LESSONS FROM THE ASIAN CRISIS

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IT'S NOW FIVE YEARS SINCE THE ASIAN CRISIS. WHAT CAN BE LEARNED FROM THE PAST, AND WHAT MEASURES ARE NEEDED TO AVOID A REPEAT?

Recent television images of riots in Argentina can easily be mistaken for scenes in Jakarta in 1997. Looting in shopping malls, breaking into ATM machines – actions of ordinary citizens who have seen the value of their currency (and their life's savings) become worthless. Global capital flows are critical for long-term development, but they can also lead to financial 'riots'. The Asian miracle was built on foreign investments and saw a decade of growth and a corresponding reduction in poverty in Asia. The sudden withdrawal of these same investor funds led to the financial riots of 1997.

Against the backdrop of the fifth anniversary of the Asian crisis, the situation in Argentina and talk of Japan being on a road to default, this maybe an opportune time to re-examine the lessons from 1997 and the road ahead.

BOOM AND BUST

Although there were important differences between individual Asian countries, a number of elements were common to most at this time, particularly a combination of excess investment, high borrowings (much of which was in US dollars) and a deteriorating balance-of-payments.

1. Investment boom: Exports had long been the engine of economic growth in the region. From 1990 to 1996 total exports from Asian countries grew 12-18 percent annually, with the resultant wealth leading to an unprecedented investment boom. This was increasingly in speculative/unproductive sectors (Thailand: real estate, Malaysia: infrastructure projects, Korea: diversification by the *chaebols*, Indonesia: crony capitalism etc.). Between 1990 and 1995, Indonesia, Malaysia and Thailand saw gross domestic investment grow 15-16 percent per annum (compared to 4.1 percent for the US).

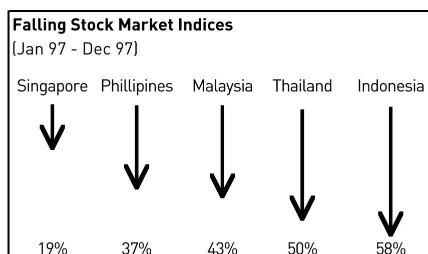
2. External debt: The rapid liberalisation of the financial sector and privatisation of the banking system lead to domestic banks borrowing substantial amounts from foreign banks and lending to domestic companies. Loans (increasingly short-term) from foreign banks more than quadrupled in Thailand and doubled in Indonesia between 1990 and 1996. In 1996 this was 181 percent of the available foreign reserves in Indonesia and 169 percent in Thailand.

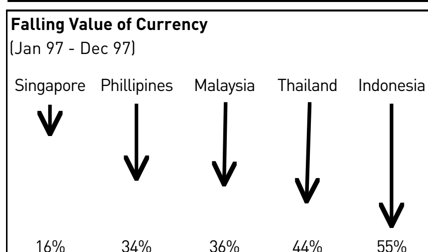
3. Excess capacity: As the volume of investments grew, their quality declined markedly. The result was significant excess capacity. For example, in Thailand there are 365,000 unoccupied apartment units in Bangkok, with supply exceeding demand for five years.

4. Expanding imports: Thailand, Indonesia, Malaysia and Philippines had their currencies closely linked to the US dollar. It worked well when the US dollar was weakening and their exports became cheaper. When the US dollar began to strengthen from mid-1995, their exports became dearer and declined. This factor, coupled with expanding imports due to the expanding investment boom, saw balance-of-payments current accounts shift strongly into the red which meant that these countries did not have sufficient foreign exchange to meet their foreign debt repayments.

5. The crisis: The over-leveraging of the domestic corporate sector made countries very vulnerable to sudden interest rate increases and falling domestic demand. As a large share of these borrowings went into stock market speculation and real estate, the economy and banking system became increasingly vulnerable to sudden collapses in the stock market and property markets.

When the loans became non-performing due to poor investments or collapses of the real estate market, domestic banks were saddled with large non-performing loans and substantial short-term foreign currency liabilities. As exports started to fall and CAD became unsustainable, foreign currency reserves dropped and foreign banks and investors started to lose confidence in the sustainability of the currency peg. Foreign funds began to withdraw from equity markets and foreign banks became less willing to roll over short-term loans, stock markets started to plummet and currencies depreciated drastically.





