

Asian Financial Crisis and the Consequence on Economic Development

The Asian financial crisis

Sorayod Kumbunlue
Universität Mannheim

The extraordinary growth of the ASEAN countries over the decade had come to an end with the Asian financial crisis which began in July 1997, and the deep of recession which followed. The Asian crisis may be distinguished by two significant components.

First, a financial crisis which came up with a currency crisis typically reveals a three-stage process that effects a country participating in large-scale international borrowing. In the first stage, the exchange rate became overvalued as a result of internal or external reasons. In the second stage, the exchange was defended, but on an account of an essential exhaustion of foreign reserves of the central bank. In the last stage, the depletion of reserves, mostly in association with currency devaluation, induced a panicked rapid outflow of short-term financial capital. Consequently, the adjustment of policy had to be done, in this case, a change of the fixed exchange rate to floating exchange rate during a period of loss of confidence. Finally, the currency depreciations and high domestic interest rates resulting from currency floats led to the collapse of domestic financial institution.

Second, an economic crisis which had originated from the financial crisis, led to macroeconomic collapse, characterized by a contraction of output, rising interest rate, depressed equity prices and a descending currency. These led to the loss of government revenue, employment, and household incomes. It should be noted that all of the countries that experienced Asian the financial crisis -in particular the ASEAN countries, Indonesia, Malaysia, and Thailand, and outside ASEAN, Korea- had three following similar features. Their successful economies were attractive to the substantial capital inflows during the 1990s. Their exchange rates were fixed or quasi fixed to the U.S. dollar. And last but not least, the combination of immense capital

inflows and a fixed exchange rate policy had driven these countries into economic and financial vulnerability, delineated by an overvalued currency, falling foreign exchange reserves, and high foreign debt, particularly short-term debt¹.

The factors that contributed to the Asian financial crisis can be distinguished in internal and external factors. The internal factors refer to deficiencies of the fundamental structure, such as high current account deficits in accordance with a weak and unstable financial sector, poor banking supervision, a speculative real estate boom, a credit boom, a deterioration of investment quality, corruption, and a misalignment of exchange rate policy. One of the relevant internal factors was the financial sector's weakness. In the 1990s, the crisis countries had liberalized their financial markets. Consequently, domestic banks and corporations could borrow from foreign lenders. The capital inflows were reinforced by the fact that with the expectation of further economic growth, the government ran a strategy of keeping domestic interest rate high relative to the interest rate from the West or Japan². These capital inflows were, to a great extent, short-term. The fact that several banks transformed these short-term capital inflows by handing out a long-term loans to the domestic borrowers had increased the fragility of the financial sector. In addition, there was diverse 'connected lending' -for instance, lending to bank directors, and their related businesses- and insufficient loan approved processes, thereby leading to high credit risks. The crisis countries encountered an 'original sin' situation, in which the domestic currency cannot be used to borrow abroad or to borrow long term. Moreover, there were currency mismatch and maturity mismatches in many investment projects. It was a situation of financial fragility³. There was immoderate government involvement in banks, providing an oblique mechanism for helping the ailing industries with government assistance, which led to moral-hazard problems. The capital inflows made the ASEAN-4 countries -Indonesia, Malaysia, the Philippines and Thailand- experience a credit boom in the 1990s. However, the quantity of investment was not compatible with its quality, so much of private

¹ Sachs J. D. and Woo W. T. (2000), p. 22

² Moreover, in some cases, for instance in Thailand, the Bangkok International Banking Facilities (BIBF), which were established to promote Bangkok as regional financial center and intended to increase funds from nonresidents and lend them on to other nonresidents, turned out to be an instrument for Thai banks and firms to borrow abroad, see Goldstein M. (1998), p. 13

³ Investment with currency mismatches refer to projects that generate domestic currency while they are financed with foreign currency.

