Asian Financial Crisis
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David Richardson
Economics, Commerce and Industrial Relations Group
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Introduction

July 1997 Meltdown

The beginning of the Asian financial crisis can be traced back to 2 July 1997. That was the day the Thai Government announced a managed float of the Baht and called on the International Monetary Fund (IMF) for 'technical assistance'. That day the Baht fell around 20 per cent against the $US. This became the trigger for the Asian currency crisis. Within the week the Philippines and Malaysian Governments were heavily intervening to defend their currencies, while Indonesia intervened and also allowed the currency to move in a widened trading range—a sort of a float but with a floor below which the monetary authority acts to defend the currency against further falls. By the end of the month there was a 'currency meltdown' during which the Malaysian Prime Minister Mahathir attacked 'rogue speculators' and named the notorious speculator and hedge fund manager, George Soros, as being personally responsible for the fall in value of the ringgit. Soon other East Asian economies became involved, Taiwan, Hong Kong, Singapore and others to varying degrees. Stock and property markets were also feeling the pressure though the declines in stock prices tended to show a less volatile but nevertheless downward trend over most of 1997.

By 27 October the crisis had had a world wide impact, on that day provoking a massive response on Wall Street with the Dow Jones industrial average falling by 554.26 or 7.18 per cent, its biggest point fall in history, causing stock exchange officials to suspend trading.

Beginnings

There is now fairly common agreement that the affected Asian currencies had been out of line with their economic fundamentals. For years, if not decades, many of the Asian economies had fixed their currencies against the $US. In earlier years they had probably kept their values low as part of their export push. Virtually all of the Asian economies that have been mentioned in the context of the Asian financial crisis have based their economic strategies on export promotion. That certainly includes Japan, the second wave of economies—Korea and Taiwan, and the third wave of economies which followed the Japanese industrial policy model to varying degrees—especially Malaysia, Thailand, as well as Indonesia and the Philippines. Hong Kong has been different, relying on a laissez
faire economic policy. All but Japan had fixed exchange rates against the $US, though some such as Singapore operated a loose link with the $US.

The appreciation of the $US against the Japanese Yen and third country currencies meant a decline in the competitiveness of these East Asian countries so long as they continued to fix their currencies against the $US. It seemed to be the case that under these fixed exchange rates countries continued to try to defend over-valued exchange rates for far too long, and long after everyone realised that the currency was over-valued.

In that way the monetary authorities concerned were offering everyone a good one way bet. If you bet against the currency the worst thing that can happen is nothing and you get your money back. However, the overwhelming odds are in favour of a win because the speculation itself becomes overwhelming. With that sort of 'game' it is no wonder that a country like Malaysia found a seemingly unlimited number of speculators willing to have a bet against the ringgit.

In addition to the currency misalignment leading up to 1997, there were other factors that have been implicated in the Asian crisis. Prior to this Asia had been the 'flavour of the month' as far as investors around the world had been concerned. Australia, for example, now has a number of listed companies that are basically investment funds that invest in Asia. The Australian Stock Exchange has been very active in the past trying to get Asian companies to list in Australia and now quotes an Asian index, an index of all the listed companies in Australia whose business is chiefly their operations or investments in Asia.

There is nothing to suggest that the Asian shares listed in Australia were anything other than sound. However, that is not the case elsewhere. A lot of speculative money went into real estate and property development. The speculative activity fed on itself and produced asset price inflation bubbles in countries like Thailand, Malaysia and the Philippines. Now of course the speculative bubble has burst, as is evident in reduced property values. In the second half of 1997 annual office occupancy costs fell by 56 per cent in Bangkok, 37 per cent in Manila, 36 per cent in Kuala Lumpur and 27 per cent in Hong Kong.4 Business Week claims that before the crisis there were 'white-elephant construction projects, a bribe-based business ethic, and way too much capacity in too many industries.'5

Since the crisis broke there has been a lot of critical comment as to issues such as corporate governance, accountability, transparency of the financial system, and the like. These issues have been addressed in the packages agreed with the IMF and have been pursued independently by countries such as Malaysia without IMF prompting. All of those accountability and transparency issues are important. However, the speculative activity in Asian assets leading up to July 1997 was unlikely to be influenced by more and better information on the underlying assets. It is in the nature of speculative booms that such rational considerations are ignored.

