# On the Financial Crisis in East Asian Economies

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**The International Centre for the Study of East Asian Development, Kitakyushu**

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Abstract

This paper examines several aspects of the financial crisis in East Asian economies. First, the paper examines the economic events that preceded the crisis. The major focus is on countries that have been directly involved in the crisis, Japan since the early 1990s and then Thailand, Korea, and Indonesia since 1997. Special attention is also played to the increasingly important role of China and to interactions among these and other economies in the region. Second, the paper examines some of the important economic principles that must be considered to understand the crisis and its evolution. The principles emphasized relate to (1) fluctuations in asset prices and economic cycles, (2) the formulation and implementation of prudent financial sector regulations, and (3) the coordination of economic reforms in the transition from a highly protected, highly regulated economy (such as Thailand, Korea, and Indonesia in the 1980s) to a less protected and less regulated economy. Third, the paper examines prospects for the future resolution of the crisis. In the short-run the prospects for the most countries in the region, especially those directly affect by the financial crisis, are not very good. Furthermore, medium-run prospects for Japan, Thailand, Korea, and Indonesia, are also highly uncertain. An optimistic scenario would suggest that large fiscal stimulus in Japan and prudent policy reform focused on the financial sector in all of these economies could result in a relatively rapid return to modest growth rates. On the other hand, if Japan's fiscal stimulus is ineffective or if financial sector reforms in Japan, Thailand, Korea, and/or Indonesia are delayed or ineffective, the scenarios become far more pessimistic. In addition, there are very large differences between the optimistic and pessimistic scenarios. Finally, the rest of Asia will also be affected and China in particular must take care to avoid the same policy mistakes that were made in Thailand, Korea, and Indonesia, as it has several of the same characteristics that these countries had before the crisis.

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# On the Financial Crisis in East Asian Economies

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## 1 Background of the Financial Crisis in the East Asian Economies

The financial crisis in East Asia did not begin suddenly in July 1997, but rather was the result of a series of economic and political events which then culminated in turmoil which began in that month. This section seeks to highlight some of the more important events leading up to the crisis.

### 1.1 Growth Cycles in East Asian Economies

First of all, there was a change in the pace of growth in most East Asian economies in the late 1980's and the 1990's, and there was an expected down-turn in the region's growth cycles around 1994. Most economists recognized these cycles but many government policy-makers did not. Figures on economic growth for this period (Figures 1a-1j) clearly indicate a strong upturn in growth cycles in all East Asian economies in the late 1980s. Moreover, growth rates of real gross domestic product (GDP) in East Asia were very high for a prolonged period. Until the present crisis there was over a decade of high growth since the previous downturn that took place in 1983-1985. One should have expected the slow-down of growth around 1994-1995. The elongated boom beginning in 1986-1987 had to end eventually. In fact the growth rates of some economies had begun to decrease toward the end of the boom, but most of governments in East Asia tried to maintain high growth rates. They did this both by providing domestic stimulus and by borrowing from abroad. Some economies such as Taiwan did not borrow too much and they suffered no financial crisis, only the normal down-turn of the growth cycle.

1.2 Bubbles, Domestic Debt, Financial Problems and the Long Growth Recession in Japan

The first financial crisis in East Asia hit Japan in 1991, not Thailand in 1997. The so-called bubble in asset prices (especially prices of land, houses, other structures, and stocks) in Japan was, in part, caused by excessive lending by commercial banks and other finance companies. These loans were in turn facilitated by the easy money policy of the Bank of Japan, a policy that was partially a result of pressure generated by the Plaza Accord. Loans by commercial banks and their subsidiaries (often called non-banks) were excessive in that the lenders often failed to secure adequate collateral and the loans often became non-performing after the decline in real estate and stock prices in the early 1990s. For example, lenders often valued real estate collateral at the inflated values attained during the bubble period only to find that the value of collateral declined so much after the bubble period that such loans could not be repaid in any scenario. These practices in turn undermined confidence in financial institutions and this decline in confidence was a major factor behind the bursting of the bubble in 1990-1992. The scope of the bubbles can be seen from data on national assets in Japan and the United States (Table 1 and Figure 2) as well as data on stock prices (Figure 3a). Since the bursting of the bubble, Japan's real economic growth has averaged just a little over 1 percent per year for a period of seven years. In 1998 it is feared that Japan is entering a deep recession, almost a depression, with zero or negative real growth expected in the absence of a major stimulus from fiscal policy. This is the most serious depression in Japan since World War II and it has contributed to lower growth rates of exports from other East Asian economies to Japan, both directly through the effect lower Japanese income and indirectly by contributing to the decline of the yen since mid-1995 (Figure 4a). In addition, the fall of the yen in June 1998 appears to be having the effect of dragging Southeast Asian currencies down with it (vis a vis the dollar), adding to the short-term difficulties in Southeast Asia.

Notably, the Ministry of Finance has hesitated to take appropriately harsh measures when screening the financial balance sheets of major banks and their subsidiaries, and when dealing with the non-performing loan problem that has become acute after the collapse of the bubble. Moreover, Japan’s so-called big bang, or the liberalization of financial markets, is now accelerating. Thus, it is crucial for the Ministry of Finance to develop

policy measures that can address the requirements of the big bang process. However, as it stands now, most Japanese banks have even found it difficult to satisfy the most basic standards of the Bank of International Settlements with respect to minimum capital-to-assets ratios in banks.[1] Indeed, these standards have created problems for Japanese banks since they were first introduced in 1992 , as banks in Japan had to deal with implementing the BIS standard while at the same time suffering from the collapse of the bubble. Partially as the result of this combination, Japan has experienced a number of bankruptcies of large and medium-sized banks, as well as other finance companies, in the past few years.

Moreover, the Japanese government has accumulated a large government debt of over 500 trillion yen, a value that is roughly equivalent to Japan's nominal GDP. The accumulation of government debt has in turn made the present government very reluctant to finance increased fiscal expenditure by issuing additional government bonds, despite the fact that Japan is in the midst of a serious recession. On the other hand, with interest rates near zero, there is little room for monetary policy to boost the level of economic activity either. The failure of more banks and finance companies is likely amid the "big bang" financial reforms. The stock market is back down to the lows experienced in 1992-1993 or less than half its peak value in the boom years. The government has had no alternative but to postpone the self-imposed limit on restoring balance in the fiscal budget by two years and allow itself to finance additional deficits in the government budget. However, it remains to be seen whether the supplementary budget for fiscal 1998, amounting to about 9 trillion yen, can boost the economy later in 1998.

### 1.3 China's Devaluation and China's Challenge to the Flying Geese Pattern of Other East Asian Economies

Another factor underlying the current financial crisis in East Asia were large devaluations of the Chinese yuan in recent years (Figure 4j). Between the end of the third and fourth quarters of 1989, the yuan was devalued 21 percent (from 3.7 yuan per dollar to 4.7 yuan per dollar) and between end of the fourth quarter of 1993 and the end of the first quarter in 1994, it was devalued another 35 percent (from 5.8 yuan per dollar to 8.7

[1] These standards were agreed to in 1988 and took effect in 1992. For details, including definitions of capital and assets, see Basle Committee on Banking Supervision (1988).

yuan to the dollar). These large devaluations certainly contributed to the rapid increases of Chinese exports in following years (for example, export growth rates (in nominal US dollars) rose from 5 percent in 1989 to 14-19 percent in 1990-1991 and from 9 percent in 1993 to 25-36 percent in 1994-1995 (International Monetary Fund 1998). Although exports from Southeast Asia and Korea also grew rapidly through 1995, it is also clear that China is a competitor with these economies in many markets. Competition between the Chinese economy and other East Asian economies has been underestimated and was not recognized well even when symptoms became very clear.

At the same time, the devaluation, together with the incentives offered to foreign direct investment (FDI ) into the special zones in China helped stimulate large inflows of foreign capital, particularly from overseas Chinese in Southeast Asia and Taiwan. As a result, China's international reserves grew rapidly from US$ 21-22 billion in 1992-1993 to US$75 billion in 1995 and $142 billion in 1997 (International Monetary Fund 1998). The growth in reserves came despite a rapid increase in external debt during this period (Figures 5f, 6f) and reflected the combination of current account surpluses and large foreign capital inflows for most of the period (Figure 7f).

In short, the positive effects of mutual dependence among East Asian economies have often been emphasized, but the negative aspects must also be considered. China is clearly a competitor for the Southeast Asian countries in that Southeast Asian countries have to compete with Chinese exports in world markets. In this respect, Indonesia, the Philippines, and Thailand would appear to have the most serious challenge from China, though there is more complementarity between China and countries like Taiwan, Korea and Japan. Thus, there is the potential for a competitive devaluation by China to spark yet another round of exchange rate instability in Southeast Asia. China is somewhat insulated from the crisis by virtue of its capital controls and the non-convertible currency. However, China's banking system has many problems that must be addressed and the recent increase in external debt is also a potential problem.

### 1.4 Excessive Dependence on Foreign Loans, Balance of Payments, and Bubbles in East Asian Economies

In Korea and Southeast Asia, dependence on external debt has become a major economic problem. In other words, although domestic savings rates were high, investment rates were even higher and the difference was financed with foreign savings, leading to the accumulation of external debt. Particularly conspicuous was the rapid increase in long-term debt of the private sector and short-term debt (which is also mainly private). These increases were largest in Korea, Thailand and Indonesia. Similar changes in the structure of debt, but at lower levels of total debt, were also observed in Malaysia and the Philippines (Figures 5a-5e and Figures 6a-6e).[2] In several of these economies, offshore borrowing and speculative capital inflows were fuelled in part by the fact that interest rates on domestic loans or deposits were much higher than interest rates abroad. The clearest example of this practice was in Thailand where it was institutionalized with the establishment of the Bangkok International Banking Facility (BIBF), a facility through which locals could borrow in offshore markets, while onshore interest rates were set at high levels by the Central Bank. Also in several of these economies, notably Malaysia and Thailand (Figure 4i), capital inflows were premised on the assumption that governments would not allow local currencies to depreciate with respect to the U.S. dollar. In other words, borrowers assumed that there was only minimal foreign exchange risk associated with borrowing in foreign currencies. Meanwhile, these countries were experiencing the bursting of their own financial market bubbles (Figures 3b-3i), a process that put enormous pressure on financial institutions that had made unsecured loans and the proportion of bad loans increased rapidly. The decline in asset prices is again most conspicuous in Thailand beginning in 1994 and accelerating in 1996. Other policy distortions such as Presidential power to influence the allocation of investments in Indonesia and the priority given chaebol-related interests in Korea when allocating credit seriously distorted the allocation of investable funds.[3] In numerous ways, political corruption related to

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[2]Due to the difficulty of gathering comprehensive and timely debt estimates, we show estimates of external debt from two sources, the BIS and the World Bank. The BIS numbers are more timely but lack breakdowns of private and public or long-term and short-term debt. The major drawback of the World Bank numbers is the exclusion of Korea from 1995 forward. Note that there are also important differences in the estimates of total debt between the two sources, both in terms of size and trends over time.

[3]In Indonesia, important examples include the authority of the President to approve or reject all investments above a certain size (both foreign and local) that are channelled through the Investment Coordinating Board (BKPM) and to influence investments supervised the Ministry of Mines and Energy. In Korea, debts of the 10 largest chaebol were estimated to total US$34 billion at the end of February 1998 or about a little more than Korea's total debt of $153 billion at the end of December 1997 (Yoo 1998).

relationships among bankers and politicians were also important elements of numerous wrong policy decisions.

Through 1996, the inflow of foreign investment (including loans) from abroad was sufficient to more that cover current deficits that were in many cases growing rapidly (Figures 7a-7f). Indeed, the large inflow of capital from abroad was so large as to contribute to the creation of asset price bubbles in these countries. However, in 1997, this pattern was reversed in Thailand, Indonesia, and the Philippines and the excess of foreign investment over the current account deficit all but disappeared in Korea and Malaysia. In Southeast Asia in particular, this was both the immediate cause and an important immediate symptom of the crisis in 1997. There was a loss of confidence by investors (both foreign and local) and net outflows of foreign portfolio and other foreign investment (mainly loans), or in other words, capital flight. Another important indicator of the crisis was the rapid decline of exchange rates that has been the topic of much attention (Figures 4c-4i). The largest declines have been in Indonesia, followed by Thailand, Korea, Malaysia, and the Philippines, but not even Singapore and Taiwan have been able to escape the trend toward lower exchange rates since mid-1997. Part of this is of course due to the strength of the U.S. dollar during this period, but the vast majority of the decline in the regions' currencies is simply the response of foreign exchange traders to the financial crisis in the region.

