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The Asian Financial Crisis:
What Happened, and What is to be Done

Abstract

We identify the Asian financial crisis to be the result of the instabilities of short-term capital flows, inadequate prudential supervision in the financial markets of the developing countries, mistaken commitments to the fixed exchange rate regime, lack of international coordination in the regulation of international financial markets, absence of an international mechanism for the orderly working out of international debt, and inappropriate "rescue" packages imposed by the IMF. We recommend 30 policy reforms to make the international economy more resilient to financial turmoil, and to reduce the costs of such turmoil.

We conclude that there is little particularly 'Asian' about the Asian financial crisis. Even though official Washington, led by the IMF, proclaimed the crisis to be one of Asian capitalism, the more generic character of the crisis became all too clear during 1998, as the crisis spread to Russia, South Africa, and Brazil. Rather than an Asian crisis, the world is experiencing a type of global crisis that reflects the rapid arrival of global capitalism, in a world economy not yet used to the integration of the advanced and developing countries.

Because we see no justification for the monopoly position of the IMF as the sole international institution on monetary affairs, we advocate the formation of regional monetary bodies to provide mutual support in the event of a financial crisis hitting one or another member country. We also advocate that an international bankruptcy system be established in order to accelerate an orderly workout of international debts when a developing country falls into an extreme indebtedness crisis. Existing key international organisations like the IMF have performed poorly, and they must be reformed to render them more transparent in their operations, and more democratic in their governance. Developing countries must have a greater role in designing future rescue packages extended to financially distressed countries so that rescue packages will no longer be biased toward the interests of the creditor countries. The new global financial architecture should have generalised floating of currencies as its mainstay.

The bad debts of the financial and corporate sectors in Pacific Asia to be quickly resolved by the infusion of public money, and the takeover of some large domestic banks by foreign banks. Furthermore, the revival of the corporate sectors in Asia requires international creditors to write-down the value of their loans, and to convert part of their loans into equity participation. There is a serious mismatch in Pacific Asia, particularly in most of Southeast Asia, between investment in physical hardware – factories and machinery – and investment in the social software – scientific research centers, administrative and judiciary systems, and growth of civil society. In a world of growing international competitiveness, when foreign direct investors are courted not just by Asia but Central Europe and Latin America, the concerns over governance are bound to grow, and to weigh increasingly heavily on the unreformed countries of Asia. The long-term competitiveness of Asia rests as much on "getting its institutions right" as on "getting the prices right."

Keywords: financial crisis, financial contagion, international financial architecture

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The Asian Financial Crisis: What Happened, and What is to be Done

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A storm has blown though Pacific Asia. Output has fallen across the region, and so have the governments in a number of countries. The causes of the economic storm are still under debate, key international organizations that have long shared a common policy framework are now divided on what to do, and predictions of recovery vary tremendously. The Pacific Asian economies that have long been hailed by many analysts as models for the rest of the developing world are now depicted by some of the same analysts as unsustainable nests of crony capitalism.

The claim that the Pacific Asian economies had imperfect economic institutions (for example, inadequate banking supervision and collusive relations between big businesses and the government officials) is surely correct, but to go on to claim that these flawed economic institutions had reached breaking points simultaneously and thereby ignited the region-wide economic crisis is also surely incorrect. The second claim would be like focusing exclusively on deforestation in Central America when discussing the damage wrought by Hurricane Mitch, while ignoring the damage from the hurricane itself. Yes, policy failures matter, but they are only part of the story in Asia's financial storm. As much attention should be paid to the financial "hurricane" itself, specifically, the tendency for international financial markets to over-react both to positive and to negative news. It was financial panic among international investors that brought Pacific Asia to its knees in 1998. Fortunately, the underlying fundamental strengths of the region will also bring an economic recovery faster than is widely predicted.