Since the events of 1997, an important body of opinion has developed, laying the blame for the Asian crisis on the interventionist policies pursued by the governments in the
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Asian countries have repeated the mistakes of many of their western counterparts (in many of which, in varying degrees, those errors persist). The desire to give government preference to particular investments—rather than to get the overall economic climate right—is a hard habit to shake. Though many governments now see the problems in attempting to 'pick winners' they nevertheless lean towards policies which seem more designed to pick losers. The most obvious example of this is incentives given to investments on the basis that they would not otherwise occur.

While there may be no apparent fiscal problem in such circumstances, when the policies become unsustainable (for whatever reason) there are inevitably pressures for the cost to be picked up in the fiscal accounts. If the mechanisms used to create the investment incentives include the direction of lending via the banking system, while that system remains under implicit or explicit government guarantee, the danger is extremely great—the more so because its magnitude is hidden until the crisis occurs.6

It is true that there has been heavy government intervention in many of the Asian economies. However, it seems unfair to blame government intervention for the current financial problems without recognising the role of government in producing the dramatic growth in economic activity and living standards in the Asian region in earlier periods.

In a recent press statement the World Bank reminded us that '[n]o other group of countries in the world has produced more rapid economic growth and dramatic reduction in poverty than East Asia. Korea, Malaysia, and Thailand have virtually eliminated poverty, and Indonesia is within reach of that goal.'7 The implication is that the East Asian development model should not be dismissed quite so casually. Indeed, an official from the United Nations Conference on Trade and Development (UNCTAD) has suggested that the problems in 1997 can be ascribed to the attempts to deregulate some of the Asian economies. Some of these economies had liberalised their financial systems following pressure from the developed countries. However, the institutional structure was not appropriate for a market driven environment. Over-borrowing and over-investment on the part of the Korean chaebol (the Korean corporate conglomerates) followed as they became multinationals, and their activities became less transparent and more difficult to monitor.8 For example, the supervisory/regulatory/accountability structures were inadequate to cope with temptations on financial institutions to enter speculative real estate and similar ventures. Deregulation meant that all of a sudden inexperienced banks were thrust into a competitive and speculative environment, taking a mass of foreign deposits on the one hand and facing property deals on the other.

The fact that the IMF has recognised the importance of institutional failings supports the interpretation that the process of deregulation in East Asian countries has not addressed the adequacy of the institutional structures. Those institutional structures were designed for a different period. Like any other social organisation, setting up a free market also requires attention to the rules and the institutions playing under the rules. Yet policy...
makers around the world often fall into the trap of thinking that deregulation can be implemented by pulling down structures without any thought as to what might or should replace them.

In many respects the Asian economies are similar to the emerging economies of the old Communist bloc. The IMF has been active in providing advice to former Communist countries on the dismantling of their regulatory apparatus. The former Communist countries pulled down the apparatus of central planning but without establishing the legal and institutional structures—the rules of the game—that might facilitate the evolution towards capitalistic economies. There are similar dangers for the Asian economies that attempt to dismantle the government/finance/industry development model.

The Managing Director of the IMF, Michel Camdessus, commented on the uniqueness of the IMF programs in Thailand, Indonesia and Korea which represented a 'marked departure' from those traditionally supported by the IMF:

Instead of austerity measures to restore macroeconomic balance, the centerpiece of each program is a set of forceful, far-reaching structural reforms aimed at restoring market confidence. The reforms included in these programs will require vast changes in domestic business practices, corporate culture, and government behaviour.9

One influential commentator, Martin Feldstein, President of the National Bureau of Economic Research, has suggested that by the time the IMF came to intervene in the Asian rescue packages it was keen to apply the structural changes it had been applying in the former Soviet Union and its satellites. In addition it was also keen to apply the traditional Latin American mix of policy prescriptions. However, the analogy of shifting from communism to a market economy was wrong and the Latin American policy mix inappropriate. Moreover, the measures are unnecessary to address the country's access to the international capital markets—the real issue at stake. Instead we have an unnecessary interference in the internal workings of the countries in question. In his own words:

The legitimate political institutions of the country should determine the nation's economic structure and the nature of its institutions. A nation's desperate need for short-term financial help does not give the IMF the moral right to substitute its technical judgements for the outcomes of the nation's political system.10

