating agencies further fueled the shift in market sentiment, triggering panic selling of foreign-owned local assets. Also, we now know that the most severely affected crisis countries experienced external liquidity crises as investors came to doubt that adequate reserves were available to service maturing foreign debts. As this doubt became widespread, panic set in, soon to be followed by a stampede – to borrow Sachs’s apt metaphor. On the one hand, local residents rushed to buy foreign exchange to cover their dollar liabilities, thereby intensifying exchange-rate pressures. On the other hand, instinctively risk-averse and with a low tolerance for uncertainty, the fickle international financial markets and their managers did what they had done in Mexico in 1994 – fleeing the region as fast as they had entered. Seen in this light, Asia’s punishment was in a sense disproportionate to the crime – it became a helpless victim of irrational panic and investor stampede.

Yet external shock by itself need not have caused a crisis of the magnitude that Asia experienced – if only its domestic economic and political structures had been robust. Confronted with a contagious external shock the highly integrated economies of Thailand, Indonesia, Malaysia and Korea, with their embedded inefficiencies and weak financial systems, could not withstand the impact. The domino effect of the weakening currencies first adversely affected the financial sector, and then the real sector of the national economies. Furthermore, an important component of vulnerability is the credibility of the government with regard to its ability to suffer (or inflict) pain in defense of the currency. A combination of weak banking systems and low reserves can undermine a country’s ability to defend the currency. If a country with low reserves cannot tolerate capital flight, weak banking systems make interest rate defenses more costly. The moral of the story is rather simple: it is difficult to point to any emerging market economy that experienced a financial crisis, but did not suffer from some fundamental

14
weaknesses. In Asia, the rapid capital withdrawal greatly exacerbated the underlying weakness.

Furthermore, it is hard to overlook the contagion stemming from the growing financial integration within the region. As Masson (1998) notes, a crisis in one country may affect the economic fundamentals of a group of countries to which it is closely associated through trade and financial links. For example, depreciation in the value of the currency of one country can affect the price competitiveness of other countries through spillover effects. Financial interdependence can also contribute to the transmission of a crisis, as initial turmoil in one country can lead outside creditors to recall their loans elsewhere, thereby creating a credit crunch in other debtor countries. Also, any major trading partner of a country in which a financial crisis has induced a sharp currency depreciation could experience declining asset prices and large capital outflows or could become the target of a speculative attack as investors anticipate a decline in exports to the crisis country, and hence a deterioration in the trade account. In the case of Asia, the initial baht devaluation certainly affected investor confidence in the Asian region, just as the decline in the Indonesian rupiah made Korean investors suffer large losses. In order to make up the losses, Korean investors started to sell Russian and Brazilian securities, thereby depressing their bond prices. Overall, the deepening recession in the worst-affected countries pulled down their neighbors, further weakening regional economic growth. Indeed, there is substantial evidence that trade linkages are an important reason for the spread of crises.37

Unfavorable external economic developments

These included China’s devaluation in 1994, Japan’s prolonged recession and the appreciation of the US dollar, which worked in tandem to make the Asian economies highly vulnerable to shocks.

China’s devaluation

Central to China’s economic growth has been the liberalization of the foreign trade and investment regime, and the adoption of an ambitious open-door strategy. Prior to the introduction of the Deng reforms, China remained a backward and closed economy, with foreign trade amounting to a miniscule 7 per cent of GNP. However, the liberalization of the foreign trade and exchange-rate regime, followed by further wide-ranging reforms introduced in 1988 (which included increased retention of foreign exchange and easier access to foreign exchange adjustment centers established in 1986), enabled businesses, in particular the enterprises, to buy and sell foreign exchange at a depreciated rate known as swap rate, and thus greatly helped to boost exports. By the early 1990s, foreign trade had grown to an unprecedented $200 billion, or roughly 40 per cent of GNP (Cerra and Dayal-Gulati 1999).
The Asian financial crisis

On January 1, 1994 China unified its exchange rate by bringing the official rate into line with the prevailing swap-market rate, resulting in a depreciation in the official rate by about 50 per cent (in effect, the yuan was devalued by 50 per cent). China’s pre-emptive devaluation, even as it led to a real exchange appreciation for the dollar-pegged currencies in Southeast Asia (sharply undercutting their export competitiveness), created an export boom for China. Moreover, reform measures such as (a) the abolition of the retention quota system for foreign exchange; (b) the revision of the tax system to allow a zero value-added tax (VAT) rating for exports by domestic firms and the newly established foreign-funded enterprises; (c) further relaxation of China’s open-door policy towards foreign direct investment, including the provision of special tax incentives to foreign investment in technology-intensive industries; and (d) generous tariff concessions (including lower income tax rates and tax holidays) to firms operating in the coastal special economic zones only served further to enhance China’s international competitiveness and helped it to expand its export markets greatly. Between 1990 and 1997, Chinese exports to industrialized countries have grown at an average rate of 15.5 per cent per annum, and for the period 1995–1997, which saw a decline in world trade growth, China’s exports to the United States grew by 8 per cent, while Japanese exports declined by 2.4 per cent. Also, China’s share of garment exports exceeded the total from the five Asian crisis economies (Indonesia, Korea, Malaysia, the Philippines and Thailand), rising from 37 per cent in 1990 to 60 per cent in 1996, and its share of electronics exports increased from 12 per cent to 18 per cent over the same period. Overall, since the start of the reform period, China’s share of world trade has almost quadrupled. Yet some analysts, while admitting that the Chinese devaluation caused a deterioration in the competitiveness of the East and Southeast Asian nations’ economies, maintain that the perceived shift after 1994 in the regional competitive advantage towards China has been exaggerated. They note that while the yuan did depreciate in nominal terms, its real depreciation was eroded by the fact that China’s inflation rate since 1995 was higher than those of its trading partners. Also, it should be noted that Thailand, Indonesia and Malaysia experienced a gradual erosion in the competitiveness of their export industries as a result of rising domestic costs, especially wage costs, against the backdrop of an industrialization process that was not very effective in shifting from labor-intensive industries to higher levels. Thus, it can be concluded that the Chinese devaluation was “at best a contributing factor to the Asian financial crisis, not the primary cause” (Liu et al. 1998, 1).

The Japanese recession
Japan, the world’s second largest economy – suffering from what has been described as the “world’s slowest economic crisis” – has inadvertently played a significant role in the emergence and spread of the Asian crisis.
Introduction: issues, debates and overview

monetary problems began with the currency agreements of 1985 (the Plaza Agreement) and 1987 (the Louvre Agreement), when the G-7 countries attempted to establish more predictable foreign exchange intervention and target bands for exchange rates between the leading currencies. Under these agreements the Japanese agreed to buy US dollars in the foreign exchange markets, the domestic counterpart being the creation of yen. This derailed Japanese monetary growth as measured by M2+CDs from its long successful growth path of about 8 per cent per year, causing money growth to accelerate to about 12 per cent per year. This was the origin of the bubble in equity prices and in real estate sectors in the late 1980s. Specifically, when the manufacturing sector no longer required significant amounts of new credits, the banks turned to the “bubble sectors” such as construction, real estate and non-bank finance to build their loan book. Soon this resulted in a number of famous anomalies, including the three-quarters of a square mile plot of land under the Imperial Palace in Tokyo, which was supposedly worth more than the entire state of California, and the fact that the market capitalization of Nippon Telegraph and Telephone (NTT) was worth more than the capitalization of entire markets such as Germany (Mera and Renaud 2000, 66–7).

The Japanese economy first showed signs of serious strain in the late 1980s, when the bubble economy of the 1980s – the speculative boom that generated hundreds of billions of dollars in bad debt – burst. Since the collapse of the asset-price bubble, economic growth in Japan has stagnated. Over the period 1987 to 1995, the Nikkei index declined by more than 49 per cent. Real estate prices have also declined by more than 50 per cent since 1990. Real investment spending, which had been growing at 20 per cent per annum in 1989, plummeted to less than 1 per cent in 1992 (Tan 2000, 41). From 1992 to 1996, annual real growth in Japanese GDP has averaged less than 1 per cent compared to 2.6 per cent in the United States over the same period. More broadly, real GDP growth in Japan averaged just 1.4 per cent during 1991–2000, one-third the average growth rate recorded during 1981–90. Japan’s performance during 1991–2000 also compared poorly with average growth rates of 3.4 per cent for the United States and 2.1 per cent for the EU.

The collapse in asset prices dealt a significant blow to Japan’s financial institutions, as Japanese banks were allowed to use 45 per cent of the market value of their equity holdings to meet the Bank of International Settlements (BIS) reserve requirements. The decline in stock prices reduced their reserves, while their real estate loans became problem loans. According to one estimation, the collapse of asset prices has caused a significant contraction of individual wealth. The total decline in the Japanese people’s wealth caused by the collapse of real estate prices amounts to 1,000 trillion yen, twice Japan’s annual GNP.

Despite prime minister Hashimoto’s call for a “big bang” approach to financial reform in November 1996, the Japanese financial system deteriorated
The Asian financial crisis

further in the second half of 1997. The large increase in consumption tax in April 1997 (implemented to address Japan’s large fiscal deficit), caused the economy to lapse deeper into recession. Real growth over the four quarters of 1997 amounted to minus 0.4 per cent, unemployment and bankruptcies increased, and the country remained trapped in recession throughout 1998. In response to the deepening contraction and a growing credit crunch, the Japanese government approved yet another (the thirteenth) broad fiscal stimulus package totaling 17 trillion yen in April 1998, a further 17 trillion yen in 1999, including 6 trillion yen in tax cuts (Horiuchi 2000, 30–1). So far, these measures have failed to resolve the roots of Japan’s economic malaise: the US$800 billion to US$1 trillion in non-performing loans. As the next section illustrates, Japan’s long recession has had a significant impact on the crisis-hit countries in the region.

During the late 1980s and 1990s, with the very rapid and sustained appreciation of the yen, Japanese manufacturers recognized that they needed to transfer a large proportion of Japan’s manufacturing production (particularly at the low end of the technology spectrum) to the lower-labor-cost countries in Asia and elsewhere. This circumstance enabled the Japanese banks (which were then among the world’s largest financial intermediaries), substantially to increase their global presence. Japanese banks were not only too happy to service Japanese companies that were increasingly involved in foreign direct investment, but also to re-cycle capital – given Japan’s position as the world’s pre-eminent source of surplus capital. Foreign direct investment (FDI) from Japan tripled in the decade to 1997, rising from US$22.3 billion in 1986 to US$66.2 billion in 1997. While the United States and Europe remained important destinations for Japan’s FDI, the Asian share showed the largest rise, increasing from around 10 per cent of the total in 1986 to 25 per cent in 1997 (Grenville 1999, 3). Moreover, an added impetus to lend came when, in order to revive the Japanese economy from deep recession, the Japanese government reduced the discount rate to 1 per cent in April 1995. Thus, facing virtually non-existent interest rates at home, Japanese banks sought higher returns through aggressive, large-scale lending, in particular, to the fast-growing East and Southeast Asian economies. Among other reasons, the East and Southeast Asian countries eagerly sought Japanese FDI because it enabled them to engage in the profitable “yen-carry-trade.” Japan’s total international investments, consisting of foreign direct investment, portfolio investment (such as equity securities, debt securities, money market instruments and financial derivatives), and other investments, including loans, trade credits, foreign currencies, foreign deposits and other assets, increased sharply – “from a net asset position of 29 trillion yen in 1986 to 124 trillion yen in 1997, of which 75 per cent was accounted for by the private sector (banking and other sector) and the balance by the public sector . . . these investments have provided the financing needs of both the private, government and banking sectors in Asia, particularly in
Introduction: issues, debates and overview

Table 1.3  Asia’s foreign bank borrowing as of June 1997

<table>
<thead>
<tr>
<th>Borrowing country</th>
<th>Total foreign loans (US$B)</th>
<th>Total from Japanese banks (US$B)</th>
<th>% of Total from Japanese banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Indonesia</td>
<td>59</td>
<td>23</td>
<td>39</td>
</tr>
<tr>
<td>Malaysia</td>
<td>29</td>
<td>10</td>
<td>34</td>
</tr>
<tr>
<td>S. Korea</td>
<td>103</td>
<td>24</td>
<td>23</td>
</tr>
<tr>
<td>Thailand</td>
<td>69</td>
<td>38</td>
<td>55</td>
</tr>
<tr>
<td>Total</td>
<td>260</td>
<td>95</td>
<td>37</td>
</tr>
</tbody>
</table>


However, the bursting of the asset bubble left Japanese banks with deteriorating asset quality, while the stagnant economy further weakened the already over-leveraged banks, culminating in the failure of several large institutions. For example, in 1996, Nissan Life Insurance, a major insurance company, collapsed. In November 1997, one of Japan’s ten large nationwide city banks, Hokkaido Tokushoku Bank (popularly known as Takugin) went bankrupt despite the effort to rescue it through a merger with the Hokkaido Bank. It was revealed that Takugin’s capital adequacy ratio (CAR) was less than zero, as against its reported figure of 9.34 per cent. Also in November 1997, Sanwa and Yamaichi Securities went bankrupt (Landers and Biers 1998, 98–105). By the end of 1997, the profitability of the financial sector had fallen sharply, resulting in the need for more write-offs of bad loans. As the crisis deepened, many of the banks suffered capital losses and were forced to re-balance their loan portfolios in adherence to capital adequacy standards. Since the capital adequacy requirement is higher for international than for national lending, many banks chose to recall foreign loans and contain the magnitude of the domestic lending squeeze. At the same time, banks and financial institutions in East and Southeast Asia that had borrowed from Japan were hit by the currency shocks and the financial outlook of Japanese banks and securities firms correspondingly deteriorated. On the basis of Japanese banks’ reports of their financial outlook for the fiscal year ending in March 1999, the 17 largest Japanese banks suffered a net combined after-tax loss of 3.6 trillion yen (US$29.5 billion
The Asian financial crisis

at US$1: 22 yen). Moreover, even after spending 10.4 trillion yen to dispose of non-performing loans in the 12 preceding months, the total non-performing loans at these banks stood at over 20.9 trillion yen. It is estimated that the bad loans of the major Japanese banks alone total about 7 per cent of GDP. This figure far exceeds the amount of government resources spent (2.5 to 3 per cent of GDP) to resolve the Savings and Loan crisis in the United States.49

Thus, Japan suffers from its own economic crisis – characterized by severe deflationary pressure and prolonged undervaluation of its currency. Overall, the prolonged recession in Japan has greatly reduced Japan’s demand for imports from the rest of Asia. In the first quarter of 1998, imports from Southeast Asia to Japan had fallen by 26 per cent from the previous year, while Japanese tourism to the Asian region dropped by 50 per cent from June 1997 to June 1998. Moreover, Japanese manufacturers sharply reduced the pace of direct investments into Asia (which had been concentrated in areas such as automobiles and electronics), as existing capacity dwarfed the reduced size of regional demand for these products. Also, as the Nobel economics laureate Merton Miller has noted, Japan in trying to export its way out of its long recession has significantly contributed to the regional downturn (Vines 2000, 14). Clearly, Japan’s ability to act as a catalyst for regional recovery has been severely limited. This is in sharp contrast to the US role in the Mexican peso crisis of 1994–95. In the latter, an expanding US economy was able to absorb the shocks and guide Mexico towards recovery. However, Japanese banks, faced with the deterioration in their balance sheets, became the first to pull out of Asia, calling in their loans and exposures to the region.