### 1.5 Economic, Social and Political Consequences of the Crisis

A key economic effect of the large declines in the regions' currencies is the potential for these declines to lead to rises in domestic prices and thus accelerated inflation. In short, the massive currency devaluations that have hit several Asian economies create the potential for an inflation in commodity prices, though the decline in asset prices may temporarily mask this impact. The extent to which consumer prices respond to the devaluation is a major question mark. In Thailand and Korea it is expected that inflation will move into low double digits in 1998 as a consequence. However, thus far, the inflation has been muted in both these cases, though prices of some essential items (rice, sugar, cooking oil, fuel) have increased. The compression of imports (and the sharp rise in the price of imports) will no doubt add to inflationary pressure, even though the price effect through the exchange rate cannot neatly be separated from the effect of declining aggregate demand on imports.

It is widely expected that economic growth in 1997 and 1998 will be sharply curtailed or even become negative in Korea and Thailand. The decline in economic growth can be seen as a correction in these countries from the exorbitant growth alluded to in the first section of this paper. In contrast, the extremely large devaluation in Indonesia may result in what might be called hyper-stagflation, with prices rising by 50 percent or more and mounting double-digit unemployment. The Indonesian economy is likely to shrink by as much as 15-20 percent in a manner reminiscent of the former Soviet republics following the collapse of the Soviet empire. Imports have shown signs of collapse in Indonesia in recent months with preliminary data (James 1998) indicating that non-oil imports have fallen from U.S.$3.3 billion in the month of July 1997 to only $1.9 billion in the month of February 1998. Exports have also shown weakness as the payments system has collapsed and trade finance is becoming unobtainable at an affordable cost to many Indonesian companies. The severity of the recession in Indonesia will make it imperative for the International Monetary Fund's (IMF's) program of reforms to include some social safeguards to prevent hunger, malnutrition, disease and unrest from getting out of hand. The social and political consequences of the decline in living standards in these countries cannot be easily foretold.

However, the economic problems brought about by the financial crises have had an undeniable positive impact in sweeping away political leaders and structures that were intimately related to the underlying causes of the crises. Most notable in this regard, is the end of the 32 year rule of Suharto in Indonesia and the promises of fundamental reforms by the new government. There have also been changes in government in Thailand and Korea, again with the new governments promising fundamental reforms. Thus, the political element appears to be a crucial part of each East Asian financial crisis. Even with political reform, an agonizing period of social trouble looms as millions of new entrants to the labor force seek jobs. One can hardly exaggerate the social threat this implies in Indonesia. Korea appears to be an intermediate case. The inability of the government to stand up to militant demands by labor organizations in opposition to layoffs by big Korean conglomerates may end in a disastrous way. It is easier to say that flexible labor markets (meaning layoffs of tens of thousands of workers in bankrupt companies) are needed than it is for politicians to admit the need for and then allow such wrenching change. The ability of informal and rural activities to absorb a substantial proportion of the job losers

and new job seekers should not be ignored. In Thailand agriculture and village economic activity has traditionally been and important social shock absorber, though this sector is now much smaller than during the last economic turndown in the mid-1980s. Export sectors, which normally are expected to experience a dramatic growth surge with a big devaluation, have yet to boom and thus have yet to experience a large increase in the demand for labor.

Of all the developed countries, it is Japan that will be most severely affected by the events following the currency and financial crises. Japanese bank exposure is huge in each of these countries. Furthermore, Japanese trade is likely to be disrupted by the financial turmoil. Japan's imports have been growing very slowly from Southeast Asia (Sugawara and James 1998) ever since the bubble economy ended in Japan. The recessionary condition of the Japanese economy is likely to worsen the prospects for these countries to expand exports as a way out of the debt problem and economic downturn. It is argued by others that the collapse in Asia will only slow economic growth in the rest of the world (chiefly in the United States and the countries belonging to the Organisation for Economic Cooperation and Development, OECD) by half a percentage point in real terms in 1998. However, the outlook could become considerably worse should the U.S. economy or key members of the European Union encounter economic problems of their own.

## 2 Some Important Economic Principles

In addition to understanding the history that underlies the recent events in Asia, it is also important to understand some of the more important economic principles related to these events.

### 2.1 Bubbles and Macroeconomic Stabilization Policies

As outlined in the previous section, these economies have all faced some important problems related to

the collapse of so-called bubbles in asset markets. As described in Section 1, all of these economies experienced bubbles or a rapid increases in asset prices (both financial and real assets) followed by a subsequent collapse of those prices. This phenomenon is closely related to the financial difficulties being experienced now because a large number of the non-performing loans that have emerged became non-performing only after the collapse of asset prices. Part of this problem could of course be dealt with by more prudent supervision of lending behavior in financial institutions as outlined below. In other words, much of the problem stemmed from the fact that financial institutions used inflated asset values (again both real and financial) as collateral when extending loans, and paid little attention to the borrowers ability to repay should asset prices collapse. Rules which force lenders to pay greater attention to the borrowers ability to repay exist in many economies and could be of benefit in these Asian economies as well.

However, even if such rules had been in place, the existence of financial bubbles, such as those experienced by Japan in the late 1980s and the rest of Asia in the early-mid 1990s, creates important challenges for macroeconomic policy makers. A major task of macroeconomic policy is to smooth or stabilize fluctuations in the business cycle. Although there is a great deal of controversy in academic circles about the effectiveness of such stabilization policies, it is clear that most central banks and fiscal authorities engage in such policies to some extent. Moreover, it is reasonable to conclude that such policies have been at least partially effective in the last half century as the world's major economies have been able to avoid major depressions in the post-World War II period. On the other hand, it is also unreasonable to assert that stabilization policies have always worked as they were supposed to.

One particularly important example in this respect is the recent experience in Japan, where the economy has generally remained stagnant since 1992 (1996 being the only exception), despite the infusion of large stimuli from both the fiscal and monetary sides. This experience indicates that there is much about the nature of economic cycles that is still not well understood. It is also common to hear the assertion that the infusion of excessive monetary stimulus in the late 1980s contributed to emergence of the Japanese bubble and thus the problems faced in the 1990s. One of the reasons that the Japanese monetary authorities may have expanded too much (or contracted too little) in the late 1980s, is that they may not have believed that the increase in asset

prices was a bubble or, more likely, they may have believed the bubble was much smaller that it actually was. Similar statements can probably be made about the way authorities viewed the bubbles in Korea and Southeast Asia as well.

Asset bubbles in these countries partially reflected an eagerness in financial institutions to extend loans for property development and construction activities that is natural in a bullish market. However, individual lenders and borrowers may not have sufficient information or may not fully take into account the investment decisions of other players. Excess supply of office buildings, hotels, luxury apartments and shopping malls may arise in such circumstances. It may be difficult for Central Bank and Finance Ministry officials to recognize an emerging property bubble or to reign in excessive lending when powerful interests are involved. The fact that boom-bust property cycles have been repeated in even small economies (e.g., Hong Kong, Singapore, Hawaii) underscores this problem.

At the core of the problem here is the question of determining just when an increase in asset prices becomes a bubble. In hindsight, it seems fairly easy to identify bubbles in asset prices as illustrated by the movements in stock prices in Figures 3a-3i and in the movements of wealth values for Japan in Figure 2. However, in the middle of an upswing in asset prices this is much more difficult. For example, what about the increase in U.S. stock prices that has been experienced in the last three years, with the Dow Jones Industrial average rising from below 4,000 in early 1995 to over 9,000 by the spring of 1998? Is this a bubble similar to that experienced in Japan a decade earlier or are these increases simply reflective of the growing strength of U.S. companies and U.S. economic fundamentals in this period? The U.S. authorities appear to think that this is not a bubble as no significant tightening measures have been taken in this period. Nonetheless, caution is clearly called for as there is a very strong tendency for unusually rapid price increases in asset markets to be followed by unusually rapid price decreases.

In Asia, the focus is now on the other side of the coin, that is on the question of when the recent collapse of asset prices will be reversed. As numerous previous studies have emphasized (e.g., World Bank 1993), several economic fundamentals (e.g., high rates of physical and human capital formation, price stability, relative openness to trade and foreign investment, generally sound fiscal policies, and generally undistorted labor

markets) remain quite sound in several of these economies. A continuing belief in these strong fundamentals is also reflected in a new survey of multinational corporations that invest in the region (e.g., UNCTAD, 1998). Consequently, the optimist might believe that recovery is just a matter of time and will be largely automatic.

We believe that such a view is overly optimistic. As outlined above there are important structural difficulties that underlie the loss of confidence in Asian asset markets, aside from the failure to correctly understand the nature and scope of the bubbles experienced in the region's asset markets.

### 2.2 Balancing Competition and Regulation in Financial Markets

Financial markets occupy an extremely important place in any economy. At the most basic level the existence of reliable financial institutions and financial markets makes it possible for a government to issue money and thus greatly reduce transactions costs for a great number of individuals compared to a barter economy. At a more sophisticated level, transactions costs can be further reduced when financial institutions can channel financial assets from savers to investors.

Economists since Adam Smith have long stressed the benefits of competition in markets and financial markets are probably no exception in this regard. First, competition is often argued to lead to reduced prices at a given point in time, or to promote static efficiency. Second, competition is often argued to lead to the development of new and competing products over time or to promote dynamic efficiency.

However, it is also important to be aware of potential limits to the benefits of competition. One of those limits is technological, that is when larger size leads to greater technical efficiency and lower costs (i.e., there are economies of scale), even though this increase in size may adversely affect competition. It is very difficult to know the importance of this technological factor in financial markets without detailed quantitative studies, though casual observation would suggest that economies of scale are at least somewhat important.

A second limit that is clearly important in the case of financial markets is the fact that the activities of financial institutions (e.g., banks, stock brokerages) clearly have important effects on the economic activities of other individuals that are not reflected in costs and/or prices faced by those financial institutions. In other words,

the activities of financial institutions impart important externalities on society. On the one hand, if a financial institution manages its assets and liabilities wisely, it contributes to public confidence in the financial system and reduces transactions costs for all involved. On the other hand, if a financial institution mismanages its assets and liabilities (e.g., by extending unsecured loans), it may go bankrupt and, in doing so, may contribute to a general loss of public confidence in the financial system and a dramatic increase in transactions costs. In this respect, it is important to note that one of the most important characteristics common to the financial difficulties in Japan, Thailand, Korea, and Indonesia, is the fact that financial institutions extended many unsecured loans, a large number of which subsequently became non-performing loans. The result was the accumulation of enormous debts in many financial institutions and the bankruptcy of several institutions. In this respect, Montes (1998) argues strongly for placing the blame on the excesses of financial markets and herd behavior and against other potential causes of the crisis.

However, there is a strong possibility that structural factors in the real economy reinforced the bad news in the financial markets or interacted with financial markets in a manner that worsened the crises beyond anything anyone could have imagined. In particular, adverse investment selection was clearly a result of improper credit practices and lack of corporate accountability. For example, Korea's chaebols were particularly guilty of borrowing huge amounts for reckless expansion and diversification of their business empires. However, bad large-scale investments were also apparent in Indonesia, Thailand and Malaysia. The IMF, World Bank, and bilateral aid donors failed to pay enough attention to the extent of these problems. The size of short-term corporate debt to banks was not known with any precision. The lack of transparency in domestic financial transactions involving banks and private companies was an obstacle to getting a handle on the potential size of the problems. In the case of state banks (or banks subject to bureaucratic control over decision making as in Korea and Japan), lending practices were equally opaque and political.

An important task for policy makers in these countries is thus to rebuild their financial institutions and public confidence in their financial systems. In this respect, it is important to emphasize that the difficulties faced in financial institutions in these economies stem largely from a somewhat paradoxical combination of past policy failures. On the one hand, there have historically been important regulatory limits on competition among

financial institutions in these economies (e.g., interest rate regulation, limits on product innovation, limits on new entry and branch expansion). Here it is particularly important to note that protection from foreign competition is generally much higher in financial markets than in most sectors of these economies. On the other hand, there has been a lack of regulation that guarantees prudent lending practices in financial institutions (e.g., disclosure requirements). In addition, all of these countries have based their previous policies on the premise that major financial institutions would not be allowed to go bankrupt. Accordingly, they suffer from the lack of clear rules governing the bankruptcy of financial institutions. In Thailand and Indonesia, this latter problem is particularly serious as there is no deposit insurance and thus no rationale for deciding which depositors should be protected when the size of the bailouts required exceed the means of the government to deal with it. And even in Japan, where there is deposit insurance, the authorities have shown a great deal of reluctance to enforce the upper limit on account guarantees, with the result that bailouts of financial institutions have been very expensive for Japanese taxpayers.