Japan

There has been pressure on Japan to stimulate its economy, increase its imports from the region, and so contribute to economic recovery among Asian economies. Japan is the major surplus country and in the best position to accept a large surge in imports. The importance of Japan for the rest of the region cannot be over-emphasised. Sales to Japan account for 12 per cent of Malaysia's GDP, and in the range 5 to 7 per cent in the case Indonesia, Korea, Taiwan and Thailand.11 For that reason the US has long been urging
Japan to stimulate its economy and act as the engine of growth for the Asian region.\textsuperscript{12} If anything the impression is that Japan has been doing the exact opposite. For example, \textit{Business Week} said:

\begin{quote}
All these measures [policy responses to the crisis] will be meaningless unless Japan also makes some serious commitments. So far, Tokyo has stood out as one of the chief villains in the crisis. It has let the Yen slide to boost its own exports at the expense of its neighbours. And it has clamped down on its domestic growth, ignoring pleas to import more Asian goods…Corralling Japan into the effort will be a major challenge.\textsuperscript{13}
\end{quote}

Japanese responsibility has been a growing concern as the crisis continued. There is criticism that Japan has not acted as decisively as the international community would have liked. On 27 March 1998 the Japanese Government announced a fiscal stimulus package worth $US127 billion to be spent on such public works as infrastructure for science, technology and telecommunications. Australia's Treasurer, Peter Costello, welcomed the package saying 'the Japanese economy has been in the doldrums for most of the decade and it is important that it once again becomes a driver in the region.'\textsuperscript{14} One estimate suggested Japan's economic growth would be boosted by 1.1 per cent.\textsuperscript{15} Since that announcement the consensus seems to be that much more needs to be done by the Japanese. For example, there is concern that the Japanese fiscal stimulus will not compensate for the slump in Japanese exports caused by the Asian crisis.\textsuperscript{16}

In the context of continuing concern by the international community, the Japanese yen has been in decline over most of the last 18 months or so. In mid June 1998 the yen had fallen to 147 to the $US, down 23 per cent from 113 yen to the $US a year earlier. The fall in the yen raised the prospect that the rest of the affected Asian economies would be forced to engage in a new round of devaluations. China's fixed exchange rate against the $US has been an important source of stability in the region. However, that relationship was seen to be threatened by the falling yen. Accordingly the US and Japanese Governments intervened on 17 June with a package of measures including the purchase of the yen by the US. For the moment this seems to have stabilised the yen/$US relationship. Nevertheless there remain continuing calls for Japan to further stimulate its economy to assist the region as a whole.

\textbf{IMF role in Asian financial crisis}

The IMF arranged rescue packages for three countries facing severe crises—Thailand, Indonesia and Korea in that order. In looking at the individual packages described below, it is important to note that there are many initiatives which go beyond the type of responses needed to quickly address currency problems. The packages include measures that affect the structure of the economies concerned, such as the accountability of the corporate sector, legislated monopoly privileges and prudential regulation of the financial institutions. IMF packages have always had their critics. However, criticism has been
particularly severe as the Asian packages have gone into such detail in areas that are arguably the domain of domestic political determination.

**Thailand**

From mid-1996 Thailand was experiencing a sharp downturn in exports and slowdown in growth, difficulties in the property markets, a sharp fall in the stock market and weakening of the fiscal position. That was followed by a series of increasingly serious attacks on the baht.17

On 20 August, as part of an overall package of reform, the IMF approved stand-by credit for Thailand of up to $US3.9 billion, $US1.6 billion was available immediately and the rest subject to performance targets and program review. The package of measures under the program included:

- a new exchange rate regime based on floating of the baht
- fiscal policy designed to produce a surplus
- ending the support for insolvent financial institutions
- strengthened financial regulation and supervision
- accelerated privatisation, and
- increased emphasis on secondary education and training.

In discussions leading up to the announcement, Australia, along with Hong Kong, Malaysia and Singapore each pledged $US 1 billion while Japan pledged $US 4 billion. Indonesia and Korea pledged $US 0.5 billion each while the World Bank and Asian Development Bank agreed to contribute $US 1.5 and 1.2 billions respectively.