In general terms, we can say that there was little particularly "Asian" about the Asian financial crisis. Even though official Washington, led by the IMF, proclaimed the crisis to be one of Asian capitalism, the more generic character of the crisis became all too clear during 1998, as the crisis spread to Russia, South Africa, and Latin America. Rather than an Asian crisis, the world is experiencing a type of global crisis that reflects the rapid arrival of global capitalism, in a world economy not yet used to the integration of the advanced and developing countries. The 1994-95 foreign exchange crises in Mexico and Argentina and, less severely, in the rest of Latin America via the "tequila effect" of 1995, were the high-profile precursors to the financial market crisis that hit Pacific Asia in mid-1997. The Asian financial crisis is really another example of financial panic involving international creditors, though of course the onset of financial panic reflected some of the conditions specific to Asia in 1997.[1]

The extent of economic devastation in each Asian country differs according to specific national structural conditions and policy reactions; for example, the amount of international debt, the proportion of international debt that is short-term, the adequacy of financial sector regulation, the amount of foreign reserves available to the monetary authorities, the tenacity with which the country defended its exchange rate, the degree to which IMF-style high interest rates and bank closing were implemented (with adherence to IMF programs often doing more, rather than less short-term damage), and the ability of the political system to preserve social stability while coping with economic shocks. The solutions to the crisis require responses both at the international level – to address shortcomings in the nascent global capitalist system – and at the regional and national levels, so that Asia can maintain and improve its competitiveness in a globalized economy.

[1] A less well-known, but also dramatic, precursor was the Turkish financial panic in 1994.

Naturally, there remains a deep division of professional opinion about the sources of the crisis (national versus international), the reasons for Asia's extreme vulnerability (poor policies versus private-sector instabilities), the appropriate policy responses (financial orthodoxy á la the IMF versus financial heterodoxy of various forms), the best ways to guard against a recurrence of crisis in the future (national level reforms versus a new global architecture). We review the arguments here and stake out our own position on the basis of the evidence in this report. In our view, the crisis was built on national weaknesses that were greatly magnified by a flawed international financial system; the initial policy recommendations from Washington, especially to raise interest rates sharply and to close a large number of financial institutions were deeply flawed, and made matters worse, not better; and long-term crisis prevention requires actions both at the national and international levels, including a basic change of strategy in exchange rate management and recognition of the inherent destabilizing risks of short-term capital flows.

The most general and important point is that global capitalism has to be understood better by global policy makers, national political leaders, and business people in all parts of the world. All of these participants in the new global economy have to recognize the types of shocks that have been magnified and rendered more common by the processes of deep economic integration and of institutional harmonisation that are key forces of global capitalism. Only with a better comprehension of the new realities will the world community be able to take true precautionary measures to head off a future crisis, and will Asia be able to make a swift recovery from the deep crisis which now engulfs the region. In short, we need to rise to the challenge of developing a new policy framework and new business strategies that are appropriate for global capitalism.

Our analysis is organized as follows. Section II offers a conceptual framework to understand the onset and evolution of the 1997-98 financial crisis. As explained below, the crisis resulted from the interaction of: (1) problematic macroeconomic policies (especially exchange rate policies) in the emerging markets, (2) shortcomings in the financial sectors of the borrowing countries, and (3) intrinsic instabilities in the global financial markets. These problems interacted with some deeper weaknesses in Asian competitiveness to trigger the sharp financial crisis of the past two years. Section III outlines the different stages in the recovery process; relates the 1977-78 crisis to earlier financial crises in developing countries; and presents our assessment of the prospects of recovery in the Asian crisis countries. Section IV discusses a wide range of policy options for reform of the international financial architecture, including: macroeconomic policy design in developing countries; the regulation of international capital flows; the revision of the roles of the IMF, the United Nations agencies, and other institutions; and the redesign of international financial assistance itself, including accelerated debt reduction.