A major part of the task at hand is thus to establish an appropriate balance between competition and regulation in financial markets in these countries. As in almost all markets, competition is a key element of encouraging an efficient allocation of resources and it will be very helpful to abandon unnecessary regulations that limit competition, including limits on competition from foreign financial institutions. On the other hand, the regulation of lending behavior needs to be tightened. In this respect, a very important element is to draw up a clear and rational set of disclosure requirements for financial institutions in the region because transparent disclosure requirements not only assist regulators in their regulation of lending practices, but also allow participants in financial markets to put pressure on financial institutions to engage in prudent lending practices.

A special case of policy issues in financial markets is the case of regulation of markets for foreign exchange. As a result of experiencing massive depreciations since mid- or late 1997, some governments are reconsidering institutional arrangements in foreign exchange markets. In particular, the case for a currency board has been aired as a means of achieving a stable and predictable exchange rate. Hong Kong has adopted a hybrid of the currency board system since the mid-eighties and, as was seen in figure 4b, has successfully maintained a fixed exchange rate since then. Indonesia gave serious consideration to adopting a currency board

in late 1997 and early 1998. The confusion surrounding the issue led to the cancellation of the second IMF agreement in January 1998 and set back the IMF stabilization program by nearly 5 months. The currency board proposal requires that the banking system be stable and reliable, that the currency board itself hold to the highest professional standards of integrity, and that the government has the means to back the domestic currency fully with its foreign exchange reserves. These conditions could obviously not be met in the Indonesian case, hence the currency board debate was a costly diversion from getting on with the reforms necessary to stabilize the economic situation there. The currency board proposal was rejected by the donor agencies and by the governments of the United States, Japan and the EU. Finally the then President Suharto was forced to put the proposal back on the shelf. The idea may well attract positive attention in future, but it is a dead issue for now.

### 2.3 The Sequencing of Economic Reforms

McKinnon (1991) warns that an improper sequence of liberalization reforms could have serious consequences. According to McKinnon, the liberalization of trade and the real economy should precede the liberalization of the financial sector in order to prevent adverse investment selection. Further, the sequence of financial sector reform should initially emphasize domestic financial markets and only later should external capital account transactions be fully liberalized.

East and Southeast Asian countries did not wholly heed these warnings that were often given by economists familiar with reform sequencing problems involved in Latin America's debt crisis of the 1980s. More recently, the Mexican economic crisis of late 1994 and 1995 provides a stark example of the problems that can result when liberalization of external capital account transactions takes place before the real sector and domestic financial transactions have been liberalized. Specifically, capital market liberalization led to large inflows of foreign capital and an appreciation of the exchange rate, thereby contributing to mounting current account deficits and the accumulation of external debt. As can be seen above, many Asian economies (most notably Thailand and Korea) had similar characteristics. However, Asian policy makers generally ignored the sequencing issues that had been discussed with regard to Mexico, partially because Mexico had many different

economic characteristics, most notably a large public sector debt and lower domestic savings rates, not found in Asia. However, these differences should not have blinded Asian countries to the potential problems that can result from prematurely opening the capital account.[4] The important principle here is that opening the capital account when the real sector and/or the domestic financial sector have not been fully liberalized can cause significant problems.[5]

Indonesia and Thailand in particular followed an unusual reverse sequencing of economic reforms. Following a period of stabilization in the latter half of the 1960s, Indonesia opened up its capital account (in 1971/72) and encouraged inward foreign investment (albeit in sectors given priority by the government) prior to liberalization of trade. Moreover, beginning in the early 1980s with the end of the oil boom, Indonesia then began to undertake liberalization of the domestic financial sector by allowing market-based interest rates and relaxing credit controls in 1983 and opening up the sector to new entrants in 1988. This in itself was not a problem but many of the new entrants were not properly regulated, largely due to the political connections of the owners. Further aggravating the situation, the goods sector remained heavily protected, even after the substantial import liberalization began in 1986. Only rather wise monetary and exchange rate management kept the lid on this powderkeg but by the mid-1990s the problems had become too deep for even the wisest macroeconomic policies to control. In Thailand, the establishment of the BIBF in 1993 was the watershed that allowed local firms to borrow offshore at low interest rates and then redeposit those borrowings on shore at higher rates. Meanwhile the exchange rate had been pegged to the U.S. dollar since the mid-1980s and the Thai monetary authorities insisted on maintaining the peg, even in the face of large increases in the current account deficit, a policy that eventually drove the country to the brink of default.

Serious problems arose from the type of domestic financial reforms that were implemented in each of the countries now experiencing a severe economic crisis. As emphasized above the most serious shortcoming of

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[4]A political factor of some importance was that the U.S. government reacted very quickly and decisively in support of Mexico and the IMF was put under heavy U.S. pressure to come up with fresh funds to stabilize the Mexican economy. However, the U.S. government was more hesitant to offer similar assistance to the more distant Asian economies.

[5]Note that Montes (1998) refers to the twin liberalization of an expansive, liberalized domestic financial market coupled with an open capital account as precursors to the currency crisis that swept across Southeast Asia in 1997/98.

all these financial market liberalization policies was the failure to pay adequate attention to the supervision of borrowing and lending practices in financial institutions. The result was that liberalization in domestic financial markets did not mean a competitive and open system, rather it meant that banks owned by domestic players (often politically well-connected) had an easier time obtaining licenses and were allowed to seek deposits from the public without much capital or scrutiny of their lending practices. Lax regulation also made it easy to exceed legal lending limits, while lax accounting standards and non-transparency in reporting requirements made it easy for banks to pursue unwise lending and borrowing policies. One of the most blatant abuses to result was that many banks lent to their shareholders or related companies far more than should have been legally possible.

Another aspect of the timing problem was that the failure to coordinate liberalization of domestic transactions with liberalization of international transactions led to large differentials between domestic interest rates and those in the major financial centers. These differentials were coupled with what Montes (1998) has called the three (implicit or explicit) guarantees of : i) the willingness of the government to back domestic banks (a quasi-public guarantee of the foreign private debt), ii) the continuation of an open capital account (allowing foreign investors to repatriate profits and/or their capital at will), and iii) a fixed nominal exchange rate. This policy mix led to a boom in bank lending supported by borrowing from overseas and in turn led to inflated bubbles in stocks, housing and property development. Here again, rather than serving as a check on private beha vior, government policies pushed the borrowing up beyond reasonable limits and central banks failed to sufficiently strengthen banking supervision and prudential regulation.

### 2.4 Politics and Governance

With advances in information technology making world capital markets highly integrated and sensitive to changes in investor sentiments, the power of the economic forces of globalization have led the Director of the IMF to call the Mexican Crisis of 1994/95, “the first crisis of the 21st century” (quoted in Summers 1995). What we are seeing in East Asia today is the power of globalized financial markets to punish or reward economies that are just emerging as part of the global market. Perceptions of the efficacy of the economic management of these

countries can play a crucial role in investors' decisions. What is more, the herd behavior of individual fund managers and investors, though individually rational, can appear irrational from the standpoint of the financial system as a whole or in any given national economy. The results can include enormous overshooting of what could be considered reasonable limits for equilibria in asset markets (e.g., exchange rates in Indonesia). In countries with open capital accounts and large external debts, this means that policy makers must pay close attention to the perceptions of investors when making economic policy.

An important assumption that underlies this point and the other arguments about the role of policy in previous sections is the assumption that the government has the ability to formulate and implement rational economic policies. However, strictly speaking, this assumption is probably never justified in reality. This mechanism is perhaps most obvious in democracies where the existence of periodic elections can in theory lead to the existence of political business cycles where governments try to engineer economic expansions just before elections. More problematic in this context, however, is the fact that the politicians and bureaucrats who are primarily responsible for economic policy making often have their policy making decisions influenced by specific interest groups. This is a general problem faced by all economies and all political structures, though the specifics of these problems clearly differ depending on the economic and political structures involved.

With respect to Asian financial market difficulties, it is particularly important to note that numerous powerful individuals and/or groups stood to gain from the lack of prudent financial market regulation. The problems get even more unwieldy when one considers a complex issue such as the timing of reforms in an economy that has long protected or over-regulated certain markets. The most obvious example this kind of problem is in Indonesia where the Suharto family and other powerful individuals still hold substantial shares in numerous financial institutions and stand to lose a lot from their reform. A very similar story can be told with respect to Thailand where a large number of politically influential people have been hurt very badly by the reform of the financial sector under IMF guidance. The story in Korea and Japan is much more complex but again similar where many influential figures stand to lose from financial sector reform and have exerted pressure to resist such reforms. In Japan, it is also significant that the powerful Ministry of Finance is likely to become much less influential as a result of financial sector reforms and this is often offered as a reason that the Ministry

has long resisted such reforms.

Another important part of the story is that significant political changes preceded major economic policy changes in Thailand and Korea, and that a similar process may be beginning in Indonesia as well. The bottom line here is that political processes and incentives have a very large effect on economic policy making. The economist ignores these factors at the risk of making his or her message irrelevant.

## 3 The Way Forward

It is certainly far too early to tell how the crisis will evolve in the coming years but two points appear clear. First, the prospects are not terribly bright for the most of the region's economies for the next few years. Second, there is considerable uncertainty surrounding the prospects for recovery. This section highlights a few topics of concern in this context.

### 3.1 When Will Japan Finally Recover?

The Japanese economy in mid-1998 is still suffering from a serous recession that began two years ago. The government announced a record increase in fiscal expenditure during the coming fiscal year, amounting to about 9 trillion yen. This is expected to stimulate a direct increase in GDP of 16 trillion yen or about 1.5 percent of Japanese GDP. Thus, *ceteris paribus* with no consideration of the multiplier effect, this action is presently expected to push the growth rate up by 1.5 percent in the latter half of 1998 and the beginning half of 1999. With no additional fiscal stimulus Japan's growth rate was expected to be *minus* 0.2 percent or lower (Inada and Sugawara 1998). Thus, the expected growth rate for the latter half of 1998 is now expected to be 0.8 percent and the growth rate in 1999 is expected to range between 1.1 and 1.5 percent, but will not be more than that unless the government undertakes another stimulative measure. The outlook is thus for rather slow recovery. The restructuring of the financial sector, in particular determining how to deal with non-performing loans and the potential for additional bankruptcies, still remains an important task for policy makers to deal with in this

context. Despite previous and continuing government efforts, it will take at least another year or so to deal with financial restructuring. One new factor to consider is that the difficulties in Thailand, Korea and Indonesia may increase the amounts of non-performing loans held by Japanese banks. For example, loans by Japanese banks and trading companies to Indonesia alone are estimated at no less than 2 trillion yen and a large portion of these loans may become non-performing. Outside of the financial sector, there is no sign that private consumption and housing construction will recover in the near future and business capital formation may not rebound either, thereby reinforcing the likelihood of a rather slow recovery.

Another critical factor in the future forecast of East Asian economies is the trend of the Japanese exchange rate with respect to the U.S. dollar. In the near future, this rate may continue to decline below 140 yen per dollar and perhaps approach 150 yen per dollar as continued stagnation in Japan's asset markets and the lack of investor confidence in Japan's financial system continue to be major factors behind large capital outflows, and in turn the weak yen. However, this trend appears likely to reverse itself for at least three reasons. First, if the Japanese economy recovers this will probably coincide with increased investor confidence and an increase in the demand for Japanese assets. Second, the implementation of the big bang reforms may also help restore investor confidence if they have the purported effect of opening up and stabilizing Japan's financial sector. Third, Japan's current account surplus increased 44 percent in U.S. dollar terms in 1997 to reach US$95 billion in that year (International Monetary Fund 1998; Japan, Bank of Japan 1998) and may well increase even more rapidly in 1998 and perhaps 1999, as the effects of the weak yen are realized. Large increases in the current account surplus will in turn lead to strong upwards pressure on the yen. Thus, the key question here is probably not whether the trend toward a weak yen will be reversed, but when the reversal will occur. A reversal could happen very quickly (within 6 months) or it could take some time (1-2 years) depending on (1) the speed of a Japanese recovery, (2) investor confidence in Japan, and (3) perceptions of Japan's large and growing surplus. A stronger yen will certainly have positive effects on East Asian exports to Japan, though it may also have some negative effects on economies with large amounts of debt denominated in yen.

