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Global Lessons of the Economic Crisis in Asia

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SUMMARY The economic crisis in Asia is not an "Asian" crisis. The conditions that precipitated it are by no means unique to the region. They have their roots in badly managed government liberalization of the financial sector, excessive borrowing and lending by private industry, and the inability and unwillingness of key players—including governments—to accurately assess risk. The resulting collapse of domestic asset values (real estate, stock market prices) and currencies is a phenomenon already seen in the 1990s in Europe, Latin America, and now Asia. With the cost of bailout packages ballooning, everyone has a stake in improving crisis prevention and response. Governments, international organizations, and domestic banks must coordinate efforts that should include: easier access to information in the financial industry, increased government oversight of private financial institutions, more flexibility in exchange rates, greater control by public authorities over the short-term flow of capital among countries. Finally, private companies that take excessive risk in financial markets should be forced to bear the costs of their own actions.

Investors with 'disaster myopia' can see only the boom, not the bust

Accurately interpreting the causes of the Asian crisis is critical to devising the most appropriate response and to preventing similar future crises in Asia or elsewhere. A key insight regarding the economic crisis that has brought the economies of Thailand, Korea, and Indonesia to their knees and undermined the prospects of other Asian economies is that similar crises have occurred elsewhere—the current state of affairs is not unique to Asia. Most memorably, it is the same kind of crisis that devastated Chile, Argentina, and Uruguay at the start of the 1980s; Norway, Sweden, and Finland in the late 1980s; and Mexico in 1994. This type of crisis is occurring with increasing frequency, although the magnitude of the bailouts required to restore the affected economies to health (see Table 1) is threatening to balloon beyond the capacities of international financial institutions.

The central role of liberalization. In each of these recent cases, the crisis resulted from perceived weaknesses in the financial system. The pattern is, by now, well known: before the crisis, a domestic financial systems enjoys three or four years of rapid expansion of credit—a "lending boom." These booms occur in countries after they liberalize their banking rules and rely heavily on foreign funds to broaden and diversify their financial sectors.

In a path-breaking study of financial panics, Charles Kindleberger[i] described the period when the funds flow in and fuel the lending boom as one of "euphoria." During this period, which he argued precedes all financial crashes, investors tend to suffer from "disaster myopia"[ii] which is evidenced by an inability to imagine a large calamity in the financial markets. The lending boom in turn creates an imprudent expansion of credit. In Mexico, for example, a consumer credit boom in 1994 saw Mexicans celebrating with excessive purchases of consumer appliances and goods, many of which were imported from the United States.

In the Asian countries and the Scandinavian countries before that, the boom occurred most heavily in property development. Lending for property development has the insidious feature that because the lending boom itself increases the number of development projects, it bids up property prices. This makes property loans appear "safe" since the values of the loan collateral are rising. But property prices are rising only because of the lending frenzy itself, creating an "asset bubble." When the bubble bursts, it becomes painfully apparent that the loans cannot be repaid from selling the collateral (which is also frequently plummeting in value). In Asia, the same kind of bubble was also created in stock and bond markets when a buying frenzy, fed by interest from foreign investors, bid prices up. Foreign investment funds were eager to buy into the domestic stock and bond markets and to lend to "successful" countries such as Thailand, Indonesia, and Korea where they could earn higher returns than in their home countries.

Foreign funds fuel dangers. This kind of asset bubble characterized the U.S. savings-and-loan fiasco in the mid-1980s and the *jusen* (housing construction) scandals in the Japan in the same period. The major difference between those crises and the current Asian crisis is that in Asia today foreign funds are a key component. It is this element that imposes what is known as the "currency attack."

The "attack" commences when those managing foreign funds begin to fear that the financial system is too weak and begin to withdraw their investments and stop renewing their credit lines. This loss of confidence and the accompanying withdrawal also affect the exchange rate, as the conversions of funds back to their home currencies undermines the value of the domestic currency. This can only be stopped when domestic authorities use their foreign reserves—until they run out—to pay off the redemptions.

When reserves run out, the currency begins to devalue. Foreign funds stand to lose according to the amount of the currency depreciation. This punches another large hole in the asset price bubble. It becomes a matter of prudence for foreign funders to withdraw as quickly as possible, becoming full participants in and further fueling the ensuing the financial panic.