Indeed, Japanese banks were not only forced to cut losses by refusing to roll over existing loans, they also refused to extend new ones, a decision that extended to closing foreign branches and selling parts of their overseas operations. According to the Monetary Authority of Singapore (2001), Japan added a total of US$69 billion in net liquidity to East and Southeast Asia during the second half of the 1980s – a figure based on the aggregate of trade, foreign direct investment, portfolio investment and bank credit flows. However, this net liquidity inflow turned to a net outflow of US$126 billion during 1991–95, and an even larger net outflow of US$374 billion during 1996–2000. These actions have contributed significantly to the vicious spiral of illiquidity and the resultant insolvency and regional credit crunches. Fred Bergsten (1998, 1–2) notes:

Japan, which accounts for three quarters of the Asian economy, has plunged into recession and is already close to a “lost decade” . . . The crisis countries must put their own houses in order but, even if they do everything right, they cannot resume satisfactory growth until Japan does so. The “flying geese” formation, whereby the rest of Asia follows the lead of Japan, may become a flock of dead ducks for a prolonged period – whereas rapid growth and open
markets in the United States enabled Mexico to bounce back from its 1995 crisis after only one year.

The US dollar appreciation
Before the crisis, Thailand, Indonesia, Malaysia, Singapore, South Korea and the Philippines all adopted a currency basket system. However, the fact that the US dollar had a high weight in the basket meant that all had de facto pegged their currencies’ nominal exchange rates to the US dollar. One of the benefits of such fixed but adjustable exchange rate regimes was to provide macroeconomic discipline by maintaining the prices of tradable goods in line with foreign prices. These regimes contributed to the relative stability of the real exchange rate until mid-1995. The currency stability vis-à-vis the US dollar was instrumental in bringing in direct and portfolio investment. In particular, the dollar-pegged regime attracted Japanese foreign direct investment and helped the governments to promote export-led growth.51

Following the 1985 Plaza Accord, the G-7 countries (USA, UK, Germany, Italy, France, Canada and Japan) undertook a major currency market intervention to realign exchange rates. One major effect of this was the appreciation of the Japanese yen and the depreciation of the US dollar. Hence, the Plaza Accord is known for bringing down the value of the US dollar and ushering in a new era of the appreciating yen. Between 1985 and 1988, the yen almost doubled in value vis-à-vis the dollar and other Asian currencies tied to the dollar. More broadly, by 1988, the yen was almost 30 per cent above its average for the 1980–85 period on an inflation-adjusted, trade-weighted basis. Overall, in the decade 1985 to 1995, the yen had appreciated dramatically against the US dollar, from about 238 to 80. This had major consequences for Japanese industry, as many firms found it increasingly unprofitable to export from Japan. For example, it was reported that for every 1 yen movement in the SUS/Yen exchange rate, the profits of the Toyota motor car company experienced a change of 12 billion yen (Tan 2000, 27). Not surprisingly, many Japanese firms began moving their operations offshore – where wages were much lower and the exchange rate was more favorable. Japanese foreign investment, which totaled about US$9 billion in 1985, jumped to US$68 billion by 1989. By the mid-1990s, 40 per cent of the total output of major Japanese electronics companies was produced offshore, while for medium-sized electronics companies the ratio was 60 per cent. The high-performing ASEAN countries (especially Indonesia, Malaysia and Thailand) were the major beneficiaries of Japanese investments.52 As Tan (2000, 28) notes, “between 1985 and 1990, Japanese foreign investment in ASEAN countries doubled (from US$11 billion to US$21 billion), much of it going into labor-intensive industries such as textiles and electronics component manufacture. By 1991, some 400,000 workers in ASEAN countries were working in Japanese-owned companies. By the early
The Asian financial crisis

1990s, the Sony Corporation was making more color television sets in Malaysia than in Japan.”

However, by the mid-1990s the era of the strong yen was over. The third external shock that has contributed to the Asian financial crisis has been the sharp appreciation of the dollar that began in 1995, especially its appreciation vis-à-vis the yen. As the dollar rose relative to the yen in the months before the crisis, the currencies of the crisis countries rose in comparison with the yen also. In some cases the crisis countries followed the dollar very closely; in others the link was looser, because they used a basket peg but still gave the dollar substantial weight. This system of a de facto peg or quasi-peg against the dollar conferred competitive advantage on these countries when the dollar was relatively weak in the international currency market. However, from April 1995, when the dollar began to appreciate against the yen, the real effective exchange rates of most of the region’s currencies started to appreciate. Since these East Asian economies exported a substantial proportion of their goods to Japan, the resultant loss in export competitiveness contributed to a deterioration in the current account of the Japanese balance of payments.

Specifically, after hitting a historic high of 80 yen to the dollar in June 1995, the yen experienced a downward trend, falling to 127 yen to the dollar in April 1997 – just before the Asian crisis broke. The yen’s sharp depreciation led to a marked deterioration in East and Southeast Asia’s export performance and current account imbalances in 1996, paving the way for the currency crisis. For example, in the case of Thailand, although the baht had edged down by about 4 per cent against the dollar in the two years leading up to the July 2, 1997 devaluation, its real effective exchange rate (trade-weighted) had appreciated by about 15 per cent over the same period. This largely reflected its sharp appreciation of approximately 35 per cent against the yen. As a result, export growth decelerated sharply, from over 20 per cent in 1995 to virtually zero in 1996, with the current account deficit reaching 7.9 per cent of GDP. The exchange-rate policy of pegging to a basket of currencies in which the dollar was weighted heavily had constrained the government from allowing the baht to depreciate against the dollar at a faster rate to stimulate exports. Similarly, other Asian countries that had also pegged their currencies loosely to the dollar suffered a sharp slowdown in exports on the back of the weakening yen. The depreciation of the yen against the dollar also affected capital flows. It increased the capital inflow through interbank short-term borrowing, notably from Japan – since depreciation of the yen against the dollar under a de facto dollar-pegged exchange-rate regime was equivalent to the appreciation of the crisis-affected countries’ own currencies against the yen. This prompted banks as well as non-banks in Thailand, South Korea and Malaysia to borrow from Japan in order to invest in high-yielding risky foreign bonds, real estate and consumer loan services. Most of these investments turned
Introduction: issues, debates and overview

into non-performing loans in these countries after the bubble burst in 1997.

Thus, since Asian countries have substantial trade relationships with Japan, the yen depreciation relative to the US dollar meant that these countries on a de facto dollar peg became less competitive vis-à-vis Japan. Korean firms lost ground to Japanese firms as the yen depreciated in 1995–96. Thai firms that lost competitiveness when China de facto devalued its currency in 1994, lost further competitiveness as the yen depreciated vis-à-vis the US dollar in 1995–96. Therefore the yen depreciation from 1993 to April 1995 produced the boom in Asia, while the yen appreciation from April 1995 to 1997 depressed economic activity. Clearly, the business cycles in Asia are fundamentally correlated with the yen/dollar cycle. While these three external factors did not trigger the crisis, they cumulatively contributed to its severity and duration.

Domestic structural weakness and mismanagement

The fact that no one predicted the crisis is hardly surprising. The celebrated “tiger economies” of Southeast and East Asia were long viewed as the “miracle economies,” with seemingly impeccable economic fundamentals and constituting a model for others to emulate. Between 1965 and 1990 the economies of Japan, the four original tigers (Hong Kong, Korea, Singapore and Taiwan), and the three emerging tigers, or the newly-industrializing economies of Southeast Asia (Indonesia, Malaysia and Thailand) grew more rapidly than any other group of economies in the world, averaging 7 per cent per year growth rates in real terms since the mid-1970s, and over 9 per cent per year since the late 1980s.54 This meant that the fast-growing Asian economies were doubling their real GDP approximately every 7 years during the 1960s and 1970s, and roughly every 7 to 10 years during the 1980s (World Bank 1993). All these economies also experienced dramatic increases in real per capita incomes. In South Korea and Singapore, for example, real per capita income grew more than 700 per cent between 1965 and 1995. Over the same period Taiwan and Hong Kong logged a 400 per cent increase, while Malaysia, Thailand and Indonesia each experienced real per capita income growth of over 300 per cent (Crafts 1999). South Korea’s unprecedented growth in per capita GNP (6.9 per cent over 1960–81 and 8.5 per cent over 1980–94) increased incomes from US$1,700 in 1981 to US$8,260 in 1994. Equally impressively, Indonesia’s per capita GNP rose from US$90 in 1972 to US$880 in 1994, Thailand’s from US$220 to US$2,410 and Malaysia’s from US$450 to US$3,480.55

Not surprisingly, a spate of popular books, including Jim Rohwer’s (1995), Asia Rising: Why America will Prosper as Asia’s Economies Boom and John Naisbitt’s (1995) bestseller, Megatrends Asia, not to mention a growing list of academic tomes, projected the inexorable shift in power towards the
Asia-Pacific economies – besides showering laudatory praises on the virtues of the so-called East Asian-style state-guided capitalism. The region’s self-styled gurus, such as the Malaysian strongman, Mahathir Mohamad, and Singapore’s patriarch, Lee Kuan Yew, found the semiotic imagery of Asian-style capitalism congenial, as it suggested that their leadership played a critical role. Predictably, they confidently asserted that Asia’s exuberant growth was destined to continue long into the next millennium. The World Bank (1993), along with a growing number of leading economists such as Columbia’s Jagdish Bhagwati (1996), concurred with the sanguine assessments. Indeed, the World Bank’s (1993) influential study, *The East Asian Miracle: Economic Growth and Public Policy*, praised the prudent role of the state in Asia’s economic development, claiming that the miracle was due to the state’s adherence to the market-friendly policies epitomized by the so-called “Washington Consensus.” That is, by adopting liberalized capital accounts, open trade and foreign investment policies, a single competitive exchange rate and a commitment to the principles of comparative advantage, economic integration and export-led growth, Asia was able to build an economy on solid foundations. In other words, an economy based on both the accumulation of factors of production (especially the massive investment in physical capital), and increases in total factor productivity, measured in terms of improvements in technology and efficiency.

In those halcyon days the lone dissenter was the iconoclastic economist, Paul Krugman. In a provocative article published a few years before the Asian crisis (in 1994), he argued that East Asia’s economic growth, impressive as it was, could be explained by basic economic factors such as high savings rates, investment in education and job creation. In other words, growth was achieved as a result of increased inputs, not as a result of increased total factor productivity. Indeed, Krugman likened the experience of the fast-growing economies of East Asia to the former Soviet Union, which grew rapidly in the 1920s and 1930s through large increases in the employment of capital and labor, rather than increases in total factor productivity. Krugman called this working harder, not smarter – growth as a result of “perspiration rather than inspiration.” This finding prompted him to refer to the high-performing economies of East Asia as a collection of paper tigers. Since there are inevitable limits to expanding growth by raising savings rates, labor force participation, etc., Krugman predicted that East Asia’s growth rates were bound to decline over time. However, Krugman’s model predicted “diminishing returns” or a gradual loss of economic growth, not a sudden and precipitous financial crash.56

As is usually the case, there is always much wisdom after the fact. Before the dust had even settled from the wreckage of the crisis, a veritable cottage industry sprang up virtually overnight to describe and analyze the many ills afflicting the Asian model of development. The one that caught the popular imagination was crony capitalism. Many now argued that the Asian
development model was in fact infected with the virus of cronyism and patronage. Rather than operating on the principles of free market economics, there was widespread political interference with the market process. This included such practices as patronage appointments of relatives and cronies to state-owned enterprises and other businesses, granting lucrative government contracts to political allies, allocating credit to favored firms and industries without prudential oversight, promoting those with nepotistic, factional and personal ties to the well-connected, and engaging in predatory rent-seeking and other activities geared towards embezzlement and self-aggrandizement. Krugman (1998, 74) describes the workings of the insidious crony capitalism in evocative prose:

how Asia fell apart is pretty familiar . . . the region’s downfall was a punishment for its sins. We all know now what we should have known even during the boom years: that there was a dark underside to “Asian values,” that the success of too many Asian businessmen depended less on what they knew than on whom they knew. Crony capitalism meant, in particular, that dubious investments – unneeded office blocks outside Bangkok, ego-driven diversification by South Korean chaebol – were cheerfully funded by local banks, as long as the borrower had the right government connections. Sooner or later there had to be a reckoning.

The following chapters will illustrate that cronyism and corruption was indeed a big problem and played a significant role in undermining economic development. The lack of transparency in economic management, besides fostering moral hazard in the form of expectations of government guarantees to politically connected lending, also resulted in the fatal mis-allocation of investment, falling returns to investment and growing fragility in the financial system. In each crisis-affected country, the connections between politicians and certain private enterprises created a moral hazard problem, whereby these enterprises were seen as carrying an implicit guarantee against insolvency. Thus there was a strong incentive for financial institutions to lend to these enterprises, regardless of the soundness of their operations. The moral hazard problem arose even more directly when banks and finance companies themselves had close political connections. In some countries, particularly Indonesia, these problems were made worse by direct political interference and official malfeasance in the allocation of credit and in creating monopolies in certain activities.

Yet this study departs from the exceptionally sweeping view of crony capitalism in two important regards. First, the case studies will show that both the statist or dirigiste policies that most Asian governments had followed for so long, and the more recent policy shift towards financial deregulation and liberalization were conducive to rent-seeking and cronyism. As is well known to area specialists, the economic success of many Asian economies was built on a particular kind of economic strategy that emphasized
export-orientation, centralized coordination of production activities, and implicit (and in some cases explicit) government guarantees of private investment projects. Moreover, there also existed a close operational relationship and interlinked ownership between banks and firms. Hailed as the “Asian developmental model,” this strategy allowed firms to rely heavily on bank credit. Not surprisingly, by international standards, firms in the crisis-affected countries were highly leveraged. Indeed, the pervasive role of government in the selective promotion of industries and in the coordination of investment, including state control over the allocation of credit and capital account transactions, spawned a government–private sector nexus with an affinity for rent-seeking behavior. Second, the evidence unequivocally demonstrates that crony capitalism did not trigger the crisis, albeit it greatly exacerbated it.

Towards a synthesis of the macroeconomic perspective

When the bubble burst in 1997, a twin crisis emerged in Asia – meaning that the currency crisis was accompanied by a crisis in the banking and financial sector. Soon a vicious cycle emerged, as the depreciation of the currencies exacerbated weaknesses in the financial sector, which in turn fueled further capital outflows and pressure on the exchange rates. The subsequent pages will show that weaknesses in the private sector (in the banking, financial and corporate sectors) were at the heart of the Asian crisis. Specifically, weak corporate structures (where the focus too often was on increasing scale and market share rather than on economic returns), weak regulation of the financial system, connected and directed lending, and implicit and explicit guarantees of financial institution liabilities created an unprecedented degree of moral hazard. The banking sectors in the crisis-hit countries were characterized by poor regulatory supervision, lack of bank transparency and excessive short-term, unhedged foreign currency borrowing. All suffered from liquidity shortages and escalating levels of non-performing loans. In fact, their balance sheets exhibited growing maturity and currency mismatches in the period leading up to the crisis. This meant that they were vulnerable to sharp swings in interest rates resulting from external shocks. Eventually borrowers – whether public (as in Mexico or Russia), or private (as in Asia) – were unable to roll over short-term debt, often denominated in foreign currency and held by a large number of creditors.

The roots of this problem date back to the all-too-swift liberalization of the financial sector (a) without having the appropriate prudential supervision and regulation in place, and (b) in conditions such that even where formal rules were in place (for example, legal lending limits, capital adequacy ratios), weak enforcement impeded the development of a healthy banking sector. In this environment, liberalization included reduction of barriers to
entry for banks and non-bank financial institutions, deregulation of interest rates, relaxation of directed credit and reserve requirements on banks, promotion of new financial markets and instruments and the liberalization of the external dimensions of the financial sector. Moreover, some variations among countries notwithstanding, liberalization permitted local residents and non-resident foreign entities to open accounts with commercial banks in either national or foreign currencies. It also permitted banks to extend credit in foreign currencies in the domestic markets; bank and non-bank private sector corporations to borrow abroad; foreigners to own shares listed by national companies on domestic stock exchanges; the sale of securities on international stock and bond markets by national companies; the sale of domestic monetary instruments such as central bank bills and treasury bills to non-residents; and the establishment of offshore banks – which were also allowed (in some cases) to borrow broad and lend domestically.