Despite having accumulated an enormous public debt, the Japanese government decided to postpone plans to restore fiscal balance by two years in order allow for greater fiscal stimulus in the hope of restoring

economic growth. Correspondingly, one may expect that the government will take similarly bold steps to continue the fiscal stimulus again in 1999. In that case, recovery may turn out to be stronger and sooner than the forecasts cited above foresee. Under the conditions of the abovementioned forecasts unemployment is expected to decline in 1999. This trend will also accelerate with additional stimulus in 1999. In summary, it will be not be until the year 2000 that the Japanese economy gets back to its normal cruising pace of 2-3 percent GDP growth rates and exchange rates of 100-120 yen per dollar.

### 3.2 Are Thailand and Korea Turning the Corner?

There are some indications that the economic downturn in Thailand and Korea may finally be bottoming out and that these economies may recover rather robustly as soon as 2000. Perhaps the clearest evidence of this is the fact that exchange rates appear to have stabilized somewhat in these economies. In Korea, the won declined to below 2000 won per US dollar in late 1997 but appeared to have stabilized in the 1400-1600 range by April-May 1998. In Thailand, the baht declined to below 55 baht to the dollar in January 1998 but here again has stabilized in the 38-42 range in April-May. However, danger signs still abound in these economies. After a brief recovery in February-March of this year, stock prices have plunged again in April-May and exchanges rates have also declined somewhat in early June. Moreover, recent forecasts of real economic growth in these economies keep getting revised downwards. New forecasts for Korea as of 8 May 1998 (Korea Development Institute 1998) project growth rates of -1.4 percent in 1998, 3.1 percent in 1999 and 5.1 percent in 2000 if the economic reforms are successful. If the reforms are unsuccessful, the forecasts are -3.1 percent, -0.4 percent, and 1.4 percent, respectively. In late May, Thailand also reduced its projected growth rate for 1998 from -3 to -3.5 percent to -4 to -5.5 percent (Thailand, Ministry of Finance 1998). These worsening growth prospects imply that the real sector will continue to face substantial economic difficulties for the foreseeable future and that it is still far too early to declare that these economies have reached the bottom in their economic cycles.

Moreover, given the worsening growth prospects in these economies, there are also important political

reasons to be skeptical about the future in these economies. In Thailand, despite the perceived popularity of the present government at home and abroad, the present coalition government remains rather weak with only a very small majority in parliament. Moreover, the opposition is continually threatening to table no-confidence motions that could potentially topple the government. If the government were to stumble, this would almost certainly postpone final action on several important financial reforms scheduled to take place in the next few months. Even if the government does manage to hang on to power, its parliamentary weakness makes it difficult for the government to smoothly implement all the policies that it wants to implement.

In Korea, the labor movement presents a potentially large stumbling block as the austerity measures continue to bite and the government moves to reform the country's rather rigid labor markets. Some labor leaders are already threatening large scale strikes, which if actually taken, could deepen the recession and slow any subsequent recovery. The political fallout of any labor market problems will also have important implications for the ability of the government to deliver on its proposed package of economic reforms. Another stumbling block is convincing the large chaebols to accept the reforms. These firms are large and, through their numerous connections to bureaucrats and politicians, have the ability to significantly slow down the reform process. A final stumbling block is the heretofore strong policy making bureaucracy which has become famous for the firm hand with which it has guided the Korean economy in the past. Bureaucrats stand to lose power in any process of substantive reform and could also slow the pace of reform if they choose to.

### 3.3 Uncertainty in Indonesia

The sudden collapse of the Suharto government following student-led protests and widespread social unrest, including violent destruction of property and loss of hundreds of lives, raises many questions. First and foremost is whether the new government, headed by President Habibie, will be able to stabilize the situation and move the country towards political reform. A second question has to do with the outcome of a successful political reform. It would be no small achievement as Indonesia has had no real experience with free elections and multiple independent political parties for almost forty years. However, there is no guarantee that a

parliamentary democracy will bring the type of stability needed to resume economic growth and development, even though there is no other political system that can satisfy the aspirations of the Indonesian populace. There is a risk that the country's unity could be undermined if religious and ethnic intolerance are allowed to fester and spread. The exodus of Chinese entrepreneurs and their families from Indonesia following the May 1998 riots, unless reversed, could have serious longer term consequences on the ability of the economy to recover. Hence, there are multiple risks in the outcome of the political reform process.

Habibie to his credit has moved quickly to establish a reform cabinet and has invited opposition leaders access to the government and input into the political reforms. The plan is to implement political reform laws as soon as possible and to hold new elections sometime in the next year. However, the economic crisis has deepened, with the failure of the largest private bank, Bank Central Asia and several other banks. Inflation is now expected to reach 100 percent in 1998. The economy may contract by as much as 15-20 percent leaving many jobless. The IMF and other donors are monitoring the situation.

Without a new infusion of funds from the international donor community the economy may collapse very soon. The donor community and the Indonesian public may demand that wealth accumulated by Suharto and his cronies be subject to investigation. At a minimum the new government will be expected to abolish special tax concessions to Suharto family related ventures and to cancel or at least review any contracts between government entities and Suharto-related business interests. The military, however, has stated it will defend Suha rto. Opposition leaders have expressed skepticism over the ability of the present government to distance itself from the Suharto interests. They suspect Suharto still retains a strong influence over the President and the military. Hence, the situation could become explosive.

An agreement on the restructuring of the large private external debt between Indonesian companies and foreign banks has been reached that may provide the economy some breathing room. The agreement creates the Indonesian Debt Restructuring Agency (INDRA) and provides for a three-year period during which interest only must be repaid. The agreement seeks to extend debt repayments over an eight year period. The arrangement seeks to restore badly needed credit lines for Indonesian trade.

The political situation remains highly fluid and Habibie's "honeymoon" period may come to an abrupt

end. Thus, unless decisive steps to break with the old regime and carry through political and economic reforms are forthcoming, uncertainty in the outlook for Indonesia is unlikely to dissipate any time soon.

### 3.4 The Regional Perspective

The two common themes that emerge from the preceding sections is that the outlook for the region as a whole is definitely mixed and very uncertain. A very important element of the story is that the Japanese economy remains very stagnant and there is as yet no clear sign of recovery. If, however, we are correct in that recovery to modest economic growth rates (of 2-3 percent per year) is not likely to come until 2000 at the earliest, this could have a very important negative impact on countries like Korea, Thailand, and Indonesia, that are counting on the ability to export their way out of their debt problems. The silver lining in this scenario is that there is now an opportunity for countries like Indonesia and Thailand, who have large portions of their debts denominated in yen, to restructure the yen-denominated debt at relatively low cost, if they can raise the funds to finance this restructuring.[6]

As in Japan, the prospects for Korea, Thailand and Indonesia are certainly not bright in the short run as indicated in the preceding sections. Moreover, as the forecast for Korea cited above indicates, the pace of reform implementation will likely have a very large impact on these pace of recovery. On the one hand, if reforms go relatively smoothly, recovery to modest growth rates (of roughly 5 percent) will probably come in 2000 in Korea and Thailand, though perhaps a year later in Indonesia. On the other hand, there is also the disquieting possibility that things could actually get much worse and that further turmoil in financial markets and/or in political circles could delay recovery until as late as 2003 or 2005. Indonesia in particular appears vulnerable to further turmoil of both types.

However, perhaps the most uncertain element is how the crisis will affect the other economies in the region. Certainly, Hong Kong, Malaysia, the Philippines, and Singapore seemed headed for much lower growth

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[6]Of course, this only makes sense if one expects the yen to strengthen again in the near future.

in 1998 than in 1997, and negative growth is a distinct possibility in some of these economies. Only Taiwan and China are likely to grow at close to their historical average for the last few decades. Moreover, there are three important reasons to be cautious with respect to the medium term prospects for China as well. First, China may find its competitiveness eroded by the depreciation of currencies in Korea and Southeast Asia. This may lead to a further devaluation of the Chinese yuan and thereby put further competitive pressure on Korea and Southeast Asia. Second, China's financial institutions are also likely to have very large problems related to non-performin g loans and China's supervision of financial institutions is also likely to be inadequate. Third, China has also experienced a very rapid increase in external debt in the last few years. In short, China probably has many of the same problems that plagued Korea and Southeast Asia before the advent of the crisis. There are major differences in China, however, as the Chinese yuan remains non-convertible, financial markets are tightly controlled, though not very efficient, and most of the debt (both foreign and local) is in public sector, not in private business. There is thus a chance that China can still control these problems with a careful program of reform that pays due attention to avoiding the problems experienced in East and Southeast Asia. In particular, the one lesson that one can draw from the recent experience of Korea and Southeast Asia, as well as the earlier experience of Mexico, is proper balance between liberalization of the real sector, onshore financial transactions, and offshore financial transactions, is crucial and not easy to attain.

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## Figures 1a-1j: Growth Rates of Real GDP in Selected Asian Economies