As the currency depreciates, it undermines the ability of domestic banks and corporations to pay off their foreign obligations, as they need to raise

more local currency to pay off loans denominated in dollars. They accelerate their buying of foreign currency (a practice called "hedging"), but this in turn forces the local currency to depreciate even faster. The continuing depreciation of the currency weakens the banking/financial system, the original weak link, even further. This downward spiral was most vividly seen in Indonesia in December and January. Similarly in Thailand, the crisis began with a successful attack on the currency peg, and Thai authorities were forced to finally devalue the baht in July 1997. At that point, Thailand had already used up its international reserves in trying to defend its peg (of about 25 baht to the U.S. dollar) since the attacks had been unrelenting since late 1996. As in previous crises elsewhere, the attack on the currency represented a dramatic loss of confidence in assets denominated in the local currency: investments in the local stock market, deposits in the local banking system, and loans to banks and corporations whose underlying assets were in the local currency.

Asia has suffered most where there was too little, not too much, government leadership

Private error, public liability. These financial crises lie chiefly in the province of the private sector. In the case of Mexico and the Asian countries, it is clear that governments, which had been running their finances prudently, had not been indulging in over-borrowing; rather, it was the private sector doing the over-lending and over-borrowing.[iii] However, the heaviest cost of these crises has been borne mostly by taxpayers. There is, therefore, a clear public interest in learning not only how to respond to these crises but also in finding the means to avoid them.

Dealing with Asset and Currency Crises

Response
- Restore confidence through actions and words
- Coordinate currency intervention
- Standardize a reliable response to banking-triggered currency crises

Prevention
- Liberalize financial markets more prudently
- Improve information and transparency
- Reduce incentives for excess private risk taking in lending
- Promote more flexible exchange rate regimes
- Insulate domestic financial systems from short-term capital flows
- Tax and regulate short-term capital flows
- Create new international regimes for coordination and mutual surveillance

Blame the "Asian Way"?

Blame is now being heaped on "the Asian way." The recriminations against the waste created by government-controlled corporations in Latin America in the 1980s have given way to accusations about the "incestuous" relationship in Asia between the government and the private sector. The floor is now open for calls to initiate a thorough cleaning out of the Asian way of doing business—as if Asia can be viewed as a monolith and the so-called "Asian way" can be structurally transformed overnight.

With their boom turning into an economic rout, Asian countries are particularly vulnerable to recriminations in the aftermath of boastful claims of superior "Asian values" made by many of the region's leaders. To say, however, that the weaknesses that have led to Asia's current problems are specifically Asian in character fails to explain how the U.S. savings-and-loan disaster—with its own "incestuous" dealings—could ever have occurred in the United States, where presumably there is no excess of Asian values.

Contrary to popular opinion, it was not over-involvement of Asian governments in economic development that created the crisis. The crisis has, in fact, been most severe where Asian governments retreated from their leading roles in development. The real failing rests with those governments that failed to curb excessive borrowing from abroad and failed to supervise the lending activities of their banking sectors when they became too aggressive.

In retrospect, it is clear that with their new-found freedom, banks and domestic financial companies needed to rapidly establish the capability to evaluate projects and judge creditworthiness. This

Asian companies suddenly had the freedom—but not the expertise—to borrow and lend aggressively

capacity had never been as important previously when the clients were the governments, state-related companies, and blue-chip private firms. The companies never did adequately develop this capacity, but this did not stop inauguration of intense competition in domestic financial systems in which dominance depended on the outcome of a "race to the swift" in expanding lending portfolios. Banks became very aggressive in hiding some of their lending from their balance sheets so they would not be subject to government supervision.

In the U.S. savings-and-loan disaster; the lending boom in the Scandinavian countries; and the failures in Chile, Argentina, and Uruguay; failure to manage the liberalization process is key to understanding the roots of the crisis. When regulations on financial systems are relaxed, excess risk taking in lending becomes attractive. It should come as no surprise that when restrictions are relaxed on those to whom loans can be extended or from whom funds can be borrowed, private friendships and networks become even more important. This is so not only in Asia, but around the world.