Maturity mismatches refer to long-term projects, which are financed by short-term loans, see Eichengreen B. and Hausmann R. (1999), p. 3

investment was aimed at speculative activities, such as real estate and equities, or at over-capacitated industries. There were several inefficient or over-ambitious projects of public investment, such as infrastructure projects. Furthermore, some estimates of actual non-performing bank loans had indicated the banking hardship situation. This overextension of credit made the ASEAN-4 economies sensitive to the shift in credits and cyclical conditions. At that time, the financial situation was not thought to be risky, because the domestic currencies had been stable to the U.S. dollar for many years. The currencies of the ASEAN-4 economies, first, followed the U.S. dollar down vis-à-vis the Japanese yen in the first half of the 1990s, but then followed the dollar's appreciation against yen. In particular, in the 1995-1997 these countries noticed an appreciation of their real effective exchange rates. The credit boom and liquidity/currency mismatches and large current account deficits were soon conducive to motivate speculative attacks. In addition, besides large current account deficits, decreasing quality of investment, and appreciating real exchange rates, the ASEAN-4 countries had to face a marked export slowdown in 1996, intense export competition from China, India, and Mexico, concern about overproduction, and a rising protectionism movement from the West. These circumstances had been deteriorating their economic situation⁴.

External factors⁵ -the stringent monetary policy of the United States in order to bring budget deficit under control and to increase market competitiveness, and the rising discipline over fiscal- and monetary policy in the EU countries in order to fulfil the Maastricht-criteria, the low economic performance and financial crisis in Japan and furthermore, the increasing competition from China, India and Mexico- have brought about a deterioration of the economic situation and on export markets of ASEAN countries. Consequently, ASEAN countries encountered increasing difficulties in keeping their fixed currencies which were pegged or quasi pegged to the U.S. dollar compatible with their current account deficits. Furthermore, the depreciation of Chinese yuan, starting in 1994, led to an increase of Chinese exports, hence an increasing competition for ASEAN export markets. Besides the low interest rate policy and the weak economic development in Western Europe in the middle

⁴ Furthermore, this situation of weak economic activity, high level of bad loans, and public antipathy to bailing out banks appeared to indicate the weak economic situation and the low interest rates in Japan, see Goldstein M. (1998) p. 9

⁵ Rieger H. C. (2000), p. 29-30, and Dieter H. (1998), p. 65-68

1990s, and the unexpectedly low investment opportunities in Eastern Europe, it was the Japanese low interest rate policy -in order to counter the deflation of the real estate market- that had consequently brought about high levels of capital inflows to ASEAN. In April 1995, the Japanese discount rate was reduced from 1,75 to 1,0 percent and in September, it amounted to only 0,5 percent. Consequently, the Japanese banks could provide themselves with domestic low cost capital and then invest, mostly short term, in the foreign capital market with high interest rates, particularly in the ASEAN-4 countries. This had brought about instability to ASEAN financial markets, since the capital inflows were mostly short-term, and the current account surplus in Japan had, partly, induced current account deficits in the ASEAN countries.

It can be concluded that it was not merely the deficient policy and weakness of the economic structure of the crisis countries that led to the crisis, but also the capital movement from the West and Japan, aiming at high and instantaneous profit, that spread out to the world, particularly to ASEAN⁶.

Structural weakness and triggers of the financial crisis

In order to understand the Asia crisis, it is essential to analyse the framework of the causes for currency and financial crisis. A framework presented in this work demonstrates a conjuncture between fundamental structural misalignments and financial panic as a possible reason for the financial crisis. First, it was the misalignment of the fundamental structure that leads to economic vulnerability. Then, as the economic situation deteriorates, the severe structural misalignment undertakes as a signal leading to financial panic or even as a trigger of the crisis by itself.

The problem of the fundamental structure encompasses institutional economic and growth theoretical aspects referring to the following main features⁷: 1) the appreciation of the real exchange rate and a high level of structural current account deficits in the 1990s, 2) over-investments in risky and less profitable projects, 3)

⁶ Rieger H. C. (2000), p. 30, and Hufschmid J. (1999), p. 64-68

⁷ Klump R. (2000), p. 37-39

Moral Hazard effects, and 4) high level of short-term foreign debts in foreign currencies. It was presumed that increasing current account deficits, growing foreign debts, and keeping domestic currency pegged or quasi pegged to the U.S. dollar and credit guarantee from the government were the ‘strategy aimed at sustaining high investment’. However, it was overseen that this had led to declining quality and profitability of investment⁸. According to the first step, the misalignment of the fundamental structure had brought about economic vulnerability. There are three relevant indicators that may indicate the economic vulnerability of a country to currency and financial crisis; first, adequacy of reserves relative to the stock of volatile capital, second, financial sector fragility, and third, real exchange rate misalignment⁹.