WHO IS TO BLAME?

Experts differ as to the causes of the Asian collapse. Explanations abound, but – with some simplification – they divide into two broad categories. One emphasises that the crisis was homegrown, the product of crony 'Asian capitalism'.

Western schools attack the Asian miracle for its reliance on 'statist' industrial policy in South Korea and crony capitalism in Thailand, Malaysia and Indonesia, both of which contributed to moral hazards in the inefficient financial sector and the resultant over-investment in a classic asset bubble.

This view is evident in:

➤ Michael Camdessus of the IMF: "The underlying cause of the rout was the mistaken faith of millions of investors in the stability of the smaller Asian currencies."

➤ MIT's Lester Thurow: "It is a basic axiom of economics that no country can run large trade deficits where its foreign indebtedness grows faster than its GDP."

➤ *The Wall Street Journal:* "...the main cause was widespread insulation from market forces – targeting of industry sectors for allocation of credit to secure higher export markets in high value added undertakings, resulting in structural imbalances, excess capacity, cronyism and corruption."

➤ *The Washington Post:* "...the lack of government oversight in a deregulated financial system run amok."

➤ Kong-Yam Tan, Professor at the National University of Singapore: "The root cause of the financial crisis was the over-borrowing and rapid accumulation of foreign debt."

Other writers emphasise panic. They point out that no one foresaw the crisis; that by conventional indicators of economic health (budget deficits and so forth) the Asian economies were in good shape; and that no economic change occurred in 1997 to justify such a massive loss of confidence.

➤ Joseph Stiglitz, chief economist, World Bank: "No other economic system has delivered so much, to so many, in so short a time. Some of the most important features of the East Asian development model – high savings, commitment to education, technologically advanced factories, aggressive pursuit of exports – are still present."

➤ Lee Kuan Yee, founding prime minister of Singapore: "The G7 finance ministers had pressed to liberalise the financial markets and free capital movements. But they did not explain the inherent dangers in today's globalised financial markets. Liberalisation should have been more carefully calibrated according to the level of competence and sophistication of their financial systems. Countries should install circuit breakers to cope with sudden flows of funds."

➤ IMF chief economist Michael Mussa: "[Are] liberal policies towards international capital wise for all countries in all circumstances? The answer, probably not. High openness to international capital flows can be dangerous for countries with weak macroeconomic policies or inadequately regulated financial systems".

KEY LEARNINGS AND REFORMS GOING FORWARD

Global capital flows are critical for long-term development. But they also need well-developed and regulated financial markets to operate in. Going forward, long-term reforms/measures required maybe categorised into three major areas: (i) Strengthen market forces in domestic economy, (ii) Improve financial infrastructure and (iii) Improve exports. The problems and measures to address them are shown in Table 1.

CONCLUSIONS

There is some truth in both interpretations, and most observers believe that the crisis was a combination of both. Where analysts differ is the relative weight they assign to each. Market openness without the requisite institutional infrastructure and managerial expertise to manage it can be a recipe for economic disaster. Even the normal workings of global financial markets can be disruptive to small open economies. On the other hand, statist industrial policy can lead to crony capitalism, excess capacity, over leverage and bad investments. Instead of picking one model it is important to consider each country's particular configuration of economic, political, social and cultural forces. **NA**

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STRUCTURAL PROBLEMS	LONG TERM MEASURES
Insulation of market forces in domestic economy	**Strengthen market forces in domestic economy**
➤ Politically motivated lending	➤ Reduce government involvement in private sector
➤ Government mega-projects	➤ Eliminate cronyism
➤ Cronyism	➤ Liberalise regulatory regime
➤ Explicit/implicit government guarantees	➤ Reduce import tariffs
➤ Highly protected industries	
Underdeveloped financial infrastructure	**Improve financial infrastructure**
➤ Loose disclosure requirements	➤ Strengthen disclosure requirements
➤ Poorly regulated/supervised banks	➤ Improve banking regulation/supervision
➤ Immature capital markets	➤ Develop stronger capital markets
Declining export competitiveness	**Improve export competitiveness**
➤ Rising real currency values	➤ Pursue sound foreign exchange regime
➤ Over capacity in key areas	➤ Pursue policies to support private sector skill/technology development