Asian nations, like others before them, relied on the private sector to enlarge the financial system and to diversify the kinds of assets that could be bought and sold. But it was the response of public authorities to signs that the soundness of the liberalized financial system had been compromised that is the critical factor in how events unfolded. Five years ago, the first bank failures began in Indonesia; three years ago a few Thai finance companies began experiencing difficulties. Alarmed by the rapidly rising property prices and overexposure of banks to its property lending, Singapore in April 1996 imposed a heavy tax on re-sales of property within three years of purchase. In the second half of 1996, the Philippines restricted further lending for property purposes.

It was at this point that the so called Asian incestuous relationships came into play: Bankers and public authorities in these countries avoided large failures by providing rescue funds, disguising losses and thus discouraging a change in private sector practices. Many Asian bankers and regulators had learned well the approaches to hiding poor investments (a practice called "parking") that had been practiced so assiduously by Drexel, Burnham, and Lambert and other junk bond dealers in Wall Street during the previous decade.

Table 1. Costs of Some Systemic Banking Crises with Heavy Capital Inflows[xiii]

Country	Scope of crisis	Cost of rescuing banks (% of GDP)
Argentina 1980-82	16% of assets of commercial banks; 35% of total assets of finance companies	55.3
Chile 1981-83	45% of total assets	41.2
Israel 1977-83	Entire banking sector	30.0
Finland 1991-93	Savings banks affected	8.2
Mexico 1995-?	Commercial banks past due to gross loan ratio reaches 9.3% in February 1995	12-15

Dealing with Crises

As the expansion of financial markets and networks becomes truly global, governments around the world, not just in Asia, must learn to deal with currency crises, both in terms of prevention and response. The Asian crisis is the third attack on a set of currencies in this decade alone. The first brought down Europe's Exchange Rate Mechanism (ERM) in 1992–93, and forced the U.K. and Italy out of the system. In 1994–95, sparked by Mexican devaluation and economic crisis, the Latin American currencies, most notably Argentina and Brazil, came under attack and had to be devalued. Each of these crises has entailed domestic and international costs which all parties want to avoid in the future.

The first response to an emerging crisis must be to recognize its features. These are a generalized collapse in the prices of domestic assets, the short route to which is an overall loss of confidence in the soundness of the banking system. Particularly in Asia where the production and export sectors were quite robust before the crisis, the situation can be seen as a genuinely "Keynesian-style" crisis in which

loss of confidence in asset markets can seriously undermine the performance of output and employment and where sharp declines in asset prices (such as the exchange rates of currencies) can be quite extreme expectations for economic recovery.

Responding. Several key actions must be taken to effectively respond to asset crises.

Restore confidence through actions and words. The first obligation of governments is to step in and stop a flight of private actors by rebuilding confidence. Credible disclosure of the problems in the banking sector and clear explanations of how the government will resolve these problems are especially important. Governments should loudly enunciate their adjustment programs and fully meet their obligations under these programs.

Coordinate currency intervention. Exchange rates of emerging economies are more tightly linked than ever before to international events. It is now clear that a devaluation in one currency can trigger an attack on other currencies. This means that single-country IMF programs will be insufficient and will often be overtaken by external events. The Thai IMF program did not take into account that a Thai devaluation would cause the devaluation of other Southeast Asian currencies, which then would prompt additional investment withdrawals from Thailand. To make things worse, the November devaluations of the Korean won and the Japanese yen encouraged still further withdrawals from Thailand. Coordinated regional exchange rate intervention or plans for how central banks will carry this out are essential in a single-country adjustment program.

Contracting demand and slowing growth weaken companies' earnings and their ability to repay loans

Standardize a reliable response to banking-triggered currency crises. Attempts must be made to standardize the international response to a banking-triggered currency crisis, so that when the formalized response is put in place, all parties, especially international fund managers, can see a path to recovery. The standard IMF package is not oriented to the rehabilitation of the domestic banking system; rather, it is designed to shrink domestic demand and bring imports rapidly into balance with exports. The approach has proven wanting, and the case of Indonesia, which sought IMF protection very early, is instructive.

Indonesia had a modest current account deficit[1] of about 4 percent of Indonesia's output, so that a required IMF package aimed at further contracting spending for imports and investment did not have to be too aggressive. Moreover, the economy would already have been contracting as the banking system buckled under the currency devaluation and investment dried up.