II. Understanding the Asian Financial Crisis

A Theoretical Framework

Before we delve into the specifics of the Asian crisis, we need a general theoretical understanding of how international capital markets work – and fail to work – in the new global capitalist system. Thus, we start with some general theoretical ideas, and only afterward focus on the Asian experience.

Emerging market financial crises, such as in Asia in 1997-8, are characterized by an abrupt and significant shift from net capital inflow to net capital outflow from one year to the next. These crises typically reflect a three-stage process that hits a developed country engaged in large-scale international borrowing. In the first stage, the exchange rate becomes overvalued as a result of internal or external macroeconomic events. In the second stage, the exchange rate is defended, but at the cost of a substantial drain of foreign exchange reserves held by the Central Bank. In the third stage, the depletion of reserves, usually in combination with a devaluation, triggers a panicked outflow by foreign creditors holding short-term claims. The trigger in most cases is the devaluation itself, resulting from the exhaustion of reserves. The panicked outflow of short-term capital leads to macroeconomic collapse, characterized by a sharp economic downturn, soaring interest rates, depressed equity prices, and a plummeting currency.

Some observers have attributed such crises to currency devaluation, since the panics have almost always followed a movement in the currency. This was certainly the case in Asia, since the Asian crisis followed soon on the heels of the unexpected devaluation of the Thai Baht, on July 2, 1997. Similarly, Korea's extreme crisis came in December 1997, following the devaluation of the Korean won. As a result of these instances, and the early case of Mexico's devaluation in December 1994, these observers concluded that currencies should be fixed in value and never allowed to weaken. We disagree with these observers. In our view, it is not the devaluation, but rather the defense of the exchange rate preceding the crisis that opens the door to financial panic. A gradual weakening of the currency by itself is not harmful -- as exemplified by the successes of many countries with flexible exchange rate arrangements, including Chile, Canada, Australia, and New Zealand.

The real harm comes from the depletion of foreign exchange reserves while trying to defend an overvalued currency. A devaluation which follows the depletion of reserves can indeed trigger a panic, but the lesson is to allow the currency to weaken <u>before</u> the reserves are depleted. When foreign reserves are depleted, short-term interbank credits in particular become subject to an abrupt, self-fulfilling loss of confidence. In summary, the devaluation signals the depletion of reserves; the depletion of reserves signals the inability of the Central Bank to act as a lender of last resort vis-a-vis foreign creditors; the short-term foreign creditors flee in panic; and the macroeconomy collapses as a result of the creditor flight.

Creditor Panic

The ubiquitous feature of recent emerging markets crises is that the exchange rate defense, typically ending in a devaluation, has often been followed by a rapid and ferocious withdrawal of credits by foreign investors. It is the panic, not the devaluation itself, which leads to the acute damage to the emerging market and to the creditors.

Typically, some key segments (e.g. banks, non-financial enterprises, and government) of the fast-growing Asian economies are heavily in debt to foreign investors, including international banks, hedge funds, and other investment funds. Much of this debt is short-term, i.e. with maturity under one year. Additionally, much of the debt has trigger clauses, such that repayment is immediately accelerated in the event of a contractual default by the debtor to other creditors. The borrowing, in general, has been converted into long-term, relatively illiquid investments. As a result, total short-term debt is often significantly greater than the available short-term assets that might be mobilized to repay creditors in the event of a withdrawal of new lending.

The level of central bank forex reserves is crucial because the central bank is widely, and rightly, understood to be the lender of last resort not only to the banks, but to the government and corporate sector as well, in the event of an external creditor panic. Suppose that foreign banks begin to withdraw credit lines from domestic banks, demanding repayment of outstanding loans. This immediately leads to financial distress in the banking system, since the banks have transformed the foreign loans into long-term investments. The bank may, to some extent, use liquid domestic assets to purchase dollars in the foreign exchange market, but even so, the bank is unlikely to have sufficient liquid assets on hand to meet a large-scale withdrawal of funds. Thus, the central bank will almost surely have to extend credit, either directly as foreign exchange loans, or as domestic credit which is then sold in the forex market. In the latter case, of course, the exchange rate will depreciate in the absence of official intervention.