However, the rapid liberalization of the financial and banking sectors created problems. First, many banks were established with very small capital bases. Second, as economic theory suggests, while lower reserve requirements (which allowed the banking industry to maintain a lower degree of liquidity), may be desirable on efficiency grounds, they can also directly exacerbate international illiquidity and increase the possibility of financial runs. Third, banks incurred excessive risks by being overly dependent upon short-term funds to finance long-term investments, many of doubtful viability. This is was not simply due to lack of oversight. Rather, state banks were routinely encouraged to lend imprudentially to questionable state enterprises and to priority projects of various ministries. As Iwan Azis (1999, 80) notes, “too often, governments in the region played favorites. A few highly leveraged and well-connected groups were given special, often non-transparent, access to credit. These private businesses could obtain loans from state banks without difficulty at interest rates that were much lower than the market rate, and under more lenient conditions. This spelled trouble for the lending banks, as the probability of default on such loans was relatively high.” Similarly, private banks, which usually had close relationships with particular business groups, routinely broke prudential rules in terms of amounts and conditions of loans to related companies. In some cases, the large conglomerates set up new banks primarily to serve their own often risky projects. In these so-called banks, lenient disclosure rules and poor banking regulations aggravated bad credit analysis and distorted investment decisions. Compounding all this was excessive lending – which fueled asset price inflation, while the corporate sector overstretched itself by engaging in risky or unproductive projects.

Fourth, poor risk management on the part of banks meant that alarm bells did not go off until the situation got out of control. Ineffective banking supervision, political interference and a critical lack of transparency prevented disciplinary mechanisms from operating properly. To make matters
worse, both the banking and the corporate sectors were taking excessive currency risks by borrowing in foreign currencies (which had much lower interest costs than domestic currencies) to fund projects that could only generate income in domestic currencies. Implicit government guarantees on exchange-rate stability eroded awareness of the risks arising from currency and maturity mismatches between the banking and corporate sectors.\(^{57}\) Last but not least, weak regulation of financial intermediaries and poor governance in corporate and government sectors induced excess domestic and external debt financing and made these countries extremely vulnerable to changes in capital market sentiment. In fact, this combination of financial system and corporate sector vulnerabilities and weaknesses contributed to the crises and magnified the negative impact of exchange-rate devaluations and foreign capital withdrawals on financial institutions.

How did this problem develop; why was it allowed to fester? How did it manifest itself (if at all), and what measures were taken to deal with them? Although the following chapters will flesh out in more detail the similarities and differences across countries, it is useful to sketch out some of the salient features – many of which were common across the crisis-affected countries and beyond. Briefly, three forces interacted to leave a number of countries in the region, notably Thailand, Korea, Indonesia and Malaysia, vulnerable to external shocks. These included: (a) the globalization of financial markets and the easy availability of private capital, especially short-term capital; (b) macroeconomic policies, in particular, haphazard capital account liberalization that permitted capital inflows to fuel a credit boom; and (c) increasingly liberalized, but insufficiently regulated financial markets that were growing too rapidly.

Since the post-war period, capital flows to developing countries have undergone some significant changes. From the end of the Second World War until the mid-1970s, the flow of resources into developing countries was dominated by official development assistance (ODA). The oil embargo and the recycling of petrodollars that began in earnest in 1974 gave rise to a new investment regime. The ready availability of funds allowed developing countries either to augment or to replace ODA and direct investment with large-scale bank lending. In 1981, more than half the resource flows to developing countries consisted of private lending. The option of borrowing from private banks abruptly came to an end in 1982, when Mexico declared a moratorium on the payment of its foreign debt, thereby ushering in the era of the debt crisis. It is now recognized that the debt crisis came about because the accumulation of foreign-currency-denominated sovereign banking debt had reached unsustainable levels.\(^{58}\) At the end of 1973 the non-OPEC developing countries carried a stock of net external foreign currency bank debt of US$4.5 billion. By the end of 1982 the figure had reached US$145.9 billion, an increase of US$141.4 billion (Lamfalussy 2000, 2).
Introduction: issues, debates and overview

With the onset of the debt crisis there was a sharp decline in capital inflows to developing countries – from US$30 billion in 1977–82 to under US$9 billion in 1983–89 (IMF 1995, 33). However, the liberalization of cross-border financial transactions in the late 1980s and early 1990s dramatically reversed this trend. The international diversification of institutional portfolios (mutual funds, insurance companies, pension funds, proprietary trading of banks and securities houses) and the progressive integration of global capital markets led to a dramatic revival and expansion in capital inflows to developing countries. Private capital flows to developing countries increased sixfold over the years 1990 to 1996. Between 1990 and 1994, net capital surges to developing countries skyrocketed to US$524.2 billion, with a disproportionate share going to the Asian economies, which received some US$260 billion, or roughly 50 per cent of all the total capital flows (IMF 1995, 3). Although private capital flows comprise a wide range of instruments, including bank deposits and credits, equities, direct investments, corporate bonds and government securities, what was significant about this new surge was the sharp rise (in terms of both absolute levels and the share of total inflows) in short-term portfolio capital flows in the form of short-term interbank loans (which can be readily withdrawn), commercial bank debt, tradable bonds and equity shares. For developing countries as a whole aggregate private portfolio capital flows increased from $6.6 billion from the base years 1983–89 to $218 billion between 1990 and 1994 to an all-time high of $167 billion in 1996.

Propelling this expansion was an aggressive search by global capital markets (which operate around the clock) for ever higher returns to capital. Large private capital flows to emerging markets were driven in part by low interest rates in Japan, Western Europe and the United States, along with international investors’ imprudent search for high yields. Developed country banks and financial institutions, often trapped in slow-growing but highly competitive home markets, scanned the globe for investment opportunities. Emerging markets, especially in Asia, were booming, and offered greater profitability than investments in the developed countries. Indeed, to facilitate the capital inflows, many Asian countries (with some pressure from the United States) opened their money and capital markets and removed foreign-exchange controls. Indonesia and South Korea gained IMF Article 8 status in 1988, Thailand in 1990, the Philippines in 1995 and China in 1996 – obliging these countries to remove restrictions on current account payments. In addition, South Korea opened its securities market in January 1992 (when it permitted non-residents to invest directly in Korean stocks as part of its plan to promote the gradual expansion of its capital market), and was required to submit a schedule of capital liberalization in preparation for admission to the OECD. China, on the other hand, was required to liberalize trade and foreign-exchange regulations in expectation of securing membership in the World Trade Organization (WTO). Other Asian countries
The Asian financial crisis

earnestly opened offshore markets in order to develop their domestic financial markets and facilitate overseas fund-raising. By the late 1980s, Hong Kong and Singapore were already established as major international financial centers. In 1990, Malaysia established the Labuan market, and in March 1993 Thailand established the Bangkok International Banking Facility (BIBF) to raise funds abroad. In fact, so determined was Thailand to become a leading financial center in Asia that the BIBF was characterized by looser regulations with regard to interest rates, reserve requirements, withholding taxes on interest and foreign-exchange controls than its onshore counterparts. Likewise, although Indonesia’s capital account had been opened since 1972, liberalization of the domestic banking system began in 1988, when domestic banks and Indonesian corporations were permitted new entries in the banking system and given much more freedom in their methods of raising financing. Thus, the number of banks increased from 111 in 1998 to 240 by March 1994. Twenty Indonesian foreign-exchange banks also opened branches in 14 countries, including offshore banking units in the Cayman and Cook Islands.

The fast-growing Asian economies quickly emerged as the most important destination for private capital flows. International commercial and investment banks, mutual fund managers, securities firms, stock brokers, portfolio investors, currency traders and others in competitive marketing-sales – given their voracious appetite for commissions enthusiastically sold (if not, oversold) the opportunities in Asia’s emerging economies. As R. Johnson (1997) notes, “from the early 1980s on, it was an article of faith that Asia was a miracle . . . for years, strong economic performance and rising asset prices inspired investors, commentators and economists to uncover more evidence of good news about Asia wherever they looked. This process of mutual reinforcement continued into 1997.” Indeed, the very economic success of Asia and its seemingly unbound potential made it an ideal investment location. According to a World Bank report (1998a, 6–7):

East Asia generally absorbed nearly 60 per cent of all short-term capital flows to developing countries. In the mid-1990s, much of the short-term private capital came from Japanese banks as they followed their corporate foreign investors into Korea and Southeast Asia. The Europeans soon followed in an aggressive search for profits. By 1996, the Bank for International Settlements (BIS) reported that European Union (EU) banks’ outstanding bank loans amounting to US$318 billion; the Japanese banks had US$261 billion; and the US banks had US$46 billion.

No doubt, capital flows between countries can yield what Larry Summers (2000) has termed “enormous socioeconomic benefits.” The efficiency gains from the reallocation of capital from industrial to developing countries can improve living standards by mobilizing global savings to finance investments in countries where the marginal productivity of investments is
Introduction: issues, debates and overview

relatively high. Capital flows also allow investors to diversify their risks and increase returns from more productive foreign projects, and allow residents of recipient countries to finance investments, and individual countries to smooth consumption. Portfolio capital flows consisting of international placements of tradable bonds, issues of equities in international markets, and purchases by foreigners of stocks and money market instruments (in particular, securities and mutual funds) can greatly benefit emerging economies by fostering financial integration and improving the returns on investments through knowledge/skills spillover, enhanced competition and market efficiency effects.

However, these benefits can be offset by various capital market imperfections, often caused by a lack of information. In the case of herd behavior, foreign investors may react to the actions of others whom they believe to have access to better information. Also, the allocation of savings may be biased owing to incomplete information about proposed projects. Thus adverse selection may take place, as lenders base the cost of credit on the average perceived creditworthiness of borrowers. Moreover, the high volatility of short-term capital flows may negate their beneficial impact. Feldstein (1994) notes that a surge in capital inflow may also increase imports and thereby dampen domestic production and investment. Surges tend to affect a country’s macroeconomic stability by causing inflationary pressure and an increase in the current account deficits. The real exchange rate tends to appreciate in the capital-receiving country, while the traded goods sector of the economy loses competitiveness in international trade. The increase in the current account deficit and the appreciation of the real exchange rate also make the economy more vulnerable to shocks. When the inflow of foreign capital is interrupted, the economy has to go through reverse adjustments in the current account and real exchange rate. On the other hand, sudden outflows may disrupt local financial markets, forcing the authorities to choose between higher interest rates and a depreciation of the exchange rate. Therefore empirical studies have found that capital flows pose fewer problems if they are long-term, in the form of direct investment, propelled by the growth prospects of the economy, and invested in physical assets, rather than consumed and domestically induced.64

However, many of the capital inflows to emerging markets (including Asia) have been described as arbitrage capital flows. That is, capital flows into emerging economies were a reflection not so much of the investors’ confidence in the economic performance of these economies, as of the ability of the governments to guarantee abnormal rates of return. The chain of guarantees included the commitment to a nominal exchange rate target as well as the implicit guarantee of deposits and solvency to the domestic banking system. In Asia (as in Mexico), the crisis erupted when the perception regarding the governments’ capacity to honor the guarantees changed. Thus, short-term capital inflows can be a mixed blessing. In other words,
The Asian financial crisis

short-term, yield-sensitive and liquid private capital inflows are not a costless lubricant, especially if the flows are large relative to GDP. When investors borrow short-term, they may fall into maturity mismatch difficulties – which arise when the assets backing short-term debt obligations are longer-term, and therefore less liquid than their liabilities. These disparities imply that, when debts are not rolled over, assets must be liquidated at a discount to cover short-term obligations. Moreover, short-term capital inflows that often show up as an expansion in liquid short-maturity bank deposits are highly sensitive to cyclical fluctuations in domestic or international interest rates. Thus they exhibit high levels of volatility, with sudden outflows potentially resulting in balance of payments problems or widespread financial crises. Indeed, Eichengreen (1999) cites short-term borrowing as a major source of financial fragility, and demonstrates that the ratios of short-term debt to reserves are robust predictors of financial crises. In Asia, the ratio of short-term debt to foreign reserves (a rough measure of a country’s ability to meet its current obligations from its own liquid resources) rose sharply from 1994 to 1997 (see Table 1.4). In the three most severely affected countries, Korea, Thailand and Indonesia, short-term debt-to-reserves ratios had risen to over 150 per cent by June 1997 – or just before the baht’s devaluation (World Bank 1998a, 8).

The unprecedented volume of capital inflows fueled a domestic credit boom (Table 1.5), and this in turn played a critical role in fueling the rapid growth of the banks’ and other financial intermediaries’ balance sheets.

Compounding these were the macroeconomic policies adopted by governments – policies that inadvertently created incentives for private agents to take advantage of the easy access to international capital markets. To many analysts the most glaring policy error was hasty capital account liberalization. Some have explicitly argued that the root cause of the Asian crisis

<table>
<thead>
<tr>
<th>Economy</th>
<th>Short-term debt ($ billions)</th>
<th>International reserves ($ billions)</th>
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</thead>
<tbody>
<tr>
<td>Korea</td>
<td>70.18</td>
<td>34.07</td>
</tr>
<tr>
<td>Indonesia</td>
<td>34.66</td>
<td>20.34</td>
</tr>
<tr>
<td>Malaysia</td>
<td>16.27</td>
<td>26.59</td>
</tr>
<tr>
<td>Philippines</td>
<td>8.29</td>
<td>9.78</td>
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<tr>
<td>Singapore</td>
<td>196.60</td>
<td>80.66</td>
</tr>
<tr>
<td>Thailand</td>
<td>45.57</td>
<td>31.36</td>
</tr>
<tr>
<td>Taiwan</td>
<td>21.97</td>
<td>90.02</td>
</tr>
</tbody>
</table>

Source: ADB (1999, 26).
Introduction: issues, debates and overview

Table 1.5  Domestic credit and growth-rates

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<tbody>
<tr>
<td>Indonesia</td>
<td>50.3</td>
<td>65.4</td>
<td>21.5</td>
</tr>
<tr>
<td>Korea</td>
<td>94.5</td>
<td>137.9</td>
<td>19.0</td>
</tr>
<tr>
<td>Malaysia</td>
<td>116.7</td>
<td>165.4</td>
<td>19.9</td>
</tr>
<tr>
<td>Thailand</td>
<td>96.3</td>
<td>147.7</td>
<td>19.1</td>
</tr>
</tbody>
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CAGR: Compound Annual Growth Rate.
Source: Shirazi (2000, 84).

was the accelerated deregulation and liberalization of the capital account (A. Singh 1999). This important issue needs some elaboration.

Macroeconomic theory tells us that free capital movements contribute to efficient allocation of capital and provide opportunities for both foreign investors and domestic residents. For lenders, the advantages include increased portfolio diversification and higher returns from more productive foreign projects. Similarly, borrowers can gain in several ways. They can obtain resources to finance cyclical downturns and balance-of-payments disequilibria, thus allowing them to smooth out consumption. Emerging economies can augment savings available from domestic sources and finance projects with higher social returns. When combined with the liberalization of entry for foreign banks and brokerages, an open capital account can support reform and competition in the financial sector. Also, by reducing the scope for discretionary policy at home, openness to international capital markets can impose fiscal and monetary discipline on domestic policymakers. Yet it is also recognized that benefits can be offset by various capital market imperfections, often caused by a lack of information. Moreover, free capital flows have the potential to affect a country’s macroeconomic stability. Unimpeded capital flows can lead to real exchange-rate appreciation and current account deficits, and force authorities to engage in sterilization operations in an attempt to retain control of the money supply. Sudden outflows can disrupt domestic financial markets, forcing authorities to choose between higher interest rates and a depreciation of the exchange rate. Thus, the Janus-faced capital flows have the capacity to both improve and to destabilize an economy.