What was really at stake in Indonesia was the ability of domestic banks and corporations to service foreign debt, especially short-term credits that normally have to be paid back within a year. The IMF program was supposed to assure short-term creditors that Indonesia could pay these credits when they came due and that foreign creditors should maintain their credit lines as before. Even under the IMF program, however, the rupiah continued to fall and Indonesian banks found it more and more difficult to repay these credits. In the end, they had to renegotiate short-term credit lines at higher cost.

An alternative adjustment package for the circumstances seen in Indonesia and elsewhere in Asia would immediately recognize the trade credits problem by providing resources *specifically* for this purpose based on best estimates of what would be required. A country's trading partners could be active in this regard. This explicit recognition provides an adjustment map not present in current programs. These packages would also recognize more explicitly the need to halt further currency depreciation (which weakens banks by making it more expensive for them to service their foreign debt) and be cautious about contracting demand and slowing growth, both of which weaken the earnings of companies to whom banks have made loans.

Preventing crises. The increasing cost of the Asian bailout package underlines the extreme importance of prevention. The size of the successful Mexican rescue package in 1995 at US$48 billion was unprecedented for its time. Subsequently, in less than six months, enormous bailout packages of

[1]The current account deficit indicates the rate at which a country is borrowing from abroad because its exports are insufficient to pay for its imports and investment spending.

US$17 billion (Thailand), US$57 billion (Korea) and US$43 billion (Indonesia) had been committed, with talk of more to come.

Liberalize financial markets more prudently. Insights gained from the market collapses of the Latin American and Scandinavian countries point to the importance of properly managing liberalization of financial and capital markets.[iv] Yet, this lesson seems to have been lost when it comes to Asia. Stronger supervision of banks, as well as strengthening the capacity of public authorities to supervise banks as they diversify into new areas, are called for. In the case of Thailand, professionals left the public sector to join the growing banking sector just as liberalization proceeded. Thus, just as the Thai public sector required more expertise in overseeing a burgeoning and more sophisticated banking sector, it was losing its best personnel.[v]

Thai and Korean authorities tried to force private parties to accept their losses; it is not clear if they succeeded

Improve information and transparency. Many are calling for increased transparency and disclosure requirements in domestic Asian capital markets, a process Asia had already begun as part of its financial liberalization.[vi] During the period just preceding the collapse, existing inadequacies did not prevent foreign investors from rushing in and particularly favoring investments in the companies of those known to be politically well connected. Ominously, the same thing is currently happening in Russia and some other European transition economies. As a means of appeasing the currency markets, the process of improving transparency is accelerating in Asia and will elicit much international support, especially from the United States.

Bankruptcy procedures also have to be upgraded, or put in place where these do not exist, as countries rely more on their own private companies borrowing from private sources overseas. In the meantime, governments in the industrial economies should aggressively inform their citizens and fund managers of the all-or-nothing stakes they accept when they invest in countries where bankruptcy procedures are lacking. Where they have the means to impose higher reserve requirements on these investments, they should do so.

Reduce incentives for excess private-risk taking in lending. The Mexican, Thai, Korean, and Indonesian rescue packages have once again raised so-called moral hazard issues, just as did the debt rescheduling packages of the 1980s. At issue is the extent to which the government will provide after-the-fact guarantees on, or accept responsibility for, servicing debt undertaken between private parties across international borders. Inserting public responsibility into these transactions creates incentives for excessive private risk taking in short-term lending. The debt negotiations in the Thai and Korean cases saw explicit attempts by public authorities to force private parties to accept losses on their loans; but it is not clear if they succeeded. These efforts should be intensified in the future and coordinated among the concerned governments.

The G7 finance ministers' meeting at the end of February 1998 produced an official communique calling upon the private sector to play a greater role in debt restructuring during these types of crises. This clearly signals that G7 governments will be asking lenders to accept their losses more quickly, thereby reducing the moral hazard problems. Taxes on external borrowings and the proposal to create an international guarantee corporation (see below) can also force private parties to internalize some of the risks they are presently ignoring.