Once forex reserves have been depleted, the central bank's lender-of-last-resort functions are deeply compromised, and international creditors understand this fact very well. In these circumstances (depletion of forex reserves, and a high level of short-term debt), the economy becomes vulnerable to a self-fulfilling run. Even if economic fundamentals are adequate to ensure long-term debt servicing without default, they are not adequate to guarantee short-run debt servicing in the event of a panic. Thus, a panic can unfold simply by the self-fulfilling belief of creditors that it will indeed occur. This explains the finding by Radelet and Sachs that when the ratio of short-term debt to forex reserves is greater than 1, the country is prone to a creditor panic.[2]

In the past four years, financial panics have been triggered mainly by three types of events:

1) the sudden discovery that reserves are less than previously believed

2) unexpected devaluation (often in part for its role in signaling the depletion of reserves)

3) contagion from neighboring countries, in a situation of perceived vulnerability (low reserves, high short-term debt, overvalued currency)

It is interesting and important to stress that currency devaluation, following a long defense of the exchange rate, has typically been the most important trigger of panic. This seems to be the result of several factors. First, many investors have been caught off guard by the

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[2] Steven Radelet and Jeffrey Sachs, The East Asian Financial Crisis: Diagnosis, Remedies, Prospects," Brookings Papers on Economic Activity, 1998: 1, pp. 1 - 90

devaluation even when it has been widely discussed. These investors seem, incredibly enough, to have taken at face value, the solemn commitments of governments not to devalue. Second, the devaluations are often the signal that forex reserves are lower than publicly announced up to that point. In Mexico, the late-December 1994 devaluation "revealed" the steep loss of reserves in early December 1994. In Thailand, the July 2, 1997 devaluation was followed by public announcements that the Thai Central Bank had a large book of forward dollar sales. These dollar sales were not previously announced, and came as a large jolt to the market. In Korea, the December 1997 devaluation was the occasion for revealing that much of the Central Bank's announced forex reserves were actually illiquid claims on Korean banks, the result of preceding unannounced deposits of the reserves in offshore Korean banks experiencing a run on inter-bank loans (in effect, the Central Bank had been making unannounced extensions of credit to offshore Korean banks). Speaking in the most general terms, the collapse of pegged exchange rate regimes appeared to have been regarded as "serious breaches of faith" by foreign investors, causing them to recall their loans even though the devaluation has already occurred.

When the panic gains full force, the effects are devastating. The rational behavior of each short-term creditor is to demand repayment as rapidly as contractually possible, and to suspend routine inter-bank lines which support letters of credit and other standard trade financing operations. Long-term fundamentals cease to play any role in investor thinking, since the logic of *sauve qui peut* dominates in a creditor scramble in which creditors are serviced on a first-come, first-serve basis. The macroeconomic results are a huge overshooting: (1) debt is drawn down even when domestic investments (e.g. in working capital, letters of credit, etc.) have a rate of return vastly greater than the world cost of capital; (2) the real exchange rate depreciates sharply, far overshooting any real correction that needs to be made; (3) the current account swings wildly from deficit to outright surplus; (4) the banking system suffers illiquidity, and perhaps an ancillary panic by domestic savers; (5) market real interest rates soar to astronomical levels, as each borrower scrambles to mobilize funds to avoid default; and (6) partial default on forex obligations becomes almost assured. The key effects on macroeconomic contraction are: (1) the collapse of bank lending leading to a collapse of trade and production; and (2) the conversion of illiquidity into insolvency over the course of a few months, as loans become non-performing under the weight of reduced production and sales, and the crushingly high interest rates on working capital.