According to the framework of these three indicators for vulnerability to currency and financial crisis of Peter G. Warr, the first indicator ‘Adequacy of reserves’ essentially directs to the stock of funds, precisely the volume of volatile capital, which can be turned over at short notice against reserves. Giving that the change in the level of reserves (flow) ΔR is equal to the net balance on capital (flow) K plus the net balance on current account (flow) C ; $\Delta R = K + C$. The capital account balance K throws back volatile -such as, equity (consisting of stock market purchases), debt instrument (such as bonds), short-term bank credit, and non-resident bank accounts- and non-volatile components -such as, foreign direct investment and long-term bank credit. This reveals the notation $K = \Delta K^v + \Delta K^{nv}$, with ΔK^v and ΔK^{nv} presenting the changes in the stocks of volatile and of non-volatile foreign capital respectively. So the equation of the change in the level of reserve becomes; $C + \Delta K^{nv} = \Delta R - \Delta K^v$, and the right side may reflects the change in the vulnerability of reserves¹⁰. It should be noted that large current account deficits are not necessarily needed to raise the vulnerability. It is, to a great extent, the size of the current account deficit relative to the volume of non-volatile capital inflows. If the volume of non-volatile capital inflows is relatively small or has a decreasing tendency, and the accumulated stock of volatile capital becomes large relative to international reserves, this will make reserves vulnerable to capital outflow.

⁸ Corsetti G., Pasenti P. and Roubini N. (1998), p. 4

⁹ Warr P. G. (2001), p. 5-16

¹⁰ The right side may be negative even though reserves are rising.

According to the ‘fragility of the financial sector’ hypothesis, the ratio of total loans from the banking system to GDP is used as a measurement to reveal the banking system’s vulnerability to increased interest rates -the average quality of loans may be expected to deteriorate, as this ratio rises. An increase in interest rates¹¹ will bankrupt the weak borrowers and therefore the banks themselves. Moreover, the ratio of foreign liabilities to total loans is used as a measurement of exchange rate exposure of the banking system, in which an exchange rate depreciation will increase the costs of servicing foreign loans relative to bank revenues.

Finally, according to the ‘misalignment of the real exchange rate’, the proper magnitude of a real appreciation can be analysed by the opportunity use of one of these two types of measures. First, the relative prices of traded to non-traded goods within a country (domestic competitiveness), or second, the prices at which country’s tradable goods can be exchanged internationally with the tradable goods of other countries (international competitiveness).

Vulnerability and trigger are related to each other. Since vulnerability does not cause a currency or financial crisis by itself, a disturbance is needed that will drive a vulnerable condition to a collapse. At the second stage of misalignment of the fundamental structure, the continuous deterioration of the economic situation - persistent overvaluation of the real exchange rate, over-investments in risky and non- or insufficient-profitable projects, moral hazard effects of implicit and explicit credit-guarantee from the government, and the immense short-term foreign debt in foreign currency- may arrive at a critical point, and then will act as a signal for financial panic or as a trigger by itself. The most relevant signal triggering the financial panic may refer to the policy of a long defence of a fixed exchange rate, whereas the real damage comes from the depletion of foreign exchange reserves in order to defend an overvalued currency. Following the depletion of reserves, a devaluation can trigger a

¹¹ If reserves are inadequate to sustain a sudden outflow of capital, and the government still wants to retain the fixed exchange rate, one possible response is an increase in the interest rate. First, this may help maintaining relative expected returns on investment in the country by compensating for the potential loss of return due to the expected exchange rate depreciation. This, in turn, reduces the net deficit on capital account resulting from investor panic. Second, increases in the interest rate may lead to a decline in domestic private consumption and investment, which, in turn, reduces the negative value of the net balance on current account, see Warr P. G. (2001), p. 8-9.

panic¹². Financial panic, furthermore, can be triggered by the sudden discovery that reserves are less than previously believed, an unexpected devaluation and contagion from neighbouring countries. There are two plausible frameworks of contagion¹³. The first one is the ‘wake up call’ hypothesis. In the case of Asian financial crisis, Thailand took effect as a wake-up call for international investors to reassess the creditworthiness of the Asian borrowers. After reassessment, the investors found the economic infirmities of several Asian countries, such as weak financial sectors with poor prudential supervision, appreciating real exchange rates, export slow down, over-expansion in certain industries, and a lowering quality of investment, therefore, the crisis expanded afterwards. The second contagion concept refers to the ‘competitive dynamics of devaluation’. After a depreciation of one country’s currency, the countries -in particular, when the countries have trade linkage to each other-, that have not devalued, may undergo a competitiveness deterioration. This will bring about vulnerability to their currencies.