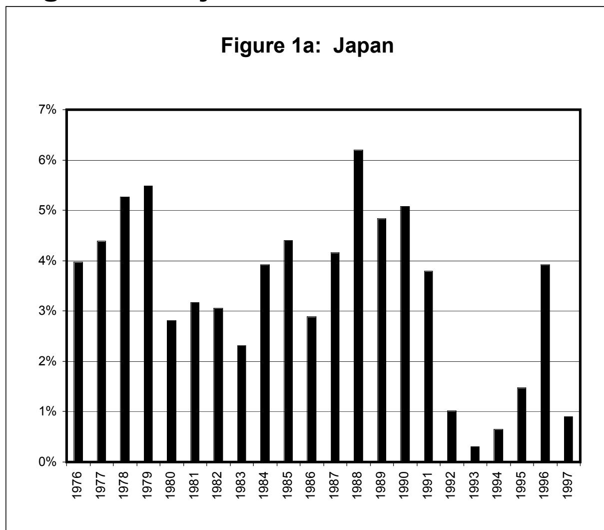



Figure 1a: Japan

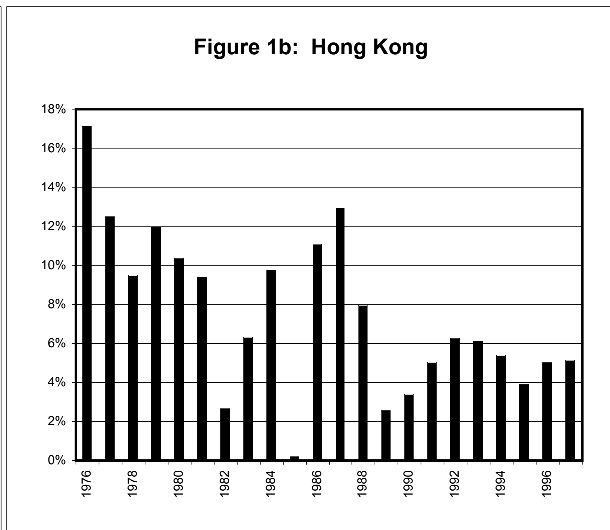



Figure 1b: Hong Kong

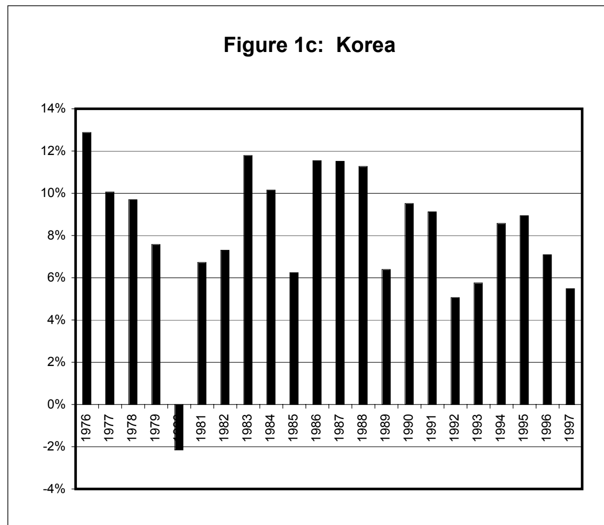



Figure 1c: Korea

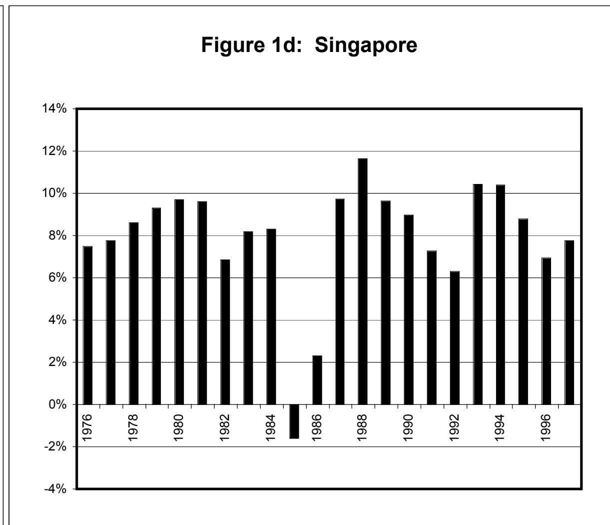



Figure 1d: Singapore

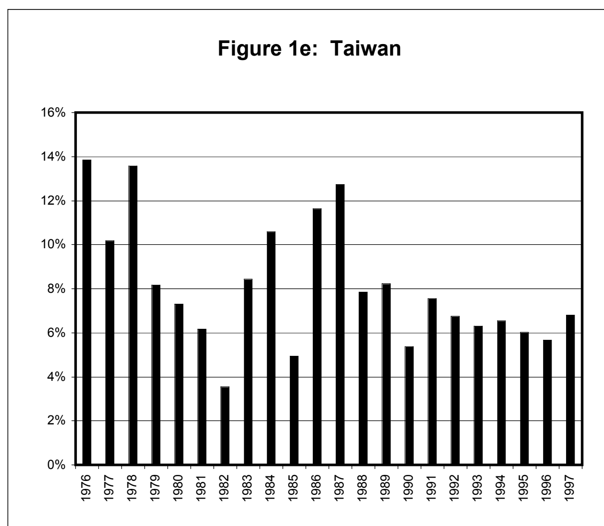



Figure 1e: Taiwan

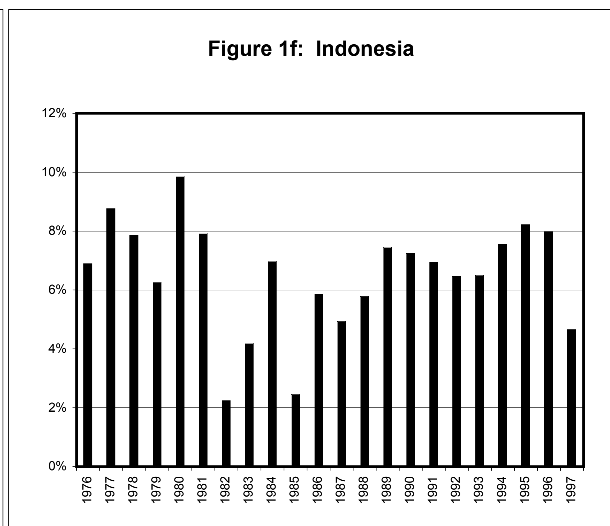
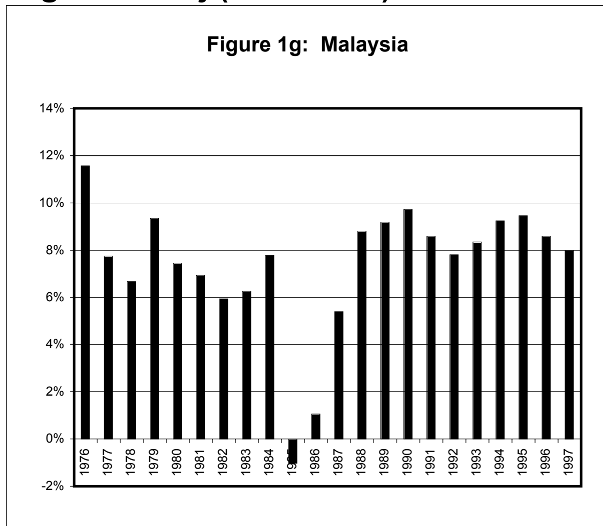
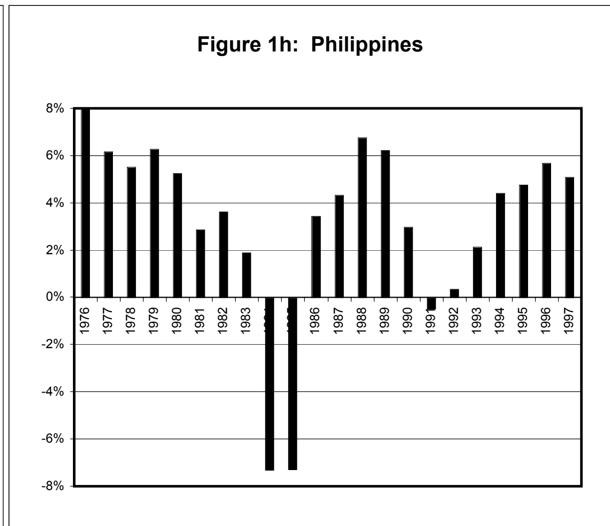
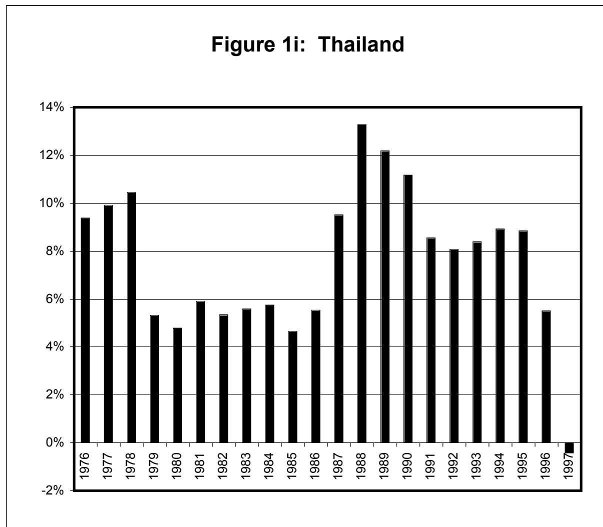


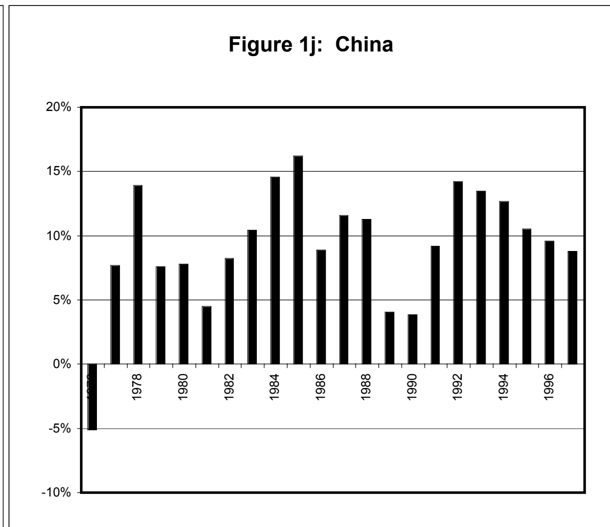

Figure 1f: Indonesia

## Figures 1a-1j (continued)



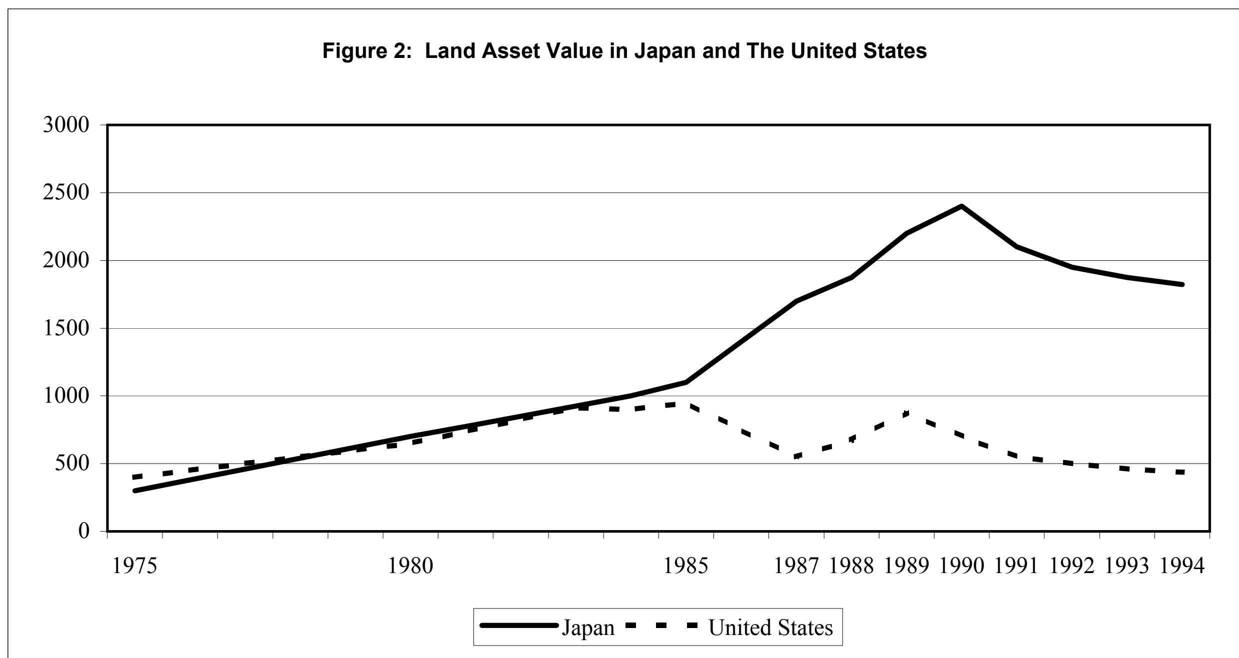




Sources: International Monetary Fund (1997, 1998); Indonesia, Biro Pusat Statistik (1998);
Japan, Bank of Japan (1998); Japan, Economic Planning Agency (1998);
Malaysia, Department of Statistics (1998),
Republic of China, Council for Economic Planning & Development (1998);
Singapore, Department of Statistics (1998); World Bank (1995, 1997).

Figure 2: Land Asset Value in Japan and The United States




Source: Japan Institute for Social and Economic Affairs (1998).

**Table 1 Components of National Assets**

| Item | Japan, 1995 | | United States, 1992 | |
|---|---|---|---|---|
| | Yen, trillions | Per cent | US$, billions | Per cent |
| Gross National Assets | 7,268 | 100.0 | 50,789 | 100.0 |
| Land | 1,840 | 25.3 | 4,289 | 8.4 |
| Housing | 252 | 3.5 | 5,188 | 10.2 |
| Building, plants, equipment, inventories,etc. | 1,023 | 14.1 | 8,831 | 17.4 |
| Financial assets | 4,154 | 57.2 | 32,462 | 63.9 |
| Net Assets (1993) | 3,204 | 100.0 | 17,887 | 100.0 |
| Land | 1,913 | 59.7 | 4,230 | 24.0 |

Source: Japan Economic Planning Agency (1997).