Till recently, most Asian economies kept their financial systems relatively closed. Foreign borrowing was limited and capital inflows controlled. The controls ensured that the financial sectors remained generally immune from external shocks, despite their domestic fragility. Most importantly, the controls prevented domestic fragility from being translated into external
The Asian financial crisis

vulnerability in the form of short-term, unhedged foreign debt. All this began to change, beginning in the late 1980s and early 1990s, as the Asian economies gradually opened and deregulated their capital and domestic markets. Bhagwati (1998) blames the “Wall Street–Treasury Complex which commands tremendous influence over financial institutions like the IMF” for inappropriately pushing for capital account liberalization, without taking into consideration the costs associated with “the inherently crisis-prone nature of freer capital movements.” In a nutshell, the argument is that rapid domestic and external financial liberalization in the crisis-affected Asian economies led to increased competition in the banking system – reducing the franchise value of banks and inducing them to pursue risky investment strategies. Furthermore, the rapid expansion of non-banking financial institutions (NBFIs) was an additional important source of competition for banks, especially in Korea and Thailand. Since the NBFIs were generally less regulated and subject to weaker supervision than banks, their rapid growth exacerbated the overall fragility of the financial system.

Clearly, managing an economy with open capital accounts is a difficult challenge in this era of financial globalization. Yet this study will show that capital account liberalization by itself was not the problem. Singapore, Hong Kong and Taiwan, which adhered to transparently market-based policies and maintained well-regulated financial systems guided by independent central banks, were able to respond more effectively to the shocks than those with poor prudential surveillance and poor financial sector transparency. However, in the hard-hit countries the problem was that supervision and regulatory oversight did not keep up with liberalization. Specifically, inappropriate sequencing of capital account liberalization and premature deregulation made the financial sector extremely vulnerable to shocks. Indeed, a study of 53 countries from 1980 to 1995 by Demirguc-Kunt and Detragiache (1998) finds that financial liberalization (understood as the deregulation of interest rates) is strongly correlated with a fall in the bank’s liquidity (measured by the ratio of liquid to total assets), and the likelihood of banking crises. However, that probability decreases if the institutional preconditions for liberalization and market discipline, in terms of contract enforcement, relative lack of corruption and bureaucratic interference, and respect for the rule of law are in place.

An equally serious policy error was the implicit insurance of the fixed exchange rate – which signaled a guarantee against exchange rate loss. That is, investors and borrowers mistook the stability of the exchange rate for the absence of exchange-rate risk. This not only encouraged both domestic borrowers and foreign lenders to increase the flow of funds; it also motivated excessive risk-taking, including large foreign-exchange risks that were passed on to the rest of the domestic economy. Also, the maintenance of domestic interest rates that were significantly higher than the world market rate, coupled with high domestic funding costs and market segmentation,
Introduction: issues, debates and overview

added to the incentives to borrow abroad – besides being a further lure for capital inflows. In Thailand, during the period 1991–96, domestic financial intermediation costs accounted for 28 per cent of the nominal baht interest cost (World Bank 1998a, 8). The domestic cost of funds was significantly higher than the costs of borrowing offshore, even after taking into account exchange-rate risks, which only added a further incentive to borrow foreign funds. Since this access to foreign markets was only available to the largest and best credit corporations, these firms and banks enjoyed a market advantage, and undoubtedly used their access to political leaders to protect their position – making it more difficult for regulators to limit offshore borrowing to prudent levels. This was compounded by the creation of offshore financial markets in which local corporations could (because of regulatory and tax advantages), obtain lower-cost finance than in domestic markets. As was noted earlier, this trend was at its most severe in Thailand.

Ironically, the large-scale capital inflows that helped fuel the rapid credit expansion led to the build-up of external and domestic financial imbalances, besides lowering the quality of credit and distorting investments. First, in all the crisis-affected countries, short-term borrowing was used to finance long-term projects. This created a sizeable maturity mismatch in the balance sheets of domestic financial institutions. Second, domestic banks lent to domestic firms in local currency, while borrowing short-term in foreign currencies without hedging. In addition, while investments were made in non-tradeables, such as land, buildings and infrastructure, which generated returns in local currency, the repayments, however, had to be made in foreign currency. These created a significant currency denomination mismatch. Third, the rapid reforms to liberalize the financial sector and to remove barriers to the entry of foreign capital without the development of the institutions or practices that characterize a mature financial market created what Eichengreen (1999) has aptly termed “an explosive mix.” Fourth, the easy availability of credit was not only associated with inefficient intermediation, but also fueled investments in increasingly risky assets, besides powering speculative booms. In fact, the investment boom was concentrated in: (a) sectors with already excessive capacity (in part through government direction); (b) narrowly specialized industries, such as electronics and other prestigious projects; and (c) non-traded sectors, particularly real estate. For example, in the case of Korea, Borensztein and Lee (1999) find that credits were systematically allocated to sectors with poorer economic performance. In Thailand, total advances to manufacturing expanded ten-fold between 1985 and 1996, but credit to the real estate sector increased twenty-two-fold during the same period (A. Islam 1999, 55). In Thailand, Indonesia and Malaysia, excessive intergroup lending practices often resulted in resources not being put to their most productive use.

Rather, in all three countries much of the lending went to finance equity purchases and land. Not only was there overinvestment caused by excessive
The Asian financial crisis

lending (as many projects with negative net present value were financed), but the prices of local assets rose beyond their true economic value, leading to overvaluation of asset prices. For example, in an environment where “large sums of money were invested in buildings in every major city in the region: whether it was Seoul, Taipei, Hong Kong, Singapore, Beijing, Shanghai, Bangkok, Kuala Lumpur or Jakarta . . . real estate investment was a tangible expression of these cities’ success and pride” property values in Bangkok, Seoul, Kuala Lumpur and Jakarta rose at double-digit rates through 1996 (Mera and Renaud 2000, 12: also World Bank 1998a, 7). Rising asset prices provided greater collateral to banks and led to greater lending, which further increased collateral values, and so on. As long as growth remained high, this became a “virtuous and self-reinforcing cycle.” All this created an appearance of high returns, not only in real estate, but also in the stock market. In what seemed like a permanent boom, stock market investors became accustomed to high rates of return. Until 1996, these expectations were self-perpetuating. When the market began to collapse in response to a realization that many firms could not generate earnings growth to justify stock values, many investors were literally shocked. As Corsetti, Pesenti and Roubini (1998) argue, these over-investment and overvaluation may have given the appearance of spectacular economic growth potential in Asia. Indeed, a cross-country comparison by La Porta, Lopez-de-Silanes and Shleifer (1998) suggests that relatively weak accounting standards in East Asian countries may have allowed firms in crisis-affected countries to cloak their actual financial position and continue in business even after they were no longer financially viable.

Paradoxically, the macroeconomic policy mix used to deal with the overheating pressures and capital inflows in the 1990s added an impetus for further inflows, particularly for the accumulation of short-term unhedged external liabilities. In particular, exchange-rate policies played a large role in motivating capital flows. Specifically, although the appropriate policy response to capital inflows is to allow greater flexibility in exchange rates – implying appreciation in nominal exchange rates during periods of large inflows and depreciation during periods of outflows – the Asian governments opted for a stable exchange rate, for a number of reasons. First, the prevention of appreciation in the nominal exchange rate following large capital inflows was seen as a policy priority with a view to maintaining the competitiveness of exports and inviting FDI inflows. It should be noted that the informal dollar pegs had not only insulated all these countries from each other and from beggar-your-neighbor devaluations; the pegs had also successfully anchored their domestic (wholesale) price levels during their remarkable rapid growth in the 1980s through to 1996. Second, there was concern that once the currency was allowed to float, it might become highly volatile, inhibiting not only capital inflows but also trade transactions. Third, a stable exchange rate was seen as an effective anchor against inflation in
the domestic economy. And fourth, governments saw their ability to maintain a stable exchange rate as an indicator of their policy credibility. However, a fixed or highly stable exchange rate regime is inherently vulnerable to speculative attacks, particularly when there are expectations that devaluation is likely. As long as Asian governments appeared certain to protect the fixed dollar peg, investors could be comfortable in the knowledge that there was little foreign-exchange risk. Thus the predictable nominal rates encouraged unhedged external borrowing, thereby rendering financial institutions highly exposed to a variety of external threats, including declines in asset values and exchange-rate devaluations. Also, the informal pegging of domestic currencies to the US dollar encouraged capital inflows, owing to the large interest-rate differentials. As was noted earlier, as the yen depreciated against the US dollar throughout much of 1996, so the pegged currencies lost competitiveness against the important yen market.

It is important to note that although capital inflows to Asia surged in the 1990s, most of the economies managed to avoid the substantial exchange-rate appreciations that have often been associated with large capital inflows, particularly in Latin America. Through a combination of tight fiscal policy and monetary policies aimed at sterilizing the monetary impact of these inflows, they avoided large appreciations against the US dollar.69 However, tightening monetary policy in an effort to sterilize inflows and curtail credit expansion increased domestic interest rates, as well as the differential between domestic and foreign rates. That is, sterilized intervention (a combination of foreign-exchange intervention and domestic open-market operation to keep the monetary base constant in proportion to GDP), will in theory keep the interest rate level; but in practice, the interest rate may rise.70 In Asia, the sterilization of capital inflows raised interest rates on domestic deposits, while the apparently durable fixed exchange rate regime led market participants to neglect the possibility of a devaluation. This had the perverse effect of creating further incentives for investors to borrow abroad to make local investments.71 Moreover, the increase in short-term interest rates as a result of sterilization discouraged long-term investment demand, as the cost of capital rose, while returns on less risky assets, such as government paper, became more attractive. Sterilization, therefore, had the unintended effect of changing the composition of capital flows away from long-term to short-term. It is hardly an exaggeration to note that the monetary policy stance created a severe moral hazard problem by implicitly guaranteeing the dollar returns of foreign investors.

Many of the capital inflows and associated investment booms were intermediated through weak domestic financial institutions that were often undercapitalized and poorly regulated. The inflows also fed into a system of corporate finance that increased risks from abrupt changes in interest or foreign-exchange rates. Therefore, the patterns of indebtedness varied across countries. In Thailand, finance companies and banks, availing themselves of
extremely low-interest yen-denominated loans, borrowed through government-sanctioned channels to invest in real estate. Specifically, the Bangkok International Banking Facility (BIBF), established in 1993, greatly facilitated foreign borrowing by residents. Predictably, financial institutions' net foreign liabilities rose from 6 per cent of domestic deposit liabilities in 1990 to 33 per cent by 1996 (World Bank 1998a, 8). Korean banks also increased their exposure to foreign borrowing, as regulations favored short-term foreign borrowing by financial institutions and strongly discouraged corporations from borrowing abroad directly. In Indonesia, corporations became the primary borrowers from foreign sources, with much of it coming from offshore.

In retrospect, the banks were able to grow their risky loans this rapidly, in part, because they were not fully exposed to market discipline until the governments’ explicit or implicit guarantees lost their credibility. We also now know that the regulations necessary to intermediate capital inflows were not in place, nor were weak firms operating with a high degree of risk sufficiently disciplined through competition and monitoring by shareholders or creditors – foreign as well as domestic. The problem was not simply the failure to develop adequate systems to monitor the extent of borrowing and its term structure; such oversight also created a blind-spot that prevented the growing problem of over-leveraged, unhedged short-term borrowing to be perceived early enough. Thus many firms were allowed to operate while their losses continued to mount. We now know that the licensing and supervision regulation of merchant banks in Korea permitted groups of companies to own both banks and the same groups of firms to whom they were lending. In fact in Korea, many conglomerates (or chaebols) had ownership links that were not confined to non-bank financial institutions: the larger chaebols were often linked with a major bank. Many of these enterprises could continue to borrow, and the banks could continue to overlook the rise in bad loans. In Indonesia, the number of banks expanded very rapidly in the 1990s, but the supervisory authorities failed to carry out prudential screening of applicants to check out their creditworthiness. Rather, in Indonesia, where roughly 50 per cent of banks belonged to a narrow circle of business groups, and the other 50 per cent were state-owned, the system allowed Suharto family members and their cronies preferential access to resources. In this environment, supervisory and regulatory frameworks could hardly stop the well-connected borrowers from getting access to funds, and in the process becoming even more highly leveraged. Similarly, in Thailand (where a small number of families owned both banks and corporations), the scope of finance companies’ activities greatly expanded in the 1990s without commensurate improvement in their prudential supervision.

The cozy collaborative relations between governments, financial institutions and borrowers, the weaknesses in bank and corporate governance coupled with poorly enforced prudential regulations (not to mention the

The Asian financial crisis

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Introduction: issues, debates and overview

The fact that creditors’ rights were weakly enforced because the judicial systems in these countries were underdeveloped, encouraged fiscal indiscipline and excessive risk-taking. Krugman (1999a) has called this the “Pangloss equilibrium” – where implicit (and implausible) guarantees offered by governments were believed by investors. In this environment, banks with insufficient capital adequacy ratios, inadequate asset classification systems, weak accounting standards, especially for loan valuation and disclosure practices, lack of adequate deposit insurance schemes and an overall poor provisioning for possible losses flourished. Claessens and Glaessner (1998) add that the limited role of foreign banks in the local Asian markets reduced the ability of banking systems to absorb shocks, and more generally, inhibited the institutional development of the banking sector. All these, together with the removal of controls over the allocation of credit, increased the channeling of funds into fueling of asset bubbles. Over time these weaknesses contributed to growing systemic fragility in the financial and non-bank corporate sectors. Combined with export slowdown, falling property and stock values, and ultimately the massive loss of confidence in international financial markets when the seeds of doubt were first sowed with the onset of the Thai currency crisis, they triggered large-scale capital flight from the region. They also greatly compromised the ability of these economies to withstand the shock of the large-scale outflow of foreign capital.

A political economy of the crisis

Behind the complex economic causes of the crisis lie the broader political factors. First, why did the so-called Asian model of development, which generated such high economic growth and equity for several decades, succumb to the crisis so quickly? The distinctive Asian model of development and the so-called “developmental states” it spawned were built around close business–government relations. This relationship had many positive features. For example, Alice Amsden (1989) in Asia’s Next Giant: South Korea and Late Industrialization attributed Korea’s phenomenal export-led economic modernization that began in early 1960 under the authoritarian Park Chung Hee regime to the collaborative relationship or “pragmatic synergy” between a highly centralized, interventionist and fortuitous developmental state and the large private conglomerates (the chaebols) it created. Endowing itself with exclusive authority over the coordination of fiscal, monetary and trade policies, Korea’s administrative state kept a watchful eye over the chaebols, while at the same time nurturing them with generous subsidies and protection from competition in return for utilitarian performance standards necessary to meet the stringent requirements of export-oriented industrialization. The state–chaebol alliance became indispensable to South Korean development. Working closely together, they were seen as formidable
The Asian financial crisis

partners, with an uncanny ability to follow market signals, to respond preemptively to externalities and to broker relations with foreign investors and creditors. In Korea and in the rest of the high-performing Asian economies, it was believed that such close government–business relationships helped improve the flow of information between the public and private sectors and helped spur rapid capital accumulation. In the banking sector, the so-called “relationship banking” was seen as having several advantages, including the capacity to manage efficiently short-term credit and investment flows. Indeed, the high-performing Asian states’ alleged need to actively mobilize citizens and corporations behind a coherent market-based development strategy became the principal justification of authoritarian rule. Ruling elites and advocates of “Asian democracy” argued that Western-style democracy often leads to undisciplined and disorderly behavior – which are inimical to rapid economic development. On the other hand, a regime insulated from conflicting societal demands and guided by prudent technocratic decision-making was seen as ideally suited to providing the requisite order and promoting economic development.