After the panic reached its climax, the economic situation became devastating. The real exchange rate depreciated sharply, the current account shifted from deficit to surplus, the debt was drawn down, the banking system encountered illiquidity, market real interest rates rose to high levels. Furthermore, the collapse of bank lending led to a deterioration of trade and production, and consequently to the economic contraction.

Economic development since the crisis

The crisis has brought about a deep recession to the ASEAN countries. These countries, in particular Indonesia and Thailand, encountered wealth loss, asset prices decline, volatility in exchange rates and financial instability. The economic development after the crisis¹⁴ can be distinguished into three phases.

¹² Radelet and Sachs indicate that when the ratio of short-term debt to the level of the central bank’s foreign exchange reserves is greater than one, the country is prone to a creditor panic, see Radelet S. and Sachs J. (1998), p. 1-90

¹³ Klump R. (2000), p.17-22

¹⁴ Sabhasri C., Charoenseang J., and Manakit P. (2000), p.21-29, Sachs J. D. and Woo W. T. (2000), p.36-40

The first phase, the end of 1997-1998, referred to a quite unsuccessful recovery phase, in which the crisis countries operated tight fiscal and monetary policies, in particular referring adjustment program from the IMF. At the end of October, Indonesia received an assistance package of 23 billion U.S. dollar from the IMF, on condition of adopting fiscal and monetary discipline and also restructuring the banking sector. Moreover, the Bank of Indonesia supported a large amount of liquidity to financial institutions under difficulties in order to prevent bank runs. However, this uncontrolled monetary expansion associated with insufficient structural reforms had induced hyperinflation and currency depreciation, GDP growth declined to -13.1 percent. Thailand received a 17 billion U.S. dollar assistance credit from the IMF in August 1997, on condition of tightening fiscal and monetary policies, such as maintaining an inflation rate at 9.5 percent in 1997 and 5 percent in 1998, and to reach a 1 percent of GDP budget surplus in 1998. However, the economy by no means indicated any recovery. On the contrary, the adjustment program drove the Thai economy into a greater recession, and the GDP growth descended to -10.8 percent in 1998. Malaysia also tightened the fiscal and monetary policy, for instance by controlling credit expansion, and increasing interest rates. The standard package of the IMF was thus implemented without being officially constrained by IMF conditions. The monetary and fiscal discipline, however, was unsuccessful to augment the economic development. On the contrary, as a consequence the control over credit led to economic recession and the ringgit continued to depreciate. The impact of the crisis was not so severe for the Philippines compared to Indonesia and Thailand. GDP growth rate was at 5.1 percent in 1997 and declined to -0.6 percent in 1998.

In the second phase, 1999-2000, the panic ended and the working capital had begun to flow again. However the financial panic had left bad debts throughout the economy. The banking sector had been in difficulties, with bad loans and currency depreciation. The high interest rates, the shortage of working capital, and a depressed domestic market deteriorated the situation of bank and non-bank institutions. To solve these problem the governments of the crisis countries had changed from tight fiscal and monetary policies to an expansionary policy strategy to promote economic activities, which had turned out to be successful. In Indonesia, the economy started to recover in 1999 with a GDP growth rate of 0.3 percent. A steady increase of reserves and tight monetary policy had supported the stability of the exchange rate. The

inflation and interest rates reached at a lower level relative to previous years, and the decline in imports led to a current account surplus of 4.9 billion U.S. dollar in 1999. Despite a weak export performance, the substantial depreciation of the rupiah increased the incentives for many countries to import from Indonesia. This led to an increase in a GDP growth rate to 4.8 percent in 2000, and FDI increased by 60 percent relative to 1999. However, there has been a sharp increase in public debt, 4.8 percent of GDP in 2000 relative to 3.7 percent in 1998, as a consequence of expansionary policies. In Thailand, GDP growth amounted to 4.2 percent in 1999 and 4.2 in 2000. The Thai expansionary policies began in the latter part of 1998. The stimulus packages encompassed the reducing of value-added tax rate from 10 to 7 percent and cutting tax on petroleum products. In addition, together with tax and tariff reductions the government launched expenditures of 53 billion and 100 billion Baht. The inflation decreased from 8.1 percent in 1998 to 0.3 percent in 1999, despite the expansionary policy, and the interest rates also fell to low levels. Besides the expansionary policies, Malaysia also launched temporary capital controls. The GDP growth rate was much better than in Indonesia and Thailand at a rate of 6.1 percent in 1999 and 8.3 percent in 2000. This performance was, to a great extent, due to a strong external demand for manufactured goods, increased consumer demand, and a recovery in gross fixed investments.