**Indonesia**

Indonesia has been hardest hit by the Asian financial crisis with massive falls in the exchange rate and stock prices. The IMF believes that Indonesia's structural weaknesses made it especially vulnerable to adverse external developments. It cites domestic trade regulations, import monopolies, lack of transparency and data deficiencies in the business environment, a weak banking system ill-prepared to withstand the financial turmoil in SE Asia, and high levels of corporate overseas debt taken out after a history of stable exchange rates which proved unsustainable.18
On 5 November the IMF announced a package including stand-by credit of $US10.14 billion for Indonesia. The rest of the package includes:

- fiscal measures designed to maintain the surplus
- tight monetary policy
- closing unviable banks
- liberalising foreign trade and investment
- dismantling domestic monopolies
- private sector participation in infrastructure
- expanding the privatisation program, and
- increasing the transparency of public sector activities to enhance the quality of governance.

In addition to the IMF credits the World Bank has pledged $US 4.5 billion and the Asian Development Bank $US 3.5 billion. Indonesia's own external assets, which are estimated at equivalent to 6 months imports, are committed to the package. In addition, Australia, as well as China, Hong Kong, Japan, Malaysia, Singapore and the US have indicated they would be prepared to consider supplementary finance to support the program in the event the IMF credit arrangements proved insufficient. Australia's commitment is up to $US 1 billion.

Since the Indonesian package was agreed the Indonesian Government appears to have lost faith in the IMF package and implementation has been delayed or avoided. On 11 February 1998 the Indonesian Government raised its proposal for a Currency Board for Indonesia. The IMF was concerned about that and the fact that the Indonesian Government was looking for solutions outside of the agreed package. The IMF warned Indonesia not to adopt the proposal and the Indonesian Government criticised the IMF program for not working to improve the Indonesian economy. In March the IMF delayed payments to Indonesia under the program and warned that Indonesia's crisis could worsen the situation throughout Asia. On 20 March Indonesia announced a 5 per cent tax on short-term capital flows. This decision was reversed on 23 March. It is probably something of an understatement to suggest Indonesian economic policy was somewhat erratic during this period. It is very likely that the erratic policy making of this period actually worsened Indonesia's plight. Evidence for that is suggested by the experience of the Indonesian rupiah. While other Asian currencies hit bottom at the end of 1997 or early 1998, the others have bounced back and are now no worse than 40 below their values (against the $US) at the beginning of 1997. Unfortunately Indonesia's rupiah fell by over 80 per cent
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against the $US to January 1998 and, after a brief recovery, had fallen again to new lows by the end of June 1998.

Indonesia's economic instability has been reinforced by its political instability. By May 1998 Indonesia was suffering from riots and ethnic violence. On 21 May President Suharto resigned and was succeeded by his deputy BJ Habibie. President Habibie soon announced a series of political reforms as well as reforms aimed at overcoming cronyst activities. The IMF had been due to distribute funds for balance of payments support in early June 1998 under a further revision of the agreement with Indonesia. However, a necessary IMF review of Indonesia was unable to take place in early May as a result of the political unrest. The IMF now expects to make new funds available in early or mid-July.

Korea

Korea's problems emerged earlier in 1997 as a number of highly leveraged conglomerates or chaebols became bankrupt as a result of over-investment in steel and cars, and weakened profitability with the cyclical downturn. The bankruptcies weakened the financial system with non-performing loans reaching 7.5 per cent of GDP. The decline in stock prices further reduced the value of bank equity. All of this led to a sharp fall in external finance.

On 4 December the IMF announced a package including a $US 21 billion stand-by credit for Korea. The package of measures agreed by Korea includes:

- tight monetary policy with high interest rates to stabilise markets
- tight fiscal policy
- strengthening the financial system through a firm exit policy, market and supervisory discipline and increased competition
- further trade liberalisation
- easing restrictions on foreign ownership, and
- making it easier to dismiss workers.

In addition to the IMF funding, the World Bank has indicated it will provide $US 10 billion to support specific structural reform. The Asian Development Bank has promised another $US 4 billion. As a second line of defence, Australia along with Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the UK, and US have indicated they are prepared, in the event that there is a need for additional resources, to consider supplemental financing. This 'second line of defence' is expected to be in excess of $US 20 billion. The second line of defence was being activated over
Christmas and the Treasurer announced an early drawing of $US 8 billion on the supplemental support arrangements. Australia's share was expected to be $US 330 million.

**The Philippines**

In addition to the three countries above the Philippines should be mentioned given that it is now part way through an IMF adjustment program. This program pre-dates the 1997 Asian financial crisis and is of a completely different order of magnitude. Following the extension of the Extended Fund Facility in July 1997, the total amount available to the Philippines is $US1037 million, considerably less than the amounts involved in the other Asian countries. However, the extension was in response to the effects of the regional capital market turbulence and the float of the baht on 2 July.