Economic Policies During a Financial Panic

In order to minimise the output collapse, it is imperative that the central bank takes the following two steps to keep the payments mechanism of the economy intact. The first step is to prevent the generalised panic sparked off by the failure of the bad banks from rendering the good banks illiquid and causing the good banks to fail too. This means that the central bank must extend sufficient reserves to the good banks to meet the withdrawal of deposits but not sufficient for them to extend new loans to finance speculation against the currency.

The second step to protect the payments mechanism is for the central bank to ensure that the good customers (especially if they are exporters) of the failed banks continue to receive working credit to keep production going. This means that the central bank musk keep the operations of failed banks going while restructuring their balance sheets for eventual sale. Again, the emphasis is on maintaining the volume of working credit to existing clients. The crucial point to keep in mind is that the creation of new reserves is to accommodate the private sector's shift out of bank deposits into currency and not to fuel the run from domestic assets to foreign assets.

During a financial panic, the central bank has to choose maintenance of the domestic payments system and of output level over maintenance of the existing exchange rate. The central bank should float the currency and allow currency depreciation to discourage capital outflow. Some banks may fail because of the exchange rate induced increase in the value of their foreign liabilities, and the central bank must keep the operations of these banks going in order to keep production credit going to the good firms. With the amount of working credit in the economy unchanged by the financial panic, domestic firms can increase exports to take advantage of the currency depreciation.

The resulting growth in exports coupled with the stability of output will help to restore confidence in the economy, prompting domestic agents to repatriate their capital from abroad and foreign creditors to resume lending, and the final outcome will be an appreciation of the currency from its over-depreciated value (although possibly not up to its pre-crisis value). The important implication is that banks that had been bankrupted by the exchange rate induced increase in value of their foreign liabilities are now likely to be solvent again.

In light of the analysis above, we see the error of the first IMF packages that were implemented in Thailand, South Korea and Indonesia. The tightening of monetary policy in order to raise interest rates to prevent further currency depreciation, the abrupt closure of bad financial institutions, and the raising of prudential ratios, all created a tremendous credit crunch that dramatically deepened the output decline, and that inflamed the panic. The closure of the bad financial institutions, particularly in Indonesia where there was no depositor insurance, spread the financial panic to the good banks. The fact that fiscal policy was also tightened ensured the crashing of these economies.

Our objection to the first IMF packages that were implemented in the crisis countries should not be interpreted as a general objection against closing of bad banks and against the adoption of higher BIS-style prudential ratios. We are only objecting to the implementation of these two actions in the middle of a financial crisis. It is the timing of the implementation of these two policies that was wrong.

Applying the Framework to Asia

Our interpretation of financial crises is a general one, not specific to Asia. But the analysis fits the Asian experience very well. All of the countries that got into trouble in Asia (especially Indonesia, Korea, Malaysia, and Thailand) shared three main characteristics. First, they were very successful economies, so that they were able to attract significant inflows of capital during the 1990s. Second, all of the countries maintained exchange rates that were practically fixed to, or depreciating at pre-determined rate against, the U.S. dollar during the 1990s. Third, the combination of capital inflows and fixed exchange rates pushed the economy into a position of vulnerability, characterized by an *overvalued currency, falling foreign exchange reserves, and a high level of foreign debt*, especially short-term debt. As discussed earlier, once the overvaluation of the currency became apparent to investors (by the end of 1996 in the case of Thailand, and by mid-1997 in the case of the other economies), currency speculation led to the worst of all worlds. To honor their exchange rate commitments, these countries simply depleted their foreign exchange reserves defending their overvalued currencies. When reserves fell to low levels, the foreign creditors panicked and demanded immediate repayments of loans, rather than rolling the loans over -- which would have been mutually beneficial for the creditors and the debtors alike.