It is now clear that the efficacy of the Asian developmental model was greatly exaggerated. The custodians of Asia’s development states (like state elites elsewhere) confirm Naim’s (1997, 309) apt observation that “while economic fundamentals eventually force governments to adopt painful corrections, political calculations make their imprudent postponement all too frequent.” Governments everywhere exhibit politically-induced learning disabilities. The evidence unambiguously indicates that ineffective policy responses and indecisiveness on the part of a paternalistic authoritarian regime (Indonesia under Suharto), a “semi-authoritarian regime” (Malaysia under Mahathir Mohamad), and the two newly established democratic governments (Thailand under Chavalit Yongchaiyudh and Korea under Kim Young Sam) played a big role in generating market uncertainty and eventually a disastrous loss of investor confidence – both domestically and internationally. Compounding this problem were the deep socio-structural and institutional weaknesses, and the much-touted close business–government relationship banking – which in the critical months prior to the crisis served to weaken the independence of central banks and regulatory authorities and slowed their ability to respond to early warning signals. The country case studies will show that the implicit government guarantees to private risk-taking contributed much to the onset and the depth of the crisis. Specifically, the long-standing patterns of business–government relations created a domestic version of moral hazard. In Thailand, Korea, Indonesia and Malaysia the pervasive involvement of government in the financial and corporate sectors created expectations that banks and firms would be protected against failure. However, over time such relationships generated widespread corruption and cronyism. This only served further to undermine the capacity of governments to respond to emerging economic problems,
including the ability of the central banks and regulatory authorities to enforce whatever rules of prudential regulation and supervision did exist on the books. This lack of transparency in business–government relations was less of a problem when the Asian economies were relatively closed, but became a serious problem following liberalization and deregulation in the late 1980s and early 1990s.

For example, in Suharto’s Indonesia the line between the public and the private had long become blurred as Suharto governed as the quintessential patriarchal ruler, granting extravagant patronage and protection to loyalists and cronies, and meting out harsh punishment to dissenters. Eventually, the capriciousness inherent in personalism – in particular, the lax distinction between public and private funds and the arbitrary use of state resources for personal aggrandizement – took its toll. Moreover, the complete absence of representative institutions and institutionalized forms of political mediation and accountability in Indonesia further exacerbated the problems of corruption, cronyism and nepotism. Yet, what about Indonesia’s famed economic technocrats (the so-called Berkeley Mafia), who were known to have Suharto’s ear, and enjoyed privileged access and influence, especially during times of economic troubles. Why did they not intervene (as they had done in the past) and guide the economy in a more sustainable direction? Like everything else in Suharto’s Indonesia, the technocrats not only lacked an independent power base, their influence “depended entirely on their relationship with Suharto” (Pincus and Ramli 1998, 729). Clearly, over the years this relationship had soured. It seems that in the months before and during the crisis, the respected technocrats were politically isolated and powerless, their influence seemingly eclipsed by Suharto’s children and cronies. In the end, Suharto’s erratic policy announcements only served to unnerve investors.

In the case of Malaysia, under the ostensible rationale for ethnic redistribution of resources, Mahathir and the Malay political elite built up an increasingly centralized political system based on patronage and cronyism. In their insightful study, *Malaysia’s Political Economy: Politics, Patronage and Profits*, Gomez and Jomo (1999) note that the emergent class of bumiputera (Malay) capitalists are neither authentic entrepreneurs nor industrial managers. Instead, they function as financial manipulators, engaged in deal-making and asset stripping and as collectors of rents of various kinds, including financial subsidies, lucrative non-competitive contracts from the state and protection from foreign competition. As a group they have failed...
The Asian financial crisis

to contribute to the efficiency, productivity, diversification or international competitiveness of the Malaysian economy. Compounding this problem was Mahathir’s “big growth push” policy to propel Malaysia to developed-country status by the year 2020. The ever-growing list of extravagant megaprojects designed to facilitate Mahathir’s “Vision 2020” included the Bakun dam (Asia’s largest hydroelectric dam, costing an estimated M$15 billion), Kuala Lumpur’s showpiece, “Petronas,” or the world’s tallest “twin towers,” built at a cost of some M$2 billion, a super-modern airport (estimated at M$9 billion), a new administrative capital for the state of Sarawak in Borneo, and, the most audacious, a M$20 billion national administrative capital near Kuala Lumpur aptly called Putrajaya (or “city of kings”), to be built as a tribute to Mahathir Mohamad himself. Such ambitious projects resulted in massive public investment expenditure and rapid credit expansion.74 Besides the big projects, not only was much of the credit directed to the property sector, which “eventually weakened the financial position of the banks, as this lending led to a property glut,” but bank-lending increasingly took “the form of ‘connected’ (state-directed) lending rooted in the long-standing intimate link between the government and business” (Athukorala 1998, 92–3).

Thus, instead of responding appropriately when the financial crisis struck (for a start, limiting the self-aggrandizing projects and connected lending), Mahathir’s first reaction was to find scapegoats. In a fiery speech on 20 September 1997 (before a joint World Bank–IMF annual meeting in Hong Kong), he argued that “currency trading is unnecessary, unproductive and immoral” and that it “should be stopped and made illegal” (Jomo 2001, 14). A few days later Mahathir suggested that there might be an international Jewish conspiracy to financially cripple his predominantly Muslim country. He lashed out against foreign currency traders with a Jewish heritage, in particular, the financier George Soros, branding him as a moron and criminal (Tan 2000, 17–18). As Gomez and Jomo (1999, 189) note, “the ringgit probably fell much further than might otherwise have been the case, as a result of international market reaction to Mahathir’s rhetorical and policy responses to the unfolding crises.” The discussion in Chapter 7 will show that the Malaysian government’s subsequent policy responses further aggravated the crisis.

What about the two democracies, Thailand and Korea? Suffice it to note that scholars have long distinguished between two forms of democratic governance. Under *procedural* forms of democracy, a minimum set of democratic rules and rights are observed, including free and fair electoral competition based on universal suffrage, guaranteed freedoms of expression and association, an independent media, court and judiciary, and accountability through the rule of law. However, a *substantive* democracy meets more than the basic procedural requirements: citizens in such settings are also broadly included in the political arena, because democratic norms and values are
highly institutionalized and routinized (Karl and Schmitter 1991). Clearly, Thailand and Korea (like most new democracies) have hardly solved the chronic institutional deficit in their polities: the exercise of democratic governance remains imperfect in both countries. Yet if we accept minimalist procedural definitions of democracy, which emphasize competition for national offices (that is, regimes that are freely elected are democratic), then Thailand and Korea crossed this threshold before the outbreak of the crisis, and Indonesia during the outbreak (or in the midst) of the crisis.

At the time of the crisis, the deeply fragmented democratic governments in Thailand and Korea – incessantly pulled in all directions by interest groups and legislative and electoral pressures – or what Haggard (2000, 49) has termed “different veto gates” – delayed dealing with the mounting problems in the financial sector. Similarly, according to Wade (2001, 69–70), “in Thailand and South Korea, new civilian democratic regimes corrupted the central policy-making technocracy and lost focus on national economic policies. Government–bank–firm collaboration came to be steered more by the narrow and short-term interests of shifting coalitions. Their experience is bad news for the proposition that more competitive politics yield better policies.” In the case of Korea, it has been argued that political gridlock and the “immature and unconsolidated nature of Korean democracy” made for poor economic policy-making. Specifically, “policy gridlock was frequent because of a traditional political culture and weak democratic institutions, which were most pronounced in the legislative process. First, the system of legislative bargaining was not firmly established. Despite its constitutional mandate, the National Assembly continued to be subordinate to the executive branch. Nor did the bureaucracy provide a stable mechanism of interest intermediation. As a result, disputing parties did not have a place in which to negotiate” (Mo 2001, 468). Compounding these problems were the growing divisions within the ruling party, and the impending general elections (in December 1997) made the government highly sensitive to pressures from corporations and the well-organized working class. Under pressure, the ruling party legislators backed away from introducing the necessary policy reforms, or indeed any policy measures they deemed would damage their chances in the upcoming elections.

In the case of Thailand, an incoherent and deeply fragmented party system produced an undisciplined coalition government subject to factionalism, blackmail and policy incoherence. As Haggard (2000, 52) notes, “all of the democratically elected governments [in Thailand] before the crisis . . . were constructed from a pool of approximately a dozen parties, and cabinet instability was a chronic problem. As leader of the governing coalition, the prime minister was vulnerable to policy blackmail by coalition partners threatening to defect in pursuit of better deals in another alliance configuration.” Indeed, weak party discipline made political parties and governments highly sensitive to demands from powerful business constituents. For
The Asian financial crisis

example, the Finance Minister Annuay Virawan and the Central Bank Governor Rerngchai Marakanond found that their efforts to close down ten ailing finance companies came to nothing because determined opposition from within the government vetoed their measure. Not surprisingly, under such inauspicious conditions, the Thai government proved slow in reacting to early warning signals before the crisis struck, and had great difficulty in formulating a coherent response once it did.

While both democratic and authoritarian regimes in Asia proved equally susceptible to the economic crisis, democracies have, nevertheless, demonstrated a remarkable ability to respond more effectively to the crisis. Specifically, the following chapters will illustrate that the democratic governments in Thailand (under Chuan Leekpai, November 1997–January 2001), in Korea (under Kim Dae-Jung, January 1998–) and to a lesser extent, in Indonesia, first under the “quasi-democratic” interim Habibie regime (May 1998–October 1999) and later under the democratic Abdurrahman Wahid government (October 1999–July 2001), were quite successful in exploiting their new popular mandates (not to mention their honeymoon periods), to implement some important reforms, including taking action against the previously favored vested interests. Thus the crisis opened a maximum window for reform – and given the substantial popular expectations that the new leaders quickly repair the economic damage – helped to empower these governments with a mandate to carry out macroeconomic reforms. This suggests that democracies not only provide legitimacy, moral authority and credibility to a regime, but that, at particular critical junctures, they may also demonstrate a remarkable capacity to formulate and implement significant political and economic reforms.

The role of the IMF

The principal responsibility for dealing with the Asian crisis at the international level was assumed by the International Monetary Fund. Soon this relatively unknown multilateral financial institution was put into the global spotlight as never before. Its every official utterance and policy move became the subject of intense public scrutiny and scathing criticism – from both the right and the left. With the benefit of hindsight, it is clear that the IMF’s record in dealing with the Asian financial crisis has been mixed. According to the IMF’s former deputy managing director, Stanley Fischer (1998a, 106), “the basic approach of the IMF to these crises has been appropriate – not perfect, to be sure, but far better than if the structural elements had been ignored or the Fund had not been involved.” The subsequent chapters will present a more nuanced picture of the IMF’s policies and its socioeconomic impact. At this stage, it is useful to understand better the role of the IMF, especially what the organization can and cannot do under
its mandate, as well as to outline the basic components of, and the controversies surrounding, the IMF-led rescue packages in Asia.76

Under the institution’s Articles of Agreement, the 182 member countries who are signatories to the charter have committed themselves to promoting global trade and deepening economic integration by maintaining a stable international monetary system.77 This goal is to be achieved by maintaining orderly exchange arrangements among members, to avoid competitive exchange depreciation, and allowing individual national currencies to be exchanged for foreign currencies in the marketplace without restriction (currently only 117 members have agreed to the full convertibility of their currencies). Member countries are obliged to keep the IMF informed of any changes in their financial and monetary policies that may adversely affect fellow members’ economies, and expeditiously to modify or reform national policies on the advice of the IMF in order to facilitate international trade. Nevertheless, as an international organization whose members are sovereign nations, the IMF cannot examine a country’s financial books without explicit permission from the country’s authorities. In fact, the IMF is not even allowed to send a mission to a country unless it has been formally invited by the country’s authorities.78 In effect, the Fund operates much like a credit union for the member countries, serving as a manager of their common pool of financial resources, estimated to be over $220 billion in 2001.79 As in a credit union, member countries are entitled to withdraw their contributions almost at will. Nevertheless, the resource base allows the Fund to establish a stable value for each currency, and to provide confidence to members by making the general resources temporarily available to them, thus providing them with the opportunity to correct maladjustments in their balances of payments without resorting to measures destructive to national or international growth. The Fund’s capital comes almost entirely from “quota subscriptions” or membership fees, assessed on the basis of members’ economic size. For example, the United States, with the world’s largest economy, contributed about 18 per cent (approximately $38 billion in 1997) of the total quota, followed by Japan and Germany, which contributed 5.67 per cent each. Quotas are reviewed every five years, allowing member countries either to increase or to lower their contributions. The size of quotas not only determines what a country can borrow in time of need, but also the voting power of the member country. For example, in 2001, the US executive director held 17.1 per cent of the votes, and Japan’s director was second, with 6.1 per cent of the votes, followed by Germany, with 6.0 per cent of the votes. On the other hand, a director from South Africa representing twenty-one African countries held 3.2 per cent of the votes, the Egyptian director, representing thirteen Arab countries, held 2.9 per cent of the votes, and Brazil, representing nine Latin American nations, held 2.4 per cent of the votes.

Members can approach the IMF for financial assistance when they experience balance of payments difficulties. Although payments and receipts for
The Asian financial crisis

imports and exports and long-term private capital flows across national boundaries rarely balance completely, the resulting imbalances are typically covered by short-term capital. However, serious imbalances may result in balance of payments difficulties. The problem may be resolved by large-scale use of foreign currency reserves – although a country’s ability to sustain an external imbalance in this way is obviously limited by its holdings of foreign reserves. At, or close to, the point where reserves are exhausted, a country has little choice other than to devalue substantially, or to float its exchange rate. This was the circumstance that confronted a number of Asian countries in 1997 and 1998. Initially governments attempted to defend their exchange rates by resorting to their own means of foreign exchange management. They began their defense against the currency onslaught by way of intervention in the foreign-exchange market, in line with their adherence to a pegged system of foreign-exchange management – a rigid pegged system in the case of Thailand and Korea, and a managed float in the case of Indonesia. After losing substantial reserves in market intervention, particularly in the first two countries, one by one the three abandoned their pegged systems and allowed their currencies to float. As was noted earlier, the massive currency depreciations that followed had severe effects, as large volume of existing foreign-currency borrowing had not been hedged against exchange-rate risk. This made many borrowers, including many banks, insolvent overnight. Just before they called on the IMF for assistance, Thailand and South Korea had perilously low reserves, and were on the verge of debt default. Specifically, although the baht was floated on 2 July 1997, it continued to depreciate, forcing the Thai authorities to request IMF assistance on 5 August 1997. The Bank of Korea announced its decision to stop defending the won at the exchange rate of 1,000 won per US dollar on 17 November 1997. The Korean authorities requested IMF assistance on 21 November 1997. On 14 August 1997, Indonesia announced that the trading band for the rupiah was being abandoned. It formally sought IMF support on 8 October 1997 – after the rupiah was already excessively depreciated. Thus, it is important to note that these three economies were already deep in crisis when they called the IMF to “restore confidence.”

IMF financing can only be provided if the member country’s authorities commit to necessary policy changes and reforms, and to maintain these policies and reforms on track – adjusting them only if the circumstances dictate. This is called “IMF conditionality.” It involves commitments on both sides. On the one hand, conditionality provides assurances to the country that as long as it implements the agreed-to policies, it will continue to receive IMF financing. On the other hand, conditionality provides safeguards to the IMF that the funds it has lent are being used for the intended purpose and that the member country will be able to repay what it has borrowed from the Fund. Generally, IMF support is organized under a number of facilities. In 1963, the Fund established the Compensatory
Introduction: issues, debates and overview

Financing Facility (CFF) to help countries overcome shortfalls in export earnings. In the 1970s and 1980s several new facilities were created. Today, regular IMF facilities include the Stand-by Arrangements (SBA), the Extended Fund Facility (EFF), created in 1974, the Supplementary Financing Facility (1979), and the Structural Adjustment Facility (1986), the expanded Compensatory and Contingency Financing Facility (1988), and the Enhanced Structural Adjustment Facility (1998).80 The SBA is designed to provide short-term balance of payments assistance for deficits of a temporary or cyclical nature; these arrangements are typically for 12 to 18 months. The drawing of funds is phased on a quarterly basis, and their release is conditional upon meeting performance criteria and the completion of periodic program reviews. The rationale for such phasing is that it maintains incentives for the authorities to continue implementing the policies agreed under the program.81 The EFF is designed to support medium-term programs that generally run for three years – with the particular aim of overcoming balance of payments difficulties stemming from macroeconomic and structural problems. In the case of Asia, much of the IMF’s support was organized under the Emergency Financing Mechanism (EFM) and the newly created Supplemental Reserve Facility (1997). These mechanisms, with a greatly reduced period of negotiation, review and IMF board approval, permitted the programs to be put in place very quickly. This meant that they forced exceptionally quick analysis and negotiation, and important decisions at times had to be made on “more-than-usually incomplete information” (Lane et al. 1999, 6). Letters of Intent and “Memoranda of Economic and Financial Policies” (or the IMF “conditionality”) laid out the strategies and sequencing of the IMF-supported programs.82 According to the then IMF Managing Director, Michel Camdessus (1998):

As soon as it was called upon, the IMF moved quickly to help Thailand, then Indonesia, and then Korea to formulate reforms programs aimed at tackling the roots of their problems and restoring investor confidence. In view of the nature of the crisis, these programs had to go far beyond addressing the major fiscal, monetary, or external balances. Their aim is to strengthen financial systems, improve governance and transparency, restore economic competitiveness, and modernize the legal and regulatory environment.