**Where will it end?**

At the end of June, 1998, currency and stock markets still seem to display a fair amount of volatility but the trend is no longer downward and the markets seem to be well off their lows. Even Indonesia had been off its lows in terms of the value of its currency and the behaviour of the stock markets. However, Indonesia now seems to be back at currency levels as low as they had ever been through the present episode. Of course, the return of relatively healthy financial markets does not necessarily mean the underlying economy has returned to health.

It will be recalled that following the 1987 Wall Street crash, which, by the end of the day became a world stock market crash, there was concern that the massive destruction of wealth could flow on to the real economy. It was feared the crash might mean a flight to liquid and safe assets and the withdrawing of credit for industrial purposes. The world's central banks quickly intervened to make sure markets remained liquid. Fortunately the crash did not make serious enough 'ripples' to affect the real economy to any major extent. Concerns of a 1929 type crash were allayed and the financial crisis remained confined largely to financial circles. It is too soon to tell if the Asian financial crisis will have such an effect on the most affected economies of East Asia. Indonesia's plight is clearly the worst and the effect of the financial crisis has been severe. There has been a massive decline in living standards among most of the population and so the financial crisis there has become a severe economic, social and political crisis. Hopefully the rest of the region can escape with something closer to a 1987-type crash rather than the 1929-type crash being endured by Indonesia. The consensus seems to be that from 1999 onward there should be a tentative return to growth throughout most of Asia, slowly at first but an eventual return to more rapid growth rates.
Japan was once the prime example of the high growth Asian economy, indeed, it was the inspiration for development strategies among other developing Asian economies. Now Japan is perhaps partly seen as an example of what might happen when governments delay deregulation for too long.

Korea was the most sophisticated of the badly affected Asian economies. However, some of its best-known chaebol, or conglomerates, are under pressure. The chaebol had been experiencing problems before the crisis—for example, Kia the car maker went broke in 1997, before the crisis was apparent, and is now effectively nationalised. Its problems stem in large part from the world over-capacity in cars and the additional problems of new entrants into foreign car markets. Large companies that had seemed healthy enough are now in difficulties. Samsung has a debt to equity ratio of 267 per cent. Interest rates have increased dramatically as part of the package of measures designed to overcome the crisis in conjunction with the IMF. That means Samsung now has a huge interest bill as a first call on its cash flow and is likely to make a loss this financial year. One of the strategies it is trying in order to reduce its debt is to sell off assets. Samsung's construction business has been sold to Volvo, and its forklift business to an American company. General Motors is purchasing 35 per cent of Daewoo. Australia's ANZ Bank and other companies are also scouring the region for bargains.

There may be a shakeout of the ownership of much of the productive capacity in the most affected Asian countries. The private sector in these countries, including the banks, have incurred heavy foreign currency debts. But no matter how that pans out, the factories, machines, the public and private infrastructure will still be there no matter how many bankruptcies and asset fire sales take place. Foreign corporations have been picking over undervalued assets. In most of the affected economies we may well one day look back and find that the main enduring effect of the 1997 crisis has been a change of ownership—especially an increase in the foreign ownership of productive assets in Asian countries.

Endnotes

2. The second wave of economies refers to those that tried to emulate Japan's post war economic strategy beginning in the late 1960s and the 1970s. These are basically the two former Japanese colonies, Korea and Taiwan. Not only did they try to copy the Japanese export-led and government-guided strategies, but they also created similar institutional structures often with the same names. They were followed in the 1980s by the third wave Malaysia, Thailand, Indonesia and the Philippines. Again even the names of the institutions were copied in many cases. China may now be thought of as part of the fourth wave.
3. Arguably Indonesia and the Philippines were less influenced by the Japanese model though they nevertheless relied heavily on government directed industry policy to achieve economic development.


6. E. Evans, 'Asia, the IMF and Australia,' Address to the Sydney Institute, 17 February 1998, pp. 6–7.


17. 'IMF approves Stand-by credit for Thailand,' IMF Press Release no. 97/37, 20 August 1997.


20. 'Indonesia aid put on hold: IMF to conduct review of economic progress before funding resumes,' CNN news service, 10 June 1998.


22. Ibid.