Promote more flexible exchange rate regimes. Countries that are liberalizing their banking and capital markets should permit more flexibility in their currency exchange rates. In the Asian case, during the period of "euphoria," completely flexible exchange rates would have permitted sharp appreciations in Asian currencies as foreign investors snapped up domestic financial assets. Such increases in currency values would have prevented the enormous injections of foreign funds into the domestic banking system—funds that were then poorly invested.[vii] The currency appreciations, however, would also have undermined the competitiveness of Asia's exports, raising the hackles of export-oriented businessmen. In an effort to control similar dynamics, Chile has enjoyed some success in unpredictably

permitting sharp currency appreciations to dampen interest on the part of foreign funds to buy Chilean assets. Chilean authorities follow these unpredictable appreciations with gradual depreciations to protect the competitiveness of exports.[viii]

Insulate domestic financial systems from short-term capital flows. Various means to insulate the development of the domestic banking system from dependence on short-term external funds is another priority.[ix] This can be achieved through a combination of capital controls (including prohibiting non-residents from purchasing short-term assets) and regulatory practice.[x] Taxes on incoming short-term investments, such as those imposed by Chile, can also reduce over-reliance on short-term funds and force borrowers and lenders to take into account the cost of the increasing possibility of currency crises as the volume of short-term investment in an economy increases.

Tax and regulate short-term capital flows. In the international sphere, discussions of the "Tobin tax,"[2] which is like the Chilean tax on short-term investments but which would be implemented on a worldwide basis to slow the speed of capital movements, intensified after the 1992 crisis in Europe's Exchange Rate Mechanism. But policy-makers' interest in a regime that requires coordination among all the major countries has been tepid. The 1997 Denver G7 summit did, however, recognize the importance of searching for ways to monitor international capital flows. George Soros, the currency hedge-fund entrepreneur who clearly had the pivotal role to play in the 1992 ERM crisis and who has been accused of being instrumental in the Asian crisis, has warned that with the Asian crisis the "international financial system appears to be suffering a systemic breakdown."[xi] He has suggested creating an international regime to counter the over-investment followed by over-withdrawal syndrome as seen in Asia. This would consist of an "International Credit Insurance Corporation" that would guarantee international loans for each country for a modest fee. The amount of loans the authority would guarantee for each country would be based on the authority's judgment as to the ability of a country to service the debt.

A proposed global tax regime aims at slowing international capital movements

Domestic financial institutions, especially in the industrial economies, are regulated in their local operations but are quite unregulated in their international lending activities. The imposition of taxes or fees for the guarantee of loans is a first, and necessary, step in regulating these latter activities.

Create new international regimes for coordination and mutual surveillance. Creation of new international regimes ready to implement these crisis responses is important to the overall prevention strategy. In particular, standard adjustment packages must be designed for broader economic emergencies emanating from banking crises. Ways must also be established to coordinate currency intervention. After its November 1997 meeting in Manila, several member countries of the Asia Pacific Economic Cooperation (APEC) forum called for "mutual surveillance" at the regional level among economies with linked exchange rates and increasing and regular consultation among central banks as a precondition for future cooperation in currency intervention. This idea holds considerable merit.[xii]

Asia's Role

Asia is but the latest victim of high volatility in short-term investment flows (both into and out of countries). As such it has an opportunity to play a positive role in efforts to improve international capital arrangements. Such efforts are key to ensuring that in the aftermath of the crisis Asia's damaged economies recover speedily.

In planning for this recovery, Asia has the advantage of possessing high savings rates and generally solvent, if weakened, government finances. Asia's growth was fueled by these high savings rates and they make Asia less dependent on short-term funds both to close current deficits and to finance its development ambitions. Indeed, it was the infusion of large amounts of short-term funds that undid the miracle by encouraging too much lending for unviable projects.

[2]Suggested by Nobel prize-winning Yale economist James Tobin.

What Asian economies most need is help in protecting their currency values

What Asian economies truly require is assistance in establishing adequate international hedging capabilities with which to protect their currencies and improve the predictability of the exchange rate for their importers and exporters. Asia's own private financial and banking companies are only beginning to internationalize. They do not yet have a vested interest in preventing the installation of rules that would increase the stability of international movements of short-term money. As beneficiaries of Asia's high savings rates it is in their interest to protect Asia's own savings.

Asia, therefore, has a clear incentive to support new international regimes to stabilize international capital markets.

Reform, of course, begins at home, with more prudent approaches to liberalization. It remains to be seen whether the governments and the private sectors in Asia will seize the opportunity to influence decisively international reform efforts, or proceed unilaterally at their own peril.

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