In the Philippines, GDP growth rate was at 3.3 percent in 1999. This was, to a great extent, conducted by the recovery of the agricultural sector from the El Nino phenomenon in 1998. The trade balance improved to a surplus of 14.7 percent in 1999. In 2000 the net export supported the economic development, and chiefly resulted in a GDP growth rate of 3.9 percent. The inflation rate was contained at 6.6 percent in 1999 and 4.4 in 2000. This drove the Philippines to reduce interest rates in 2000. The efforts to stimulate domestic demand led to an increased fiscal deficit of about -3.7 percent in 1999 and -4.1 percent in 2000. Although the short-term capital outflows continued, the current account was in surplus of 9.1 percent as a consequence of a two-year standby facility of the IMF.

It can be concluded that the economic recovery in 1999-2000 was brought about by the expansionary policies and export expansion. During the beginning of the crisis, the export performance of the ASEAN-4 countries was very weak. The export

value in 1998 decreased in every countries, except the Philippines. This was a result of the fall in export prices due to the fallen regional demand, from ASEAN countries themselves, from the NICs and from Japan. However, on the other hand, the real depreciations had made the ASEAN exports more competitive. The currency depreciations had made the ASEAN export cheaper in U.S. dollar terms. The value of exports from ASEAN countries grew rapidly to the industrialized countries, except to Japan. As the ASEAN currencies had turned out to be stable, in the middle of 1999, the ASEAN exporters became more competitive than they had been preceding the crisis. This can be indicated by the real exchange rate index¹⁵ that displays real depreciations about 10-20 percent in June 1999 relative to June 1997. In addition, the expansionary policies have enhanced the demand of the ASEAN countries. These policies have led to the augmentation of export value growth rate, through increased intra-ASEAN export, since the middle of 1999. However, ASEAN export are still weak and not completely rebound, because the low world prices and still weak regional demand.

The third phase refers to the present situation, in which the clean up of the debts is in process or already done for several bank and non-bank institutions. The most significant aim of this phase is to stabilise the economy and to raise and ensure long term competitiveness. Even though, the ASEAN countries have been real sector oriented economies, it is now relevant to pay serious attention to the financial sector development. Since the Plaza accord, the financial globalisation has increased the role of the financial sector, hence at the further stage of economic development the financial sector is not negligible and has to be harmonized with the real economic sector. Furthermore, the governments should improve the effectiveness of fundamental politic and economic institutions, financial market oversight, prudential regulation and supervision. Accounting practices should be brought up to international standards. Balance sheets of financial institutions should be reported more fully and frequently. Regulations for the entry of foreign banks should be relaxed in order to increase competitiveness in the financial sector. The capitalisation of banks and non-bank financial institutions should be improved and their risk management systems should be made more efficient. Moreover, on the real sector

¹⁵ The real exchange rate is calculated as the ratio of the trade-weighted average of the major trading partners' wholesale price indices to the local consumer price index -an increse in the real exchange rate index displays a depreciation-, see Hussain M., and Radelet S. (2000), p.80

fundamental recovery, the ASEAN countries should take more advantage from the access to a well-trained workforce, the many years of experiences in competing on world markets, and a better location near to major markets like China and Japan. One of the most important points is the need to improve the human and physical capital as well as the technology, while these must be compatible to each other and harmonised in order to upgrade the countries' export in the field of higher-end products. Infrastructure and communications have to be expanded and augmented internationally.

The improvement of real and financial sectors should not be merely proceeded within the countries individually, but the ASEAN countries should cooperate and carry on the development together as well. Furthermore, the economic and monetary integration must be seriously considered. On the one hand, the economic and monetary cooperation must proceed within ASEAN, and on the other hand, the ASEAN countries may act as a group to cooperate with the other major countries, such as China, Japan, the NICs, as well as the United States and the EU.