## Figures 3a-3i: Stock Prices in Selected Asian Economies (end of year or quarter, 1990=1)

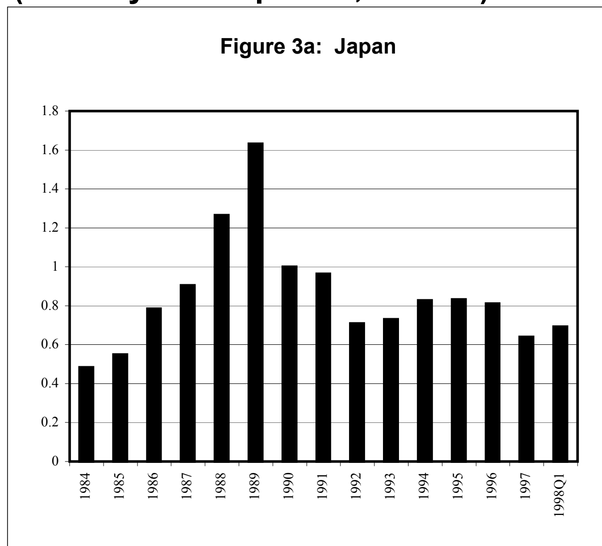



Figure 3a: Japan

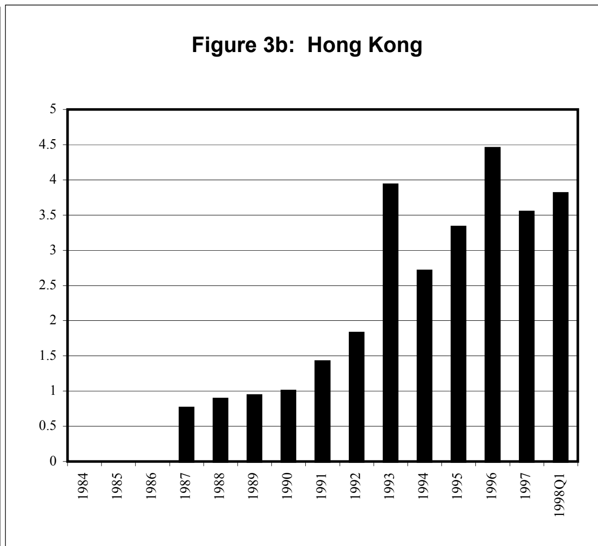



Figure 3b: Hong Kong

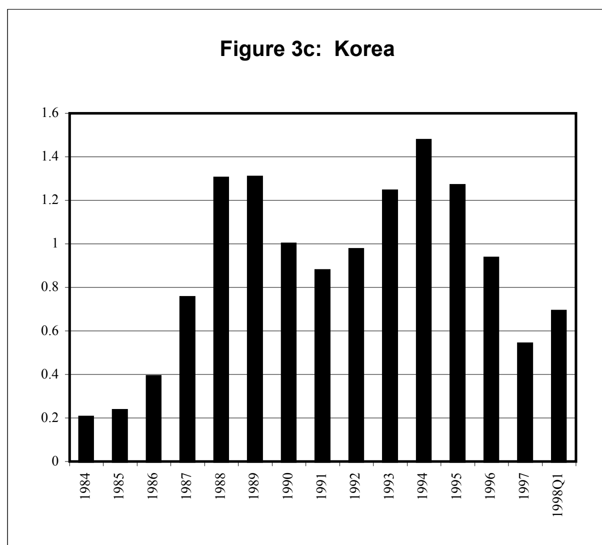



Figure 3c: Korea

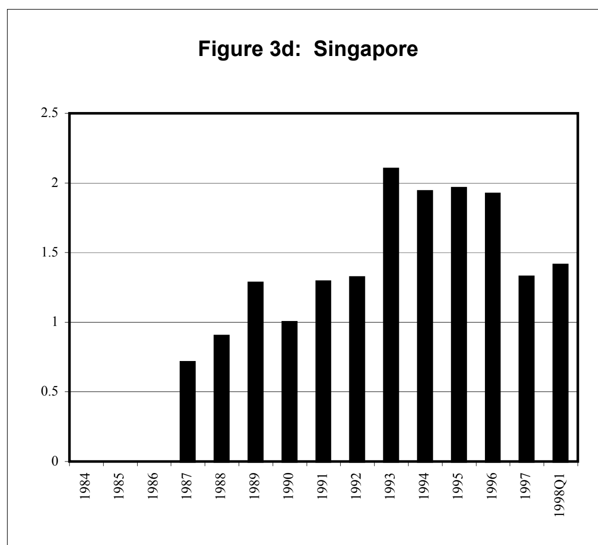



Figure 3d: Singapore

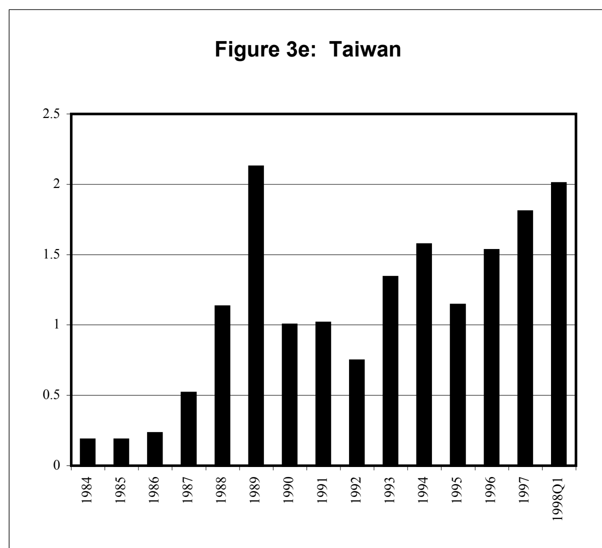



Figure 3e: Taiwan

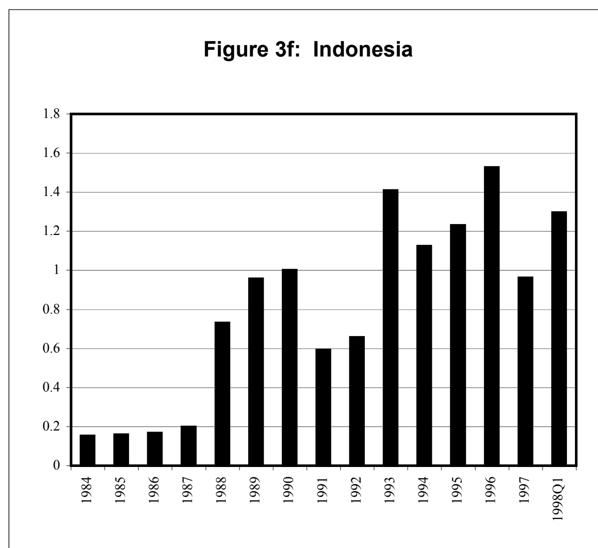
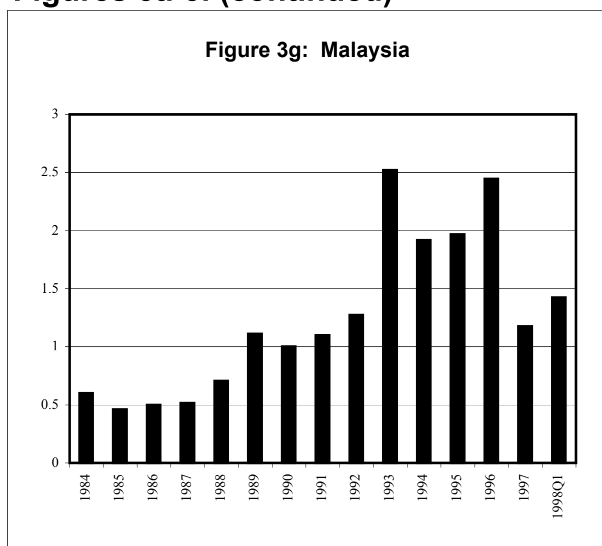
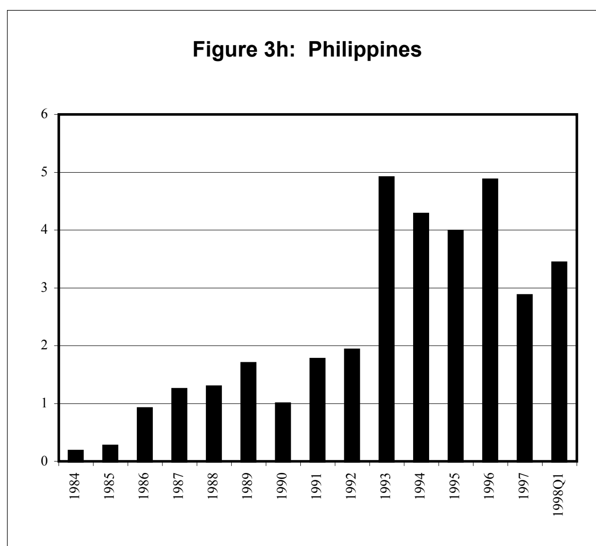
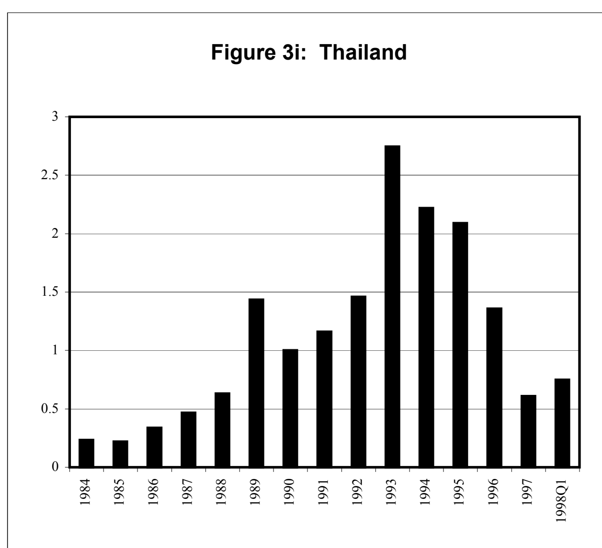



Figure 3f: Indonesia

## Figures 3a-3i (continued)




Sources: International Monetary Fund (1998); Nomura Research Institute (various years); Republic of China, Central Bank of China (various years).