The conditions that the IMF imposed on Thailand, Indonesia and Korea in exchange for IMF-led rescue packages consisted of three basic components. The first concentrated on macroeconomic policy reform, in particular (a) the introduction of tight fiscal and monetary policy (i.e. an increase in interest rates and the adoption of strict limits on the growth of money supply), in order to produce current account surpluses and to stabilize the value of the currency by slowing currency depreciation; and (b) the maintenance of high interest rates to stem (or reverse) the capital outflows. It was believed that such a strategy would improve the current account and the...
The Asian financial crisis

balance of payments, halt the depreciating exchange rate, reduce money growth and inflation and reduce the government budget deficit. The second component focused on structural reforms of the financial sector. It is important to note that structural reforms come within the purview of IMF supported programs when tackling them is essential to solve a country’s macroeconomic problems. And the third consisted of non-financial microeconomic policies such as the removal of trade barriers, the elimination of monopolies, enterprise reform and restructuring, creating competitive factor markets and curtailment of government budgets – in particular, the elimination of subsidies. It was presumed that all these measures could be implemented without significantly harming the real economy.83

However, the following chapters will show that the initial results of the Fund-supported programs in Indonesia, Korea and Thailand were not what had been hoped. Specifically, the programs were not successful in quickly restoring confidence. On the contrary, capital continued to exit and the currencies continued to depreciate after the IMF-supported programs had been adopted. Moreover, the economies sank deeper into recession, contrary to initial projections of only a mild slowdown. Why was this the case? One of the IMF’s sternest critics, the Harvard economist Jeffrey Sachs (1999, 1997a, 1997c) has asserted that the IMF’s unimaginative “one model fits all” prescriptions actually made Asia’s financial turmoil worse. He argues that the problems in the Asian economies were “far from fatal.” On the contrary, the economies had deep strengths, such as high rates of savings, budget surpluses, flexible labor markets and low taxation. Hence, “there is no fundamental reason for Asia’s financial calamity except financial panic itself.” In effect, “the crisis is a testament to the shortcomings of international capital markets and their vulnerability to sudden reversals of market confidence.” This problem was made worse by the Fund’s callous overdose of unnecessary conditions: notably, pressing beleaguered governments to raise the existing budget surpluses still higher and to tighten domestic bank credit by increasing interest rates, including the imprudent closing down of several weak (but viable) banks. For Sachs, such ill-advised policies only served to prolong asset-price deflation in real estate and to erode investor confidence further. This resulted in a “stampede mentality,” with resultant capital flight and economic contraction.

In their more comprehensive study, Radelet and Sachs (1998) argue that the IMF’s fiscal and monetary tightening undermined confidence by contributing to the economic downturn and raising fears of insolvency – thereby adding to downward pressures on exchange rates. They claim that given the huge deflationary shock caused by the massive outflow of capital, fiscal tightening was the wrong policy response. Furthermore, in view of the low levels of government debt and the fact that the balance of payments deficits had not been caused by loose fiscal policy in the first place, fiscal tightening was as unnecessary as it was damaging. Instead, the appropriate policy...
response should have been one of loose money and low interest rates, and an orderly working out of arrangements in which the “debtor country” would fall under IMF protection, which would facilitate negotiations between the debtor and private sector creditors to restructure the repayment program. To the extent that structural reforms were needed, they should have been undertaken more gradually, and only as the economy recovered from the effects of the crisis; not, as the IMF insisted they were, in the midst of the crisis (Radelet and Sachs 1998, 73–5).

Similarly, according to Furman and Stiglitz (1998), the IMF in raising interest rates greatly worsened the condition of corporate balance sheets, thereby prompting further capital flight and depreciating the exchange rate. In addition, they argue that structural reforms were a distraction in that they imposed heavy costs on economies already under strain. Thus fiscal and monetary tightening undermined confidence by contributing to the economic downturn and raising fears of insolvency. Yoshitomi and Ohno (1999) concur, arguing that monetary and fiscal policies should if anything have been eased, not tightened. In a similar vein, Corsetti, Pesenti and Roubini (1998) and Wade (2001) have argued that the sharp interest rate hikes were ineffective in slowing down currency depreciation. Rather, they claim the policy only worsened the extent of the crisis by leading to widespread banking and corporate bankruptcies. Indeed, the effects of these policies have been described in terms of a vicious cycle. That is, the credit crunch imposed severe financial losses on otherwise solvent companies and the widespread fall in profitability translated into higher levels of non-performing loans and credit risk, exacerbating the crisis-induced recessions and, in turn, causing a further contraction in the supply of credit. For the critics the failure of the currency and equity markets to make the expected quick recovery was clear evidence that the Fund’s policies made the contraction deeper than necessary.

The following chapters will show that some of these criticisms are quite valid – especially in the case of South Korea. However, some are problematic. For example, contrary to Sachs, we now know that the crisis-hit Asian economies were not simply mere victims of the sharp shifts in capital flows, but suffered from serious financial sector weaknesses and external-imbalance problems, not to mention non-existent prudential supervision and regulation. In its response to the critics, the IMF has argued that “before the Asian crisis broke, the IMF had warned Thailand of potential problems, but the government took no action. The IMF’s staff also warned governments about financial sector weaknesses in several of the countries that were subsequently badly hit in the crisis” (Fischer 1998d, 5). Second, the fund has argued that, although it failed to foresee the virulence of the contagion effects produced by the widening crisis, the IMF-mandated programs introduced in Thailand, Indonesia and Korea were initially unsuccessful in restoring macroeconomic stability because the reform programs
The Asian financial crisis

failed to bolster private sector confidence, and private sector capital outflows far exceeded program projections (Fischer 1998, 1998a; Mussa 2000). The IMF has also correctly pointed out that when Thailand, South Korea and Indonesia approached it for funds they already had perilously low reserves, and the Indonesian rupiah was excessively depreciated. Thus, under these circumstances, the IMF had a difficult call. On the one hand, economic recovery may be imperiled if the currency does not stabilize. Further depreciation may generate capital losses to foreign investors, thereby discouraging their return, and cause further bankruptcies in domestic firms with foreign-currency exposure. One the other hand, the costs of keeping domestic interest rates high after a currency collapse may prove to be very high. Rising or maintaining high interest rates under crisis conditions may so weaken the economy that it may destabilize the exchange rate, causing it to depreciate further, thereby raising the risk premium or the probability of default on credit.

Following standard textbook macroeconomics, the IMF made the decision that the first order of business was to restore confidence in the currencies. In order to achieve this interest rates had to be temporarily increased – even if the higher interest costs complicated the situation of weak banks and corporations. Indeed, the IMF was fully aware that in the crisis-hit countries, where corporations had high debt-equity ratios, with much of that debt being short-term, sharply higher interest rates could threaten much of the private sector with bankruptcy. Nevertheless, the Fund reasoned that restoring confidence and preventing a currency free fall required a period of high interest rates, and that, once confidence was restored, interest rates could return to more normal levels. Yet, as Sachs asks: why not operate with lower interest rates and a greater devaluation? For the IMF, the answer was twofold. First, the level of devaluations was already excessive, and second, the Asian economies needed to avoid further devaluations and sustain capital inflows to finance their current-account deficits and their large stock of short-term debt – much of it denominated in foreign currency. On the basis of its past experiences, the IMF was well aware that once the market loses confidence in a currency, raising interest rates is the only way to support the currency (Fischer 1998a; 2000; Mussa 2000). Also, it is not clear that low interest rates would have worked any better in a panic situation. If the authorities failed to raise rates and instead allowed their currencies to fall, banks and firms with large foreign-currency denominated liabilities would find their solvency threatened by the increase in the domestic currency cost of servicing foreign debts. Therefore, considering the severe balance sheet problems in Asia, the IMF concluded that sharper currency depreciation would exact a higher cost than the temporarily high interest rates.

The Fund has also maintained that some period of tight monetary policy was inevitable to prevent the depreciation-inflation spirals and the contagion
they threatened. Given the high levels of private external debt in the crisis-affected economies, exchange-rate depreciation had a direct and extremely debilitating impact on the health of companies and banks, as well as on their access to financing. Under these circumstances loose monetary policies in the early stages of a currency crisis would have only contributed to exacerbating the extent of the depreciation and increasing the burden of foreign currency-denominated liabilities issued by banks and firms. Moreover, in the presence of large external net liabilities, a monetary expansion could actually produce financial distress and bankruptcies, setting in motion the same vicious circle described earlier. In addition, the IMF has contended that loose fiscal policies at the onset of the crisis would have raised doubts about the policy-makers’ commitment to reducing the outstanding current account imbalances, jeopardizing the credibility of the plans. Finally, the IMF has claimed that the fiscal tightening was relatively slight (1.5 per cent in the case of Thailand), and that it was necessary to pay for the cost of restructuring the financial sector. According to the IMF’s Stanley Fischer (1998, 2), “the fiscal programs vary from country to country.” In each case, the IMF asked for a fiscal adjustment that would cover the carrying costs of financial sector restructuring – the full cost of which is being spread over many years – and help to restore a sustainable balance of payments. Thus, pace to the critics, the IMF has repeatedly stated that it adopted a flexible policy in regard to fiscal targets – loosening them when the economic down-town proved to be more severe than anticipated (Lane et al. 1999; Mussa and Savastano 1999, 23–7). Indeed, the following country case studies will show that the IMF did modify some aspects of its program. In all three crisis-hit countries, the original targets of budget surpluses of 1 per cent or 2 per cent of GDP for 1998 were changed to budget deficits of similar range. In Indonesia, the IMF also agreed to let the government continue to subsidize some basic foodstuffs.

Yet, having noted this, the subsequent chapters will show that the IMF made mistakes in the fields both of crisis prevention and of crisis management. While the Fund’s most damaging mistake was in its insistence on fiscal surplus for the crisis-stricken countries, this study will also show that the targets and tactics of the IMF did not remain unchanged over time. As the initial results of the Fund-supported programs in Indonesia, Korea, and Thailand proved not to be what had been hoped, and as the situation in Asia progressively deteriorated, the requests of the IMF became less and less restrictive over time. The Indonesian case provides a good example of such changes. The first IMF package of October 1997 encompassed strict fiscal discipline, while the agreement of June 1998 allowed the Indonesian authorities to limit the budget deficit – as opposed to targeting a budgetary surplus – to below 8.5 per cent of GDP. Yet the following pages will also show that the IMF was slow in revising its approach to fiscal policy. It was only when recessions rapidly materialized in the course of 1998 that the
IMF progressively loosened its fiscal conditions to allow for cyclically adjusted fiscal deficits. As Corsetti, Pesenti and Roubini (1998, 3) aptly note, “to some observers, such evolution represents an unequivocal sign of flexibility and open-mindedness. For others, these changes occurred too late.”

With regard to the question of interest rates, the IMF has steadfastly maintained that a significant rise in interest rates was necessary to restore confidence in currencies that had suffered huge depreciations, and to arrest the spiral of competitive devaluations. While acknowledging that such a policy would impact negatively on domestic firms with high debt, the IMF opined that it was still a better option than a failure to stabilize currencies. The reasoning behind this was that with so many firms carrying high levels of foreign short-term debt, an easing of their debt burden through a recovery of the exchange rate would do more to minimize insolvency than the maintenance of low interest rates. Furthermore, the rise in interest rates need only be temporary, since it could be reversed once confidence is restored in the currency market. Critics, on the other hand, have argued that this IMF medicine, inappropriately dispensed, hardly worked to restore confidence (Kristov 1998; Krugman 1998a; Sachs 1999). On the contrary, high interest rates only strengthened the deflationary pressures, besides having a profound effect on the credit crunch and corporate bankruptcies in these highly leveraged countries. The negative effect was exacerbated because stabilization policies were imposed in conjunction with rapid financial restructuring. To this the IMF has responded by claiming that several factors contributed to weak confidence, including half-hearted program implementation and growing political uncertainties, especially in Indonesia.

The second component of the IMF agreements focused on structural reforms of the financial sector. Given the IMF’s view that lax prudential rules and financial oversight (which permitted the quality of banks’ loan portfolios to deteriorate sharply), was at the root of the crisis, the reform measures included (a) the immediate closure of insolvent or weak financial institutions to stem further losses, and (b) the restructuring and recapitalization of potentially viable financial institutions, often with substantial government assistance. Further, to prevent a recurrence of the fragilities that had led to the crisis, the program required the implementation of institutional reforms, such as instituting effective bankruptcy laws, strengthening the regulatory framework and increasing the transparency of financial and corporate governance. These measures, seen by the IMF as addressing the root causes of the crisis, were deemed critical to restoring market confidence and the resumption of sustainable growth. However, the critics have argued that the IMF’s “ill-conceived” closure of banks and finance companies (together with the unduly contractionary macroeconomic policies, with their insistence on reduced spending, high taxes and even higher interest rates) was directly responsible for the bankruptcy of otherwise viable firms and the overall economic slowdown (Radelet and Sachs 1998). Indeed, in the case of
Indonesia there is compelling evidence that the bank closures were carried out in an *ad hoc* manner, ignoring issues such as deposit insurance, thereby leading to panic withdrawals of funds and undermining investor confidence. Also, there is little doubt that the long lists of structural reforms imposed heavy costs on the already strained economies. There is general agreement that, to the extent that structural reforms were needed, they should have been undertaken more gradually, and only as the economy recovered from the effects of the crisis.

The *third* component consisted of non-financial microeconomic reform policies, such as an overall reduction of the role of government in the economy, the break-up or the abolition of monopolies, privatization of government corporations, deregulation of labor markets, and the removal of barriers to trade. This third *tranche* of measures marked a significant departure from past IMF practices, where the conditionalities had been mostly confined to macroeconomic policy – especially in its major area of competence, monetary and fiscal policy. While not questioning the need for such reforms, critics have argued that the timing of such unduly intrusive measures was inappropriate and not necessary for economic recovery. For example, Martin Feldstein (1998) has argued that the IMF’s intrusive policies greatly aggravated the crisis. Instead of focusing on balance-of-payments adjustment, the IMF stepped out of bounds (since its charter provides no such mandate) when it began to meddle arbitrarily in the domestic economic affairs of sovereign countries. Insisting on structural reforms that lie beyond its traditional competence in macroeconomic adjustment, the Fund’s misguided domestic structural and institutional reform measures had adverse consequences – turning a temporary liquidity problem into a country-wide and later region-wide financial meltdown. Feldstein (1998, 25) notes that Asian economies had prospered for decades despite the structural problems in their economy, and the IMF’s intrusive measures (which included among other things “specifying in minute detail such things as the price of gasoline and the manner of selling plywood”) were not a prerequisite to economic recovery. It is not difficult to argue that the IMF went overboard in its demands, especially in Indonesia, where the Fund’s demands skyrocketed from 15 bullet points in November 1997 to 50 bullet points by the time the second deal was signed on January 14, 1998, to 115 bullet points by the third deal in April 1998.