## Figures 4a-4j: Exchange Rates in Selected Asian Economies (end of quarter, 1990Q4=1)

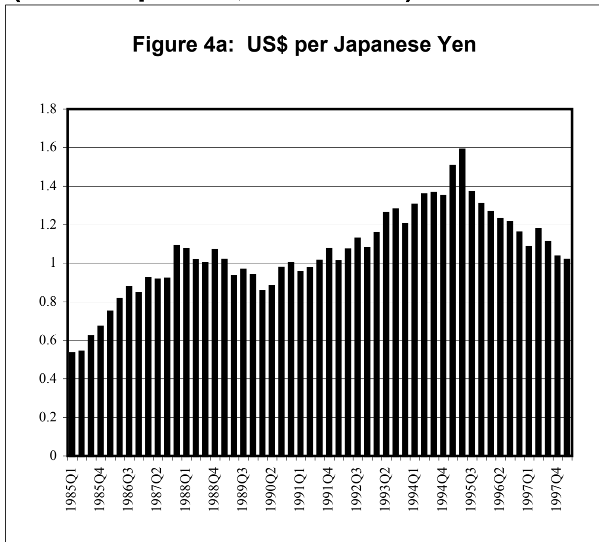



Figure 4a: US$ per Japanese Yen

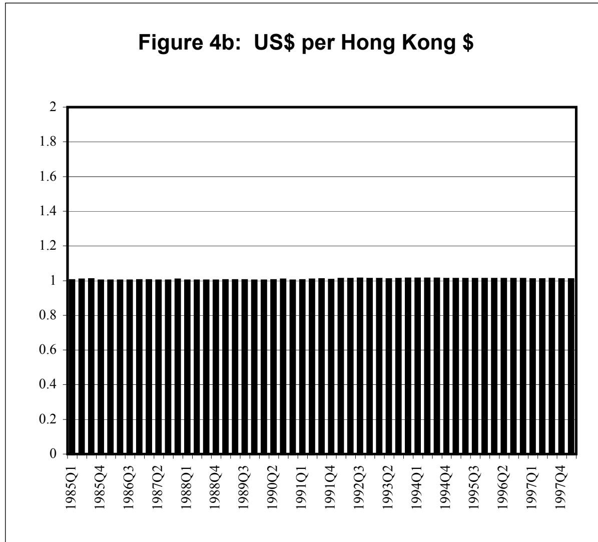



Figure 4b: US$ per Hong Kong $

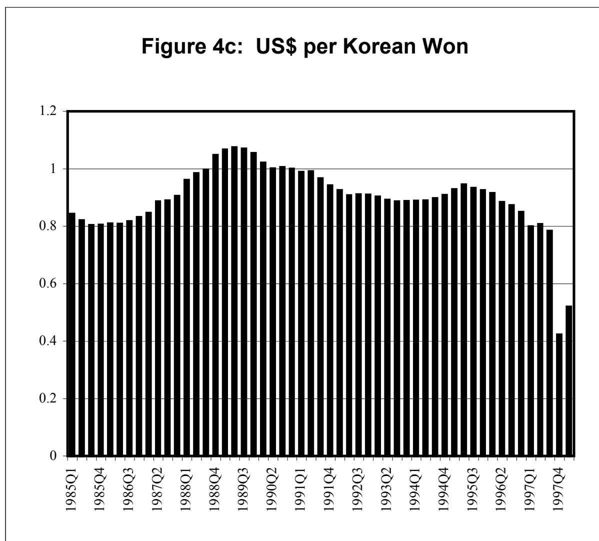



Figure 4c: US$ per Korean Won

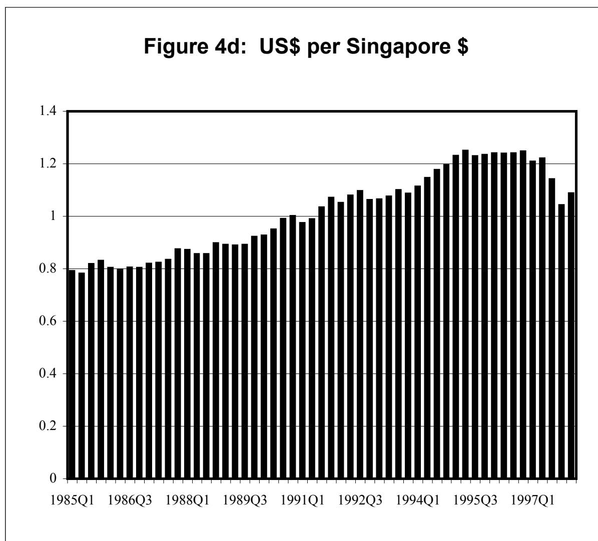



Figure 4d: US$ per Singapore $

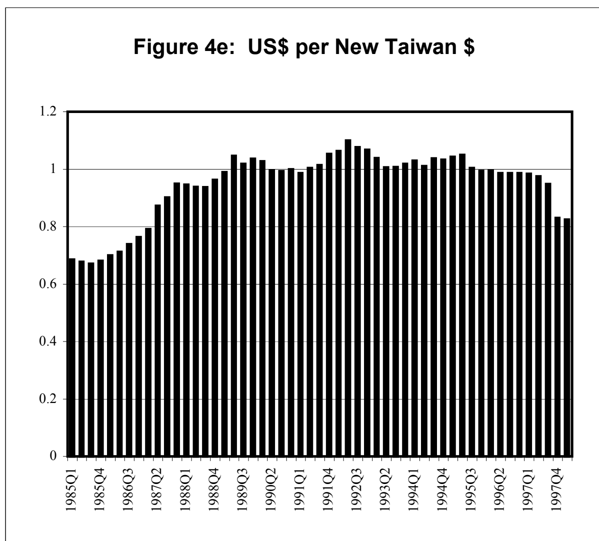



Figure 4e: US$ per New Taiwan $

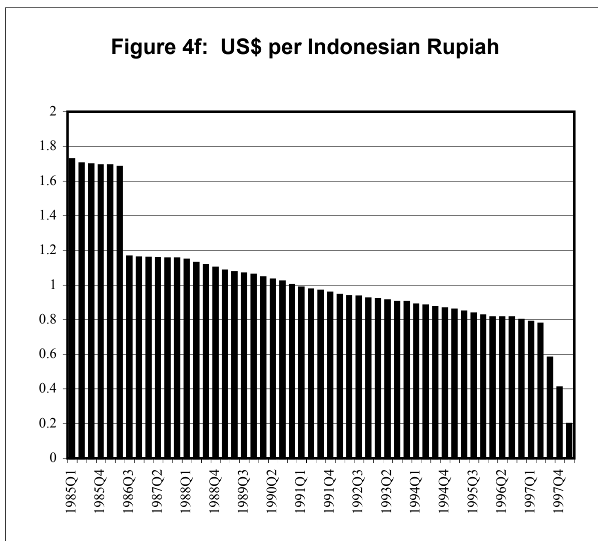



Figure 4f: US$ per Indonesian Rupiah

## Figures 4a-4j (continued):

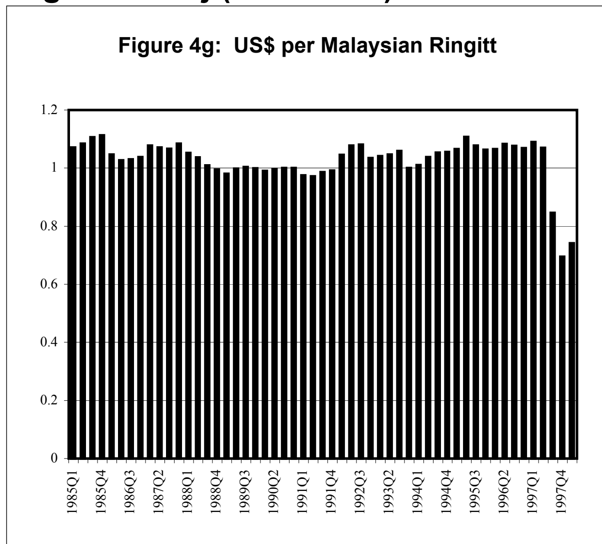



**Figure 4g: US$ per Malaysian Ringitt**

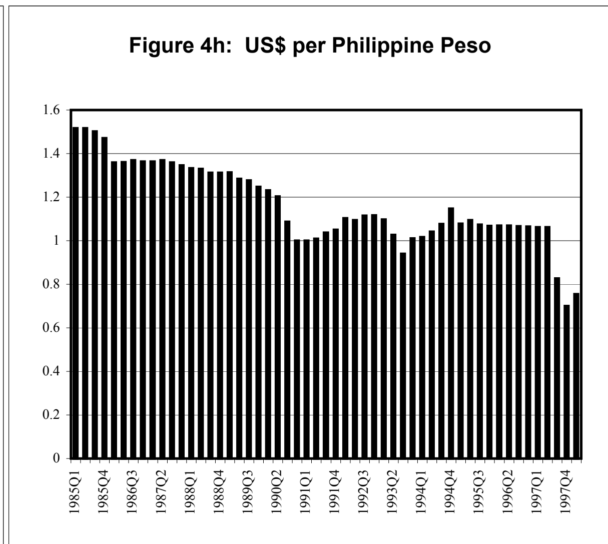



**Figure 4h: US$ per Philippine Peso**

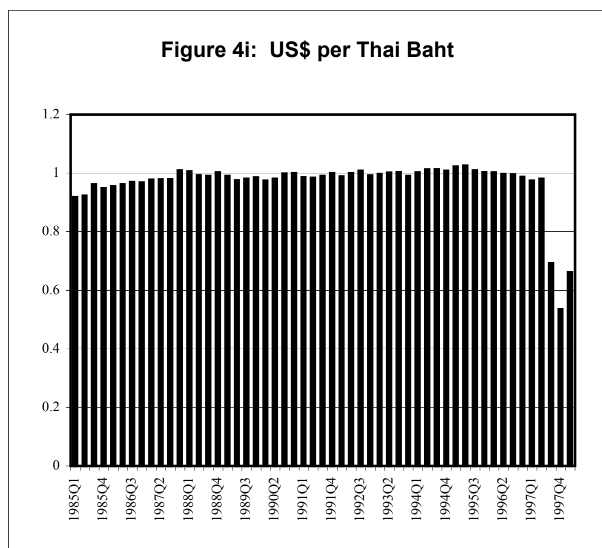



**Figure 4i: US$ per Thai Baht**

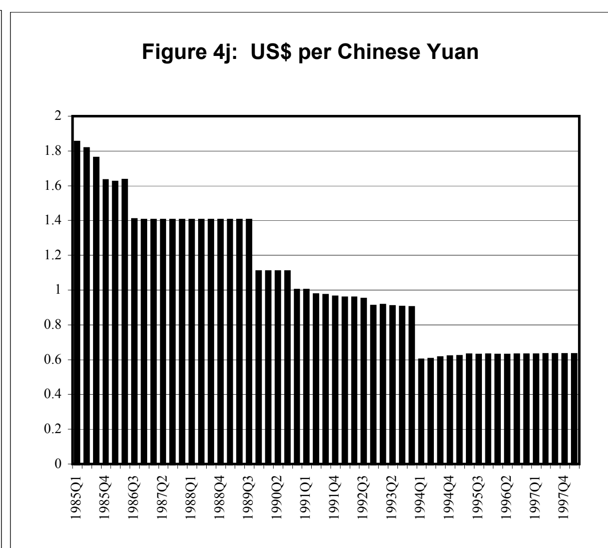
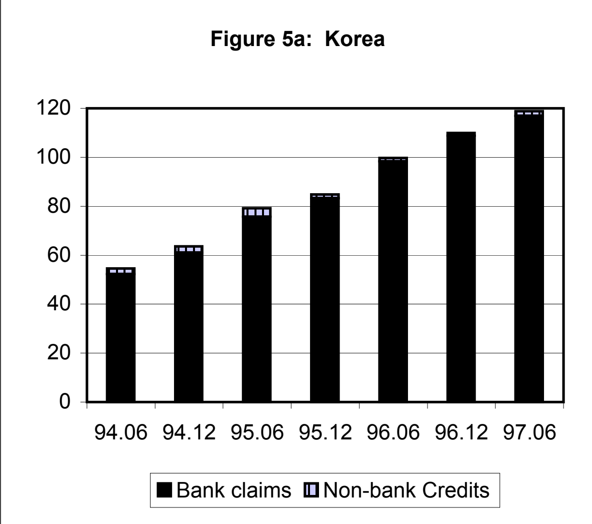
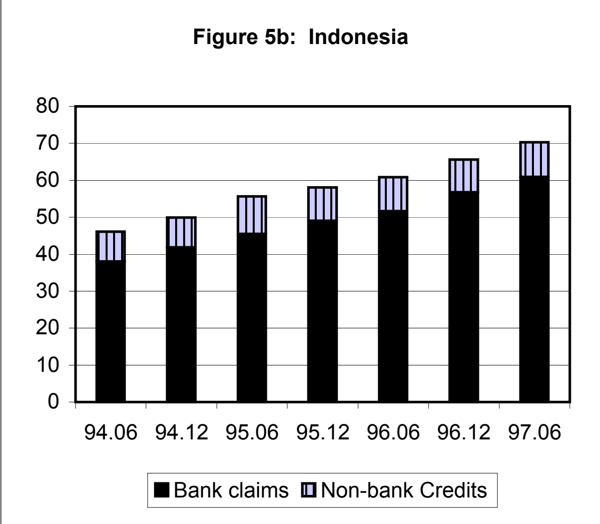


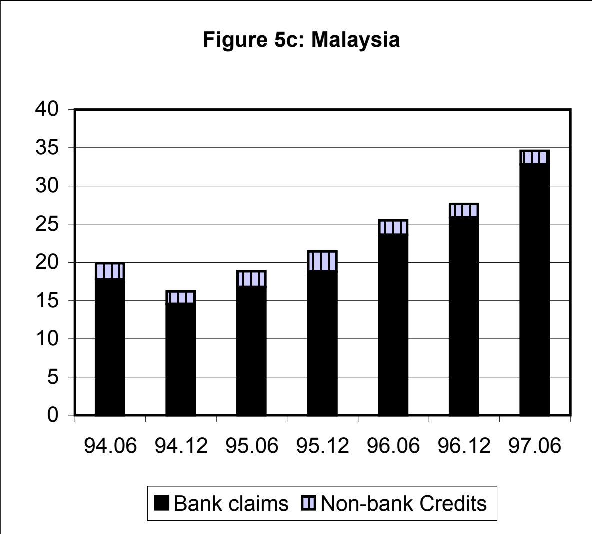

**Figure 4j: US$ per Chinese Yuan**

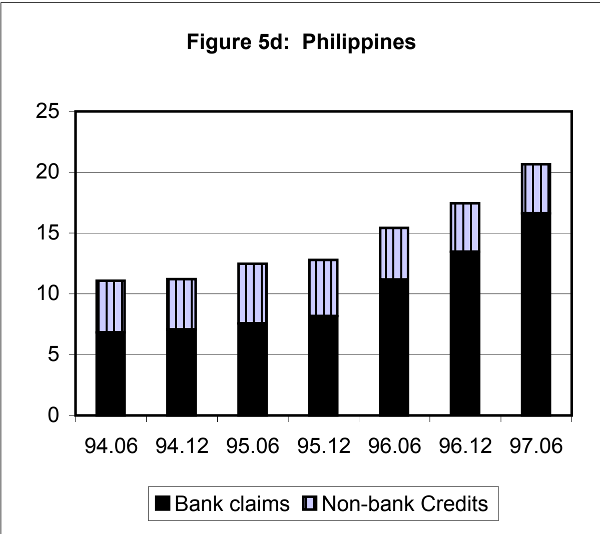
Sources: International Monetary Fund (1998); Republic of China, Central Bank of China (various years)

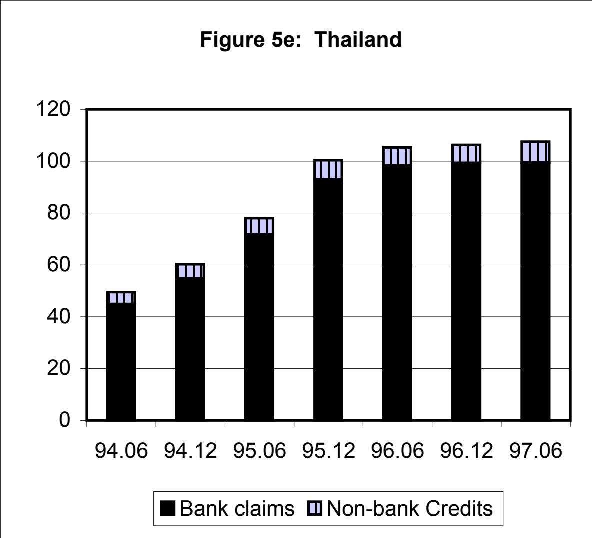
## Figures 5a-5f: External Debt in Selected Asian Economies, BIS Estimates (US$ billions)

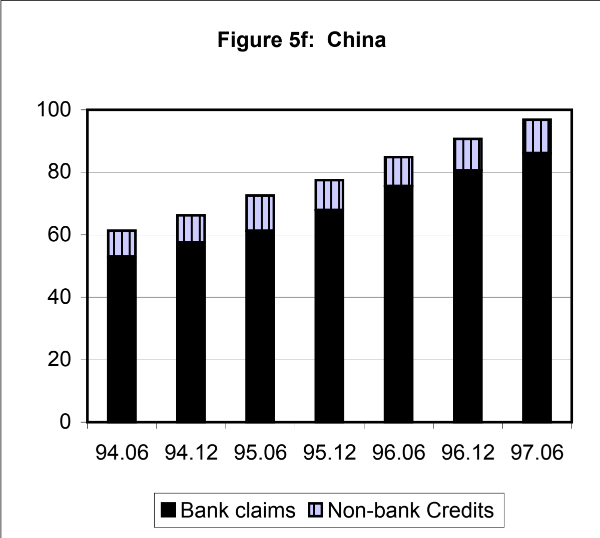


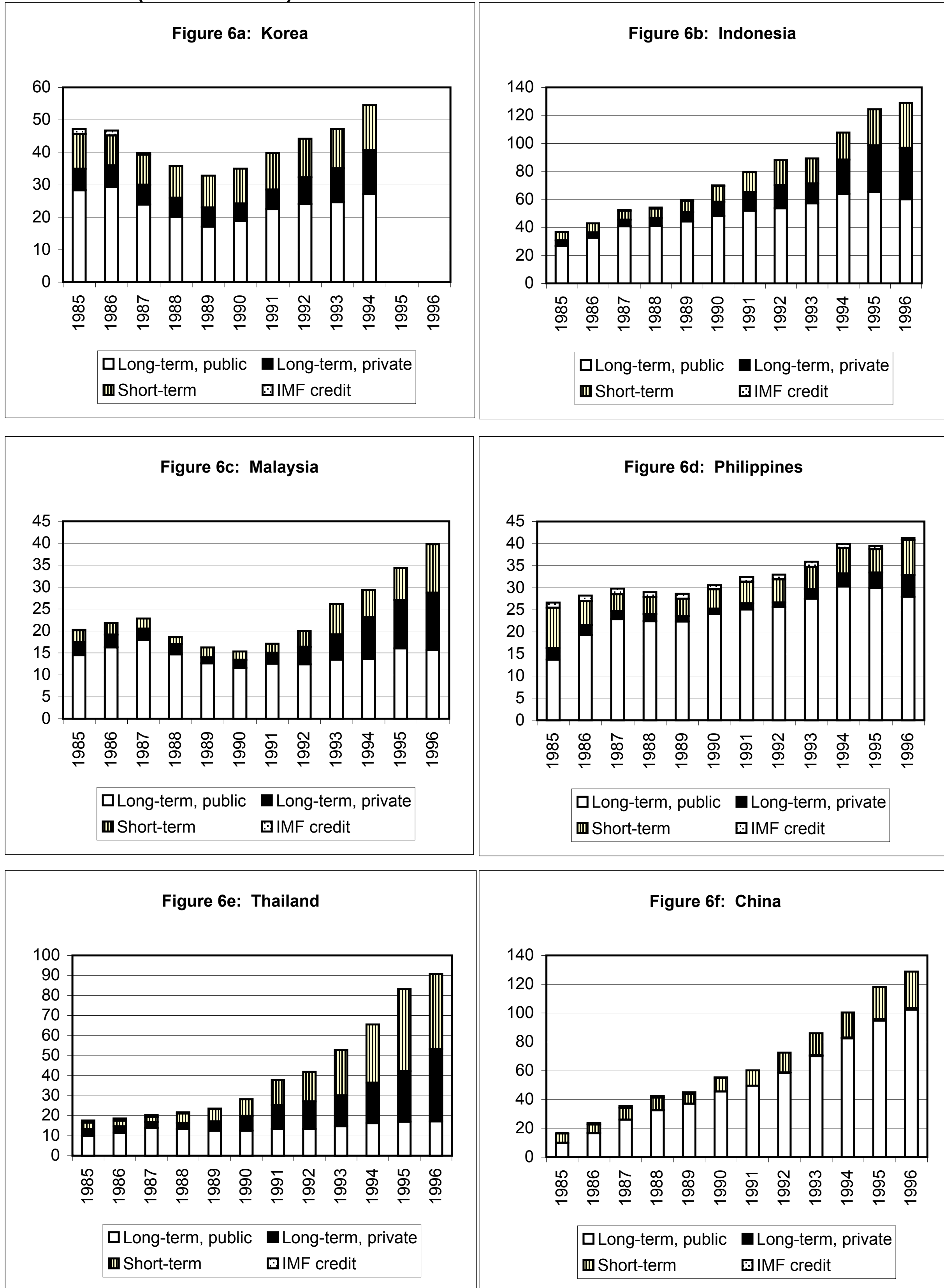



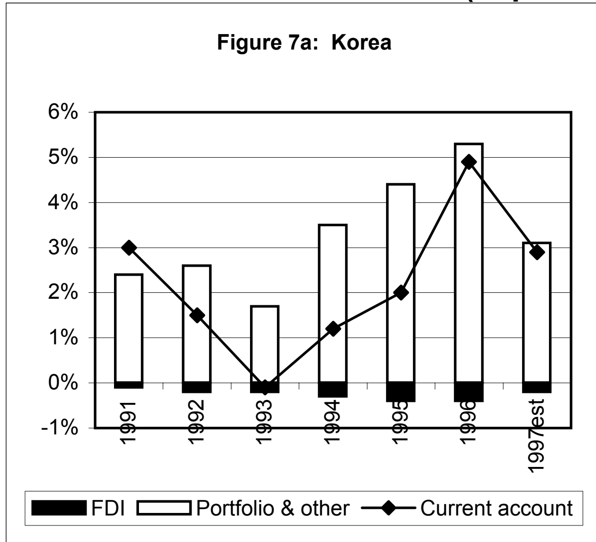

Sources: Bank for International Settlements (various years).

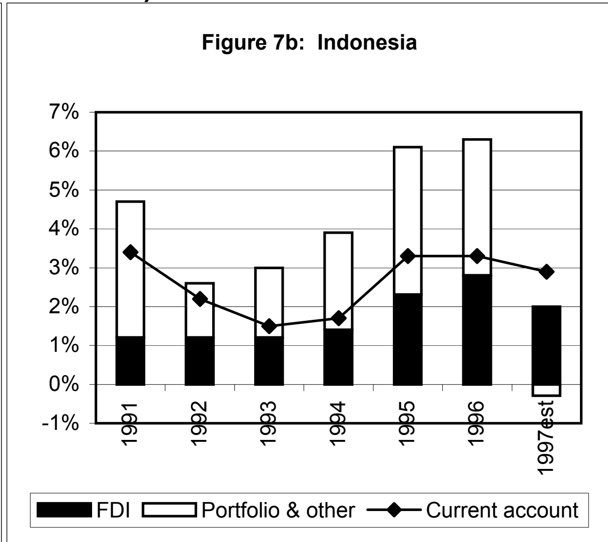
**Figures 6a-6f: External Debt in Selected Asian Economies, World Bank Estimates (US$ billions)**

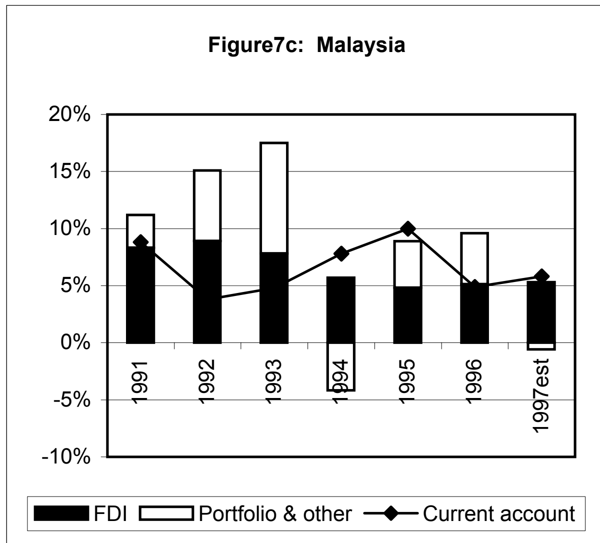


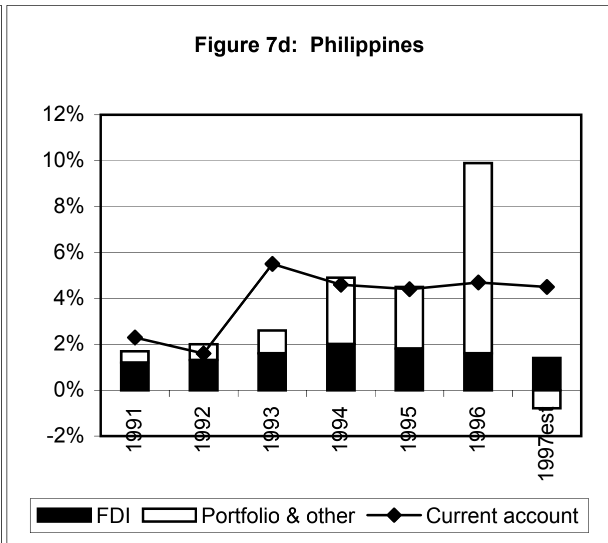

Sources: Asian Development Bank (1997); World Bank (1998).

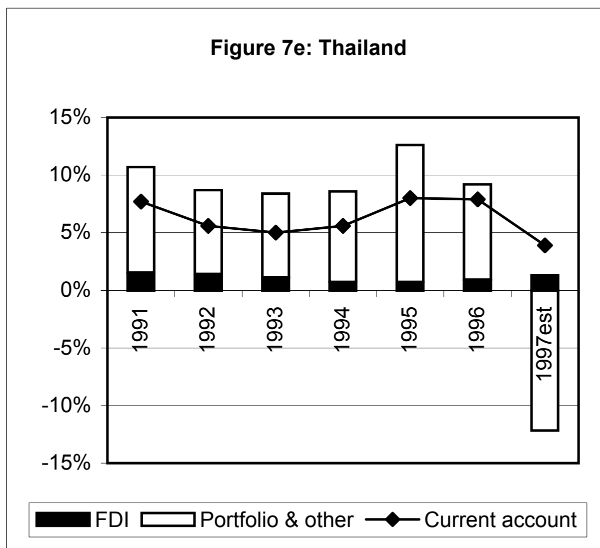
**Figures 7a-7f: Current Account Deficits and Foreign Investment Financing in Selected Asian Economies (in percent of GDP)**

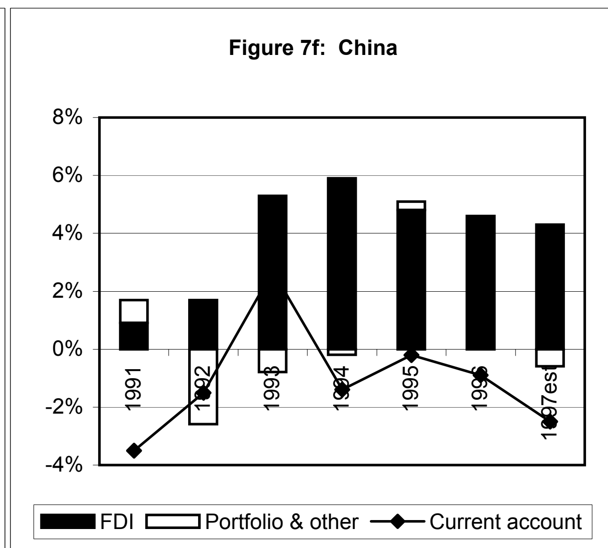



Note: FDI is foreign direct investment, portfolio is portfolio investment, and other investment consists primarily of loans.
Sources: International Monetary Fund (1997).