Why did the IMF pursue such a radical surgery? The prevalent view within the Fund was that in this era of high capital mobility and market integration, it was impossible to fix the international financial system without simultaneously fixing the domestic microeconomic structures of crisis-affected countries. Hence, stabilizing a country’s financial system necessitated institutional reforms that extended well beyond the traditional monetary, fiscal and exchange-rate policies (Mussa 2000). Also there was concern, since the international financial markets now knew about the pervasive structural
The Asian financial crisis

problems, whether market confidence would be regained without the affected countries’ agreeing to implement transparent auditing and accounting practices, improve corporate governance and reform (if not dismantle) their shaky banks, finance companies and government monopolies. The IMF has argued that, without its determined intervention, it was highly unlikely that Thailand and Indonesia would close their insolvent banks and finance companies or that South Korea would rein in its greatly over-leveraged and out-of-control chaebols, or that Indonesia would dismantle the corruption-ridden and inefficient government monopolies in plywood and clove. Thus, in response to Radelet and Sachs (1998), who claim that the IMF’s misguided three-pronged approach only exacerbated the panic by giving investors the misleading impression that something was fundamentally wrong with these economies, the IMF has argued that to the extent that the Asian crisis was attributable to structural problems rather than the traditional macroeconomic imbalances, an effective reform strategy had to address the “structural problems that lie at the heart of the economic crises in the three countries” (Fischer 1998a, 103). That is, IMF bailout packages would have served no purpose if the weaknesses of the financial sector were not corrected by the appropriate structural reforms, not to mention the fact that half-hearted reforms would not have helped to re-establish market confidence. As Fischer (1998a, 103) notes, “to ignore the structural issues would invite a repetition of the crisis.”

Beyond these policies, IMF bailouts are seen as creating moral hazard. “Moral hazard” refers to a situation where people can reap the rewards from their actions when things go well, but do not suffer the full consequences when things go badly. Hence investors do not have to exercise due diligence, since they would expect a bailout in the case of default, or for that matter, debtor countries can choose to pursue risky economic policies with the expectation that they will not have to pay the full costs of their debts and investors will not lose the full amount invested if a financial crisis occurs. According to this reasoning, the history of IMF bailouts, especially the bailout of Mexico following the peso crisis (where the IMF and the G-7 effectively guaranteed in full the dollar-denominated Mexican government securities, the so-called tesobonos), convinced lenders that they would be able to get their money back regardless of whatever happens in a borrowing country. Jeffrey Sachs (1998, 16) comments on “the failings of recent IMF bailout loans, in which private sector creditors walked away with the IMF money while debtor countries in effect nationalized the private sector debts . . . the IMF money went out to foreign creditors as fast as it arrived to the debtor governments.” Thus the IMF, by cushioning the losses of imprudent lenders and borrowers with generous bailout packages, only encourages reckless behavior – with Asia and Russia being the most recent cases in point.

It is undeniable that IMF bailouts have created the problem of moral hazard – after all, despite weak underlying fundamentals, investors purchased
large amounts of Russian government securities under the expectation that geopolitical and security concerns would prompt the G-7 and the IMF to provide funds – and they were not wrong. Yet, it is important to note that not all investors in emerging market securities escaped losses as a result of the Mexican and Asian rescues. It is almost impossible for investors to ignore the fact that IMF financial support, even when exceptionally large, tends to be much smaller than what would be needed to imply a full and credible guarantee. Nevertheless, it is critical that market participants do take a bigger hit (or receive a bigger haircut) to ensure that they do not escape all losses as a result of multilateral assistance for the crisis country. Also, in all fairness, the IMF cannot exclusively be held responsible for creating moral hazard. Bailing out the foreign holders of tesobonos and letting the Russians sell ruble-denominated treasury bills to foreigners had the strong support of the IMF’s main shareholders, the G-7 countries. Finally, it should be noted that, unlike other forms of insurance, disbursements of IMF resources are not a cash payoff. Rather they are loans, to be repaid with interest. Thus, if investors are eventually bailed out of crises, it is not by the Fund, but by debtor countries themselves – that is, any “bailout” is funded by a member’s own savings flows, as reflected in its external current account. This study will show that (a) moral hazard is a far more complex problem, and (b) it was not as pervasive or as severe as some have made it out to be. The study will also critically assess the IMF’s efforts to reduce moral hazard.

Notes

1 During 1992–93, the countries of the European Monetary System spent US$150–200 billion on intervention in foreign-exchange markets in an unsuccessful effort to stave off the devaluation of 10 European currencies. The crisis brought down the ERM, and forced the United Kingdom and Italy out of the system.

2 Prior to its floating, the baht was pegged to a dollar-dominated basket for almost 13 years. On July 11, less than two weeks after the baht was set free to float, the Philippine central bank widened the band within which the peso was allowed to fluctuate. Three days later, the Philippines became the first crisis-hit Asian country to receive financing from the IMF. The Bank of Indonesia widened its intervention bands from 8 per cent to 12 per cent in July 1997. However, on August 14, 1997 the rupiah was floated and immediately went into a free fall. In Malaysia, the central bank (Bank Negara) also intervened in order to prevent the ringgit from depreciating too quickly. In July 1997, following the devaluation of the baht, the ringgit fell 2 per cent to 2.25 against the dollar. Bank Negara spent 10 per cent of the country’s foreign reserves propping up the ringgit. On July 14, the ringgit was de-linked from its dollar-denominated currency and allowed to float.

3 Under competitive devaluations, exports of countries whose currencies undergo a devaluation become more competitive in world markets as against the exports
The Asian financial crisis

of countries whose currencies do not undergo a devaluation to the same extent. This puts tremendous pressure on countries with stable currencies to devalue in order to make their exports competitive in world markets.

4 By end of 1997, the New Taiwanese dollar had depreciated by 15 per cent, while the stock market fell by 30 per cent.

5 The design of the currency board and linked exchange-rate system in Hong Kong is as follows. The three note-issuing banks in Hong Kong can surrender a certain amount of US dollars to the Exchange Fund of the Hong Kong government in exchange for an equivalent amount (at the official exchange rate of 7.8) of Certificates of Indebtedness – which will entitle them to print the said amount of Hong Kong dollars. With the Certificate of Indebtedness, the three note-issuing banks can use the same amount of Hong Kong dollars to redeem the equivalent amount of US dollars. According to the design, any discrepancy between the market and official exchange rates would be removed by cash arbitrage. However, in actual practice, the HKMA sells US dollars and buys Hong Kong dollars whenever the market exchange rate comes close to the intervention rate of 7.75. Thus, the currency board system operates with a self-adjustment mechanism to restore exchange-rate stability when it comes under pressure. That is, when there is an outflow of funds and the domestic currency is sold to the currency board, the monetary base will contract and interest rates will rise automatically. For details, see Yam 1998a.

6 The HKMA was sharply criticized for relying on this single tool, the interest rate, to defend the Hong Kong dollar. However, what is not always recognized is that the currency board’s automatic adjustment mechanism would require local interest rates in the interbank market to go up in the event of a capital outflow – which would take the form of Hong Kong banks’ selling Hong Kong dollars to the HKMA for US dollars at the fixed exchange rate. Moreover, the Hong Kong authorities also took several other steps, such as asking banks to limit loans to the speculative property and stock markets, strengthening prudential standards for non-performing loans of banks, increasing bank reporting requirements, and insisting on greater transparency of the banking sector.

7 According to theory, any speculative attack that bid up the domestic interest rate would attract capital inflows (thereby bringing the domestic interest rate back to the US level), making speculative attack unprofitable. However, such a process did not materialize. The huge gap between the Hong Kong dollar and US dollar interest rates was due to the so-called “Asian Risk Premium.” Also, it should be noted that while the speculative attack on the forward currency market was the prime mover of the crisis, most of the profits came from the speculative selling in the stock futures market. For example, a fall of the Hang Seng Futures Index by 1,000 points would mean half-a-billion Hong Kong dollars’ profit for every 10,000 contracts. If speculators altogether sold 50,000 contracts and gained 4,000 points in the futures index, the profit would be HK$10 billion.

8 On October 23, 1997, stock prices in Hong Kong fell by 10.4 per cent, a larger fall than what occurred following the Tiananmen incident. However, nothing better illustrated the crisis in Hong Kong than the spectacular collapse of Peregrine Investment Holding. This regional investment house, known for its risk-taking, fell because of its unsound investment in the ironically named Indonesian taxi company, Steady Safe. On the eve of its collapse, Peregrine held $270 million in
promissory notes, denominated in US dollars, from Steady Safe – or about one-third of its capital assets. In addition, it held an estimated US$400 million in other Indonesian debt securities. Because of the sharp decline of the value of the Indonesian rupiah and its failure to hedge against currency risk, Peregrine’s investment became worthless virtually overnight.

9 Since Singapore and Taiwan competed directly with Korea in a wide range of export products, the fact that both had allowed their currencies to depreciate put Korea at a serious competitive loss.

10 Since 1990, South Korea had operated a managed floating system known as the “market average rate system (MARS).” Under this system the Bank of Korea would intervene actively if exchange-rate fluctuations exceeded the permitted plus or minus 2.25 per cent band against the preceding day’s closing price.

11 The Malaysian Prime Minister Mahathir Mohamed lamented that “the financial turmoil had reduced the Asian Tigers into whimpering kittens, and . . . that the massive damage to their economies will take decades to restore”: *Singapore Straits Times*, March 3, 1998, p. 11.

12 According to Gopinath (1999, 82), “Nowhere was the US influence more evident than in the decision to bail Russia out. The Clinton administration wanted to keep President Boris Yeltsin and his so-called economic reformers in office. The IMF staff, including Michel Camdessus and Russia expert John Odling-Smee, were reluctant because they worried they wouldn’t be able to monitor how the money would be used. But with its largest donor urging it to go ahead, the IMF had little choice but to agree to pledge $11.2 billion to a $22.6 billion Russian rescue.” Also see Bueno de Mesquita et al. (1999, 27), and *IMF Survey*, vol. 27, no. 17, August 31, 1998, pp. 275–6.

13 Illarionov (1999) argues that the refusal by the Duma (Russian Parliament) to accept key fiscal measures in the modified economic program worked out by the IMF and the Russian government in early July 1998 was the final straw.

14 The devaluation exposed the insolvency of the banks by leaving them with dollar obligations on forward contracts many times greater than their capital. For details, see *IMF Survey*, vol. 28, no. 15, August 2, 1999, pp. 241–3. Also see IMF 1999, 55–8.

15 See *IMF Survey*, vol. 27, no. 23, December 14, 1998.

16 In October 1997, speculators attacked the Brazilian real with the aim of profiting from an expected devaluation by selling the currency “short” – that is, borrowing the currency and selling it with the hope of repurchasing it more cheaply before repaying the lender. While this strategy is usually not sufficient to force a devaluation, it can put tremendous pressure on a currency. The outcome depends on the government’s response. It can defend its currency by selling reserves and/or raising interest rates, or it can allow the devaluation to occur.

17 For details, see *IMF Survey*, vol. 27, no. 21, November 16, 1998; *IMF Survey*, vol. 27, no. 23, December 14, 1998; *IMF Survey*, vol. 28, no. 6, March 22, 1999.

18 Also, on January 6, 1999, when Itamar Franco, governor of the state of Minas Gerais, announced a moratorium on debt payments owed to the federal government (totaling US$15 billion), market confidence in the success of Brazil’s fiscal stabilization plan waned further. And when a number of other Brazilian states joined the request of Minas Gerais, the net outflow of capital intensified.

57
The disorderly exit from the peg caused the real to overshoot (the real lost over 50 per cent of its value in a few months), hurt economic activity, and propelled unemployment to a decade-high 8.3 per cent in February 1999. For details, see *IMF Survey*, vol. 28, no. 3, February 8, 1999.

The G-7 (or Group of 7) countries comprise the United States, Great Britain, Germany, Japan, France, Canada and Italy. The OECD countries include the G-7 plus 15 other major economies of the world.

The US$20 billion was funded through a conditional collateralized loan funded from the US Treasury’s Exchange Stabilization Fund.

Prior to Mexico, the largest IMF stand-by credit arrangement was the US$4 billion agreement with the United Kingdom in 1977. It is important to note that while the IMF and other multilateral institutions provided the rescue packages to ailing Asian economies quickly, the amount and timing of disbursements depended on the countries’ performance under IMF-agreed reform programs. Between August 1997 and October 1998, Thailand received some 60 per cent of the financing committed for that period by the IMF and the World Bank. Korea received almost 90 per cent of the financing committed in the very early stages of the crisis. By contrast, official lending to Indonesia was held up, after an initial disbursement of US$3 billion in early November 1997, owing to the slow implementation of reforms. IMF disbursements resumed only in May 1998, and stepped up during the summer, after major political reforms took place in the country. For details on IMF lending, see *IMF Survey*, vol. 28, no. 5, March 8, 1999.

The Miyazawa Initiative announced by the Japanese government on October 3, 1998 was designed to help the crisis-affected countries restructure corporate debt, reform financial systems, strengthen the social safety net, increase employment and ease businesses’ financial constraints. To achieve this quickly, the initiative provided for US$15 billion in short-term swap arrangements and the rest for medium and long-term use. Japan’s Export–Import Bank was selected to guarantee loans to Southeast Asian nations as well as purchase bonds issued by their governments. In fact, an important element of this initiative is that it allows official Japanese institutions to guarantee bond money raised by crisis-hit Asian countries at rates available to the Japanese government. As of April 2000, only US$6.75 billion remain unused.

Gilpin (2000, 145) notes that “as early as the spring of 1997, Japan urged joint action to prevent a crisis, but the Clinton Administration, fearing a negative domestic reaction, failed to act.” He adds that “the Clinton Administration was very slow in recognizing the serious nature of the unfolding crisis; indeed, as late as the November 1997 Asia-Pacific Economic Cooperation (APEC) Summit in Vancouver, the President dismissed the crisis as a few small glitches on the road” (p. 146).

Quotations cited in CPER (1998, 2), Gilpin (2000, 143) and Council on Foreign Relations (1999, 23). According to Tan (2000, 207), “one possible reason for the lack of interest and concern on the part of the Americans was the fact that US banks were the least exposed to countries affected by the currency crisis. At the end of 1996, total lending by US banks to Thailand, Malaysia, Indonesia and South Korea was US$22 billion. This was only about a quarter of the total lending of Japanese banks (US$92 billion), or European banks (US$82.3 billion) to these countries.”
At the Birmingham summit in May 1998 the G-7 leaders and finance ministers stressed the need for reforming the international monetary system.


The terms “moral hazard” and “asymmetric information” will be elaborated later.


Asymmetric information” emerges when one party to a financial contract does not have the same information as the other party.

“Herd behavior” suggests that investors’ decisions are not always rational.

As is well known, even well-managed banks or financial intermediaries are vulnerable to panics, because they traditionally engage in “maturity transformation.” That is, banks accept deposits with short maturities (up to three months) to finance loans with longer maturities (up to one year or longer). Under normal conditions banks should have no problem managing their portfolios to meet expected withdrawals. However, if all depositors decided to withdraw their funds from a given bank at the same time (as during a panic), the bank would not have enough liquid assets to meet its obligations – threatening the viability of an otherwise solvent financial institution.

Radelet and Sachs (1998, 4) note that there is “a critical distinction between illiquidity and insolvency. An insolvent borrower lacks the net worth to repay outstanding debts out of future earnings. An illiquid borrower lacks the ready cash to meet current debt servicing obligations, even though it has the net worth to repay the debt in the long term. A liquidity crisis occurs if a solvent, but illiquid, borrower is unable to borrow fresh funds from the capital market in order to meet current debt servicing obligations.”

Implicit in the Radelet and Sachs (1998) account is the view that investor behavior was irrational. It should be kept in mind that when the currency crisis is analyzed as a bank run, investor behavior does not have to be irrational. Given that other creditors are withdrawing funds, it is rational for an investor to withdraw funds. In fact, it may be rational to be first in line.

“Contagion” refers to the spread of market disturbances from one country to another, which is observed through movements in exchange rates, stock markets and interest rates. Empirical examination of the evidence for contagion consists of four types of tests. The first estimates correlation coefficients of financial variables. According to this approach, a marked increase in correlations among markets of different countries is regarded as evidence of contagion (Calvo 1996). Eichengreen and Rose (1998) define contagion as a case where knowledge of a crisis elsewhere increases the probability of a crisis at home. The third type of tests estimates levels of volatility among financial markets. This approach examines whether conditional variances of financial markets are related to each other during the crisis period (Edwards 1998). Finally, a fourth type of test examines whether foreign news affects financial variables at home (Kaminsky and Schmukler 1999a).

Fratzscher (1998) has found that the financial markets in Southeast and East Asia are highly integrated, meaning that the financial channel of contagion is highly influential. While Fratzscher also found that Asian economies are close
The Asian financial crisis

trade competitors in terms of the similarity of export structures and export destination (including intra-regional trade), the size and significance of the coefficients in his econometric equations however suggest that the financial link was the most important channel of contagion in the Asian crisis.

Various factors may account for crises spreading across countries. First, simultaneous crises may be triggered by a change in the external environment such as increases in international interest rates. Second, crises can spread through trade and financial linkages. Portfolio reshuffling by investors in response to developments in one country may affect another country’s access to flows. Third, the similarity of fundamentals with affected countries, such as geographical proximity or common development strategies, can lead to contagion.

At the time the official rate of the RMB (renminbi = yuan) was at 5.8 RMB per US dollar versus the 8.7 RMB per dollar at the swap center.

For a discussion of how China’s pre-emptive devaluation contributed to the Asian financial crisis, see Corsetti, Pesenti and Roubini (1998).

The tax change meant that exporters could claim a refund of the VAT paid on inputs.


The quotation is from Mattione (2000, 185).

The classic bubble economy is one in which real estate prices continue to rise well beyond levels justified by the productivity of the assets. However, so long as the prices continue to rise, existing investors are rewarded and collateral is created for new loans to finance further investment, and so on – until the inevitable crash.

For the first four decades following the Second World War, Japan’s overall economic growth was spectacular: a 10 per cent average in the 1960s, a 5 per cent average in the 1970s, and a 4 per cent average in the 1980s. For details, see Posen (1998).

Until the outbreak of the Asian financial crisis, the Japanese authorities had managed to cover up the seriousness of the banking crisis by a series of government-sanctioned takeovers of smaller failed banks by larger banks under the so-called “convoy system.” Why has Japan failed to address its loan problem effectively? According to Lincoln (1998), politics is at the root of the problem. That is, Japanese politicians have incestuous relations with borrowers and the banking community. For example, investment banks commonly lend money to politicians to buy a particular stock and then ramp up stock prices, allowing the politicians to sell out, repay the loan, and make a profit. If the non-performing loan problem were cleared up, many such illegal transactions would come to light, causing embarrassment to those involved.

Grenville (1999, 3) notes that “the interest differential between the major industrial countries and the emerging market economies was the greatest for Japan – hence, the rise of the yen-carry trade – borrowing at low interest rates in yen, and on-lending at high returns in other countries, particularly in Asia. When local-currency borrowing rates were around 20 per cent (which was the case, for example, in Indonesia), yen-based interest rates seemed extraordinarily attractive.”

Dobson (1998, 153) notes that “in 1996, only three out of twenty major Japanese banks recorded positive rates of returns on equity, and the rest had negative
rates ranging from −19.4 per cent to −3.15 per cent. In 1995, 13 trillion Yen of loan write-offs and loan loss provisions more than offset the operating profits of all Japanese banks, which led to a net loss of 3.8 trillion Yen.”

48 The Basle Accord, an international agreement that set common standards by which to evaluate capital adequacy, was introduced in 1988. In order to create a “level playing-field” it requires that all internationally active banks satisfy the same two (minimum) risk-based capital ratios.


51 Japanese investors did not need to worry about risk associated with overvaluation of a host country’s currency as long the authorities succeeded in keeping inflation rates in line with the appreciation of the dollar.

52 Japanese manufacturing companies also shifted their production to North America, partly to avoid trade conflicts and partly to prepare for the North American Free Trade Area (NAFTA).

53 A study by Frankel and Wei (1994) on the exchange-rate policy of nine East Asian countries during the period 1979 to mid-1992 has shown that the weight that was attached to the US dollar in the currency baskets of most East Asian countries ranged from 0.9 to 1.0. The only exception was the Singapore dollar, which assigned slightly more weight to the yen. A study by Kwan (1995) further confirmed the dominant position of the dollar in East Asian currency baskets.

54 The only exception was the Philippines, which during 1991–95 posted a mere 2.2 per cent annual growth rate.

55 Within a broader historical perspective, the fast-growing Asian economies were doubling their average incomes approximately every 11 years. On the other hand, it took Great Britain about 60 years to double its average income after 1780; the United States took about 50 years to double its average income after 1840; and Japan took roughly 35 years to double its income after 1885 (Tan 2000, 23).

56 Krugman’s findings have been questioned. According to Sarel (1997), Singapore, Malaysia and Thailand all had a TFP (total factor production) growth of 2 per cent to 2.5 per cent between 1978 and 1996, compared with only 0.3 per cent in the United States.

57 When private investors borrow short-term, they may fall into maturity mismatch difficulties. Maturity mismatch difficulties arise when the assets backing short-term debt obligations are longer-term, and therefore less liquid than their liabilities. Illiquid assets (such as real estate) cannot be sold quickly at fair value.

58 That is, governments in the developing world (especially, Latin America), which had borrowed heavily from foreign commercial banks during the 1970s (encouraged by very low real interest rates and by high prices for their commodity exports), were unable to service their debts when real interest rates rose sharply at the end of the 1970s, and a world-wide recession reduced demand for developing country exports.

59 Since the 1990s, the international bond market has been the largest provider of net financing to emerging markets. It has also served as the mainstay of external financing for sovereign borrowers (in marked contrast to the 1980s, when syndicated bank lending performed this role).
The Asian financial crisis

60 The 1996 figure is from the World Bank (1996a, 11–12). The other figures are from the IMF (1995, 2–4).

61 Calvo, Leiderman and Reinhart (1993) found that declines in US interest rates were correlated with increases in proxies for capital inflows (foreign reserve accumulation and real exchange rate appreciation) to Latin America in the early 1990s. Fernandez-Arias (1996), who studied a broader sample of emerging markets, estimated that global interest rates accounted for nearly 90 per cent of the increase in portfolio investment flows for the “average emerging market” in 1989–93.

62 Hong Kong, Japan, Singapore and Malaysia were accorded IMF Article 8 status as early as the 1960s.

63 Nidhiprabha (1998, 195) notes that “by the end of 1995, the short-term debt through the BIBF amounted to $41 billion, out of a total debt of $80 billion.”

64 Lipsey (2001) finds that direct investors, especially those who operate manufacturing facilities in foreign countries, are much more likely to ride out economic crises than those involved in foreign bonds, equities, bank loans and other forms of investment. The major reason for this appears to be that much of the direct investment is bound up in enterprises that, in times of instability, can redirect sales from a country’s local markets to export markets. Lipsey also credits the direct investors with being more willing to hang tough in the midst of seeming chaos. For example, he finds foreign direct investors operating in Asia “to be much less skittish than other investors in responding to the crisis.”

65 Illiquid assets cannot be sold quickly at fair value. One common example of an illiquid asset is real estate – where it takes some time to locate a buyer willing to purchase the asset at its fair value.

66 There are a number of different instruments and approaches that can be used to manage currency risk in international trade transactions. These include (1) forward foreign-exchange contracts, (2) structural or balance-sheet hedges, (3) invoicing in local currency, and (4) use of foreign-exchange option contracts.

A forward foreign-exchange contract involves contracting today to buy or sell a foreign currency at a future date at an exchange rate agreed today. Thus, for example, exporters can contract today to sell the foreign-exchange proceeds they expect to receive at a future date so as to insulate themselves from fluctuations in the exchange rate in the interim. Generally, the forward exchange rate on a given day will not be the same as the spot rate. The difference stems directly from the interest rate differential between the two currencies. However, it is also the case that forward contracts are generally favored for shorter-term hedging of trade flows, while borrowing or lending in foreign currencies is normally seen as a way to establish a long-term structural hedge. One reason why forward contracts are used to establish shorter-term hedges is their relative flexibility. Contracts can readily be rolled forward, or closed out according to the firm’s view of the exchange rate. Also, forward contract maturities can be managed flexibly, through the use of swaps contracts. For example, a common practice for a firm is to enter into a spot contract immediately it sees a favorable opportunity in the market. Later, by executing a swap contract, the spot contract can be turned into a forward contract, with a maturity date that matches the underlying export receipt or import payment date.
The arrangements under which banks will deal with firms in foreign exchange, including in forward contracts, are also more flexible than those under which they will establish debt facilities. The documentation and security that banks require to support a foreign exchange dealing line often are less demanding than those required for debt facilities. For these reasons, managing foreign-exchange risk by managing the currency composition of the balance sheet through foreign currency borrowing tends to be limited to large corporations with the financial strength and profile to access offshore debt markets, or with offshore operations that can fund themselves directly in the markets in which they operate. **Invoicing in local currency** is another possible way to manage exchange-rate risk by passing it to the trading counter-party. However, invoicing in local currency does not of itself provide complete protection against exchange-rate risk. What matters, therefore, is not just the currency of invoicing, but the ability to negotiate a pricing arrangement (either in foreign currency or local currency), that leaves the effect of exchange-rate changes with the trading counterpart. Another hedging possibility available to local exporters and importers facing foreign exchange risk is **foreign exchange options**. As the name suggests, an option contract differs from a forward contract in that it gives the holder the right, but not the obligation, to buy or sell one currency in exchange for another at a specified exchange rate, and at an agreed point in the future. Under a forward contract the holder must buy or sell on the agreed date; with an option the holder has the choice.

67 Of course, in Mexico, the capital inflows fueled a consumption boom.

68 The underlying rationale is that the flexibility in exchange rates would introduce some uncertainties that might discourage purely speculative and highly reversible inflows. It also allows the monetary authorities a greater degree of independence in exercising control over monetary aggregates as they become relatively free from preoccupation with the stability of the exchange rate.

69 Intervention can be sterilized or left unsterilized. Unsterilized intervention will increase the monetary base, resulting in lower interest rates. The stimulating effect of lower interest rates may cause inflation if the economy is already at the full capacity of production – which is often the case for emerging market economies that attract massive capital inflows.

70 Suppose the initial capital inflows were in the form of FDI. The domestic end of sterilization is most likely effected in the short-term money market. Then, the short-term interest rate may increase, while the long-term interest rate will decline. The higher short-term interest rate will invite more capital inflows in the form of portfolio investment. Hence, sterilized intervention may increase capital inflows.

71 Montiel and Reinhart (1997) argue that the sterilization policies followed by the host (capital inflow) countries played an important role in setting the stage for the subsequent crisis. Specifically, sterilization operations kept domestic interest rates in the host countries higher than would otherwise have been the case, thereby inducing both larger net inflows and a high share of interest-sensitive short-term flows.

72 The Malaysian political system is sometimes referred to as “semi-authoritarian” or “semi-democratic” because it contains features of both systems. That is, although the constitutional framework of the Malaysian political system is essentially democratic (elections have been held regularly, the government is responsible to
The Asian financial crisis

an elected parliament and the judiciary is constitutionally independent), the democratic framework is accompanied by a wide range of authoritarian controls that greatly limit the scope for effective political opposition. The controls also makes the defeat of the ruling party at the polls almost impossible.

As Max Weber (1947) noted long ago, inherent in personalism is “patrimonial bureaucracy” with a penchant for official malfeasance and outright corruption.

Athukorala (1998, 89) notes that “public investment expenditure surged, pushing the total investment to GDP ratio to 46% in 1997, the highest in the region.”

Haggard (2000, 49) defines a veto gate as an institution that has the power to veto a policy proposal, thus forcing a reversion to the status quo. Veto gates can include the president, the legislature, a second chamber of the legislature, a committee within a legislature, or the courts. In authoritarian governments, they may include the military. The preferences of these veto gates may be more or less closely aligned: thus the president and the legislature may represent distinct veto gates, but may either be of the same party (unified government) or of different parties (divided government).

The IMF’s mandate is outlined in the charter of rights and obligations. This is contained in its constitution or “Articles of Agreement.” The IMF’s purpose is to promote international monetary cooperation, exchange-rate stability and the expansion of international trade by serving as a short-term lender, providing liquidity for member countries with short-term balance of payments problems. On the other hand, the World Bank’s role is to provide longer-term development finance. Although the total size of the IMF’s quotas increased from about US$9 billion at its creation in 1944 to nearly US$200 billion in 1997, it has declined relative to almost all relevant global economic indicators, whether the size of world trade, international reserves, or international financial flows.

The IMF has 182 members as of June 30, 2001.

Under Article IV of the IMF’s Articles of Agreement, the IMF holds bilateral discussions with member countries, usually every year. An IMF staff team visits the country, collects economic and financial information and discusses with government officials the country’s economic policies. On return to headquarters, the staff prepares a report – which forms the basis for discussion by the IMF Executive Board. At the conclusion of the discussion, the Managing Director, as chairman of the Board, summarizes the views of the Executive Directors, and this summary is than forwarded to the country’s authorities.

However, much is in the form of currencies not readily used in international financial transactions. That is, once we take into account the fact that 75 per cent of country quota subscriptions are in domestic currency, and that approximately half the money on the IMF balance sheet cannot be used, the $215 billion figure does not look very large.

The other facilities include the Systemic Transformation Facility (STF), which is a temporary facility designed to extend financial assistance to transition economies, and the Structural Adjustment Facility (SAF) and the Enhanced Structural Adjustment Facility (ESAF), designed to assist the low-income and least-developed member countries.

However, in a capital account crisis such phasing may be problematic, since the authorities do not have the funds up front to counter capital outflows – and
indeed, owing to conditionality, it is not certain that they will ever have access
to this money.

Conditionality is the mechanism whereby the IMF ensures that countries imple-
ment the necessary adjustments. The provision of the IMF’s assistance is con-
tingent on a government’s agreement to a program of specific policies, and its
subsequent adherence to that program. Credit is disbursed in periodic installments
as a government fulfills its obligations – otherwise a program can be suspended
or altogether terminated.

For details, see Michael Mussa (2000), who at the time was economic counselor
and director of the Department of Research at the IMF.

There is agreement that South Korea got into trouble in mid-1997 because its
financial sector had incurred short-term foreign debts that far exceeded its
foreign-exchange reserves. Korea’s problem was one of unsustainable corporate
debt and the resultant temporary illiquidity, rather than insolvency. In such a
context the IMF’s demand for a fundamental restructuring of the Korean
economy was not very prudent.

As Stanley Fischer (1998a, 104–5), notes, “the first order of business was to restore
confidence in the currencies.” To achieve this, countries have to make their curren-
cies more attractive, which requires increasing interest rates temporarily – even
if higher interest costs complicate the situation of weak banks and corporations.

Nellor (1998) notes that in the absence of comprehensive reforms, it would not
have been possible to restore investor confidence in the crisis economies.

Specifically, the IMF and the G-7 extended the Mexican government loans that
permitted it to pay off the holders of the tesobonos in full.

The fact that the strategy of investing in Russian debt securities in 1997–98 was
referred to as the “moral hazard play” suggests that the international commun-
ity’s repeated resort to financial rescue packages influenced investor behavior.
The community’s official decision not to avert a Russian default in August 1998,
and its bail-in efforts in Ukraine and Ecuador, were an attempt to moderate this
expectation.

Holders of equities and long-term debt securities, especially those who sold at
the height of these crises, took significant hits.