In fact, in the case of Asia, we can definitely view the crisis as a "crisis of success" rather than a crisis of failure. Only successful economies would have been able to attract so much capital inflow as did the Asian economies. Ironically, these economies did not really need so much foreign capital. During their high growth phase of the 1980s, the Asian countries tended to save around 25-30 percent of GDP and to invest a similar amount, so that they relied little on foreign borrowing. In the early 1990s, these countries liberalized their financial markets with the effect that domestic banks and corporations could suddenly borrow from abroad, thereby raising the investment rates even higher than the already high levels of domestic saving. There was certainly no shortage of willing foreign lenders. As a result, the ratio of investment to GDP rose to around 35 percent or more, with 5 percent of GDP or more being financed by foreign loans.

There is plenty of evidence that neither the foreign nor domestic financial markets were able to allocate the increased investments very efficiently. Both microeconomic and macroeconomic data support the view that the incremental investments in the 1990s were only moderately profitable. Too much money poured into speculative real estate projects, for example in downtown Bangkok. There is also a fairly clear over-investment in sectors such as memory chips, especially among the copy-cat Korean *chaebols*. Still other investments were thoroughly wasted in crony projects such as the abortive "national car" program linked to former President Soeharto's family. Yet, even though the incremental investments added little to economic growth, they were hardly a disaster on average, and certainly not a sufficient explanation for an abrupt economic collapse.

The collapse came mainly because of the macroeconomic problems outlined earlier, not the microeconomic inefficiencies of the investment boom, though such inefficiencies certainly added to the troubles. More important was the fact that the investments were financed by short-term loans, under conditions of pegged exchange rates (or, in the case of Indonesia, a crawling peg). As the capital inflows proceeded in the 1990s, domestic prices and wages were bid higher. As a result, the wage level expressed in dollars began to creep up to unsustainable levels. The steady devaluation of the Chinese Yuan in 1991-94 (through the swap market mechanism) further decreased the competitiveness of these countries. Then, when the U.S. dollar appreciated sharply relative to the Japanese Yen and the European currencies in 1995 and 1996, these currencies appreciated alongside the dollar, further eroding international competitiveness of these countries. Export growth faltered severely in 1996 as a result. By the end of 1996, market participants began to suspect the need for a currency depreciation in several Asian countries, most notably Thailand.

The rest, as they say, is history. Thailand depleted its foreign reserves in an ill-fated attempt to stabilize its currency. After using most of its reserves, it announced defeat on July 2, 1997, allowing the Baht to depreciate. The IMF announced several draconian measures for the Thai economy, most notably a sharp increase of interest rates, a significant cut in budget outlays, and a dramatic closure of 58 finance companies. The combination of depleted foreign reserves, high levels of foreign short-term debt, and market anxieties surrounding the tough IMF measures, all conspired to produce a full-fledged financial panic. The panic spread to the rest of Pacific Asia, engulfing Indonesia and Malaysia in the Fall of 1997, and Korea in December 1997.

When the crisis hit, many observers began to point out some of the weaknesses of the Asian economies: poor banking supervision; excessive lending in the 1990s; cronyism in the allocation of loans; and so forth. These weaknesses were, and are real, but they hardly explain Asia's collapse. The Asian economies were not "miracle" economies to be sure, but they were also not disasters waiting to happen, except as victims of global panic. These economies were, overall, somewhere in the middle of the world's major economies in terms of institutional quality, good enough to achieve rapid growth given that they were starting at fairly low levels of income (and therefore with plenty of room to import technologies to catch up with the leaders). For example, the World Economic Forum's Global Competitiveness Reports consistently ranked the Asian economies just a bit above average in overall competitiveness. For example, of the 53 countries evaluated for competitiveness in 1997, Indonesia ranked 15th, Thailand ranked 18th and South Korea ranked 21st. Investors knew about the weaknesses, at least in broad terms, but they also knew about Asia's great strengths: high rates of domestic saving; export promotion policies; a skilled and disciplined labor force; private-market orientation. What nobody counted on was a suddenly withdrawal of foreign credits that would bring these economies to their knees.

III. Setting the Stage for Asian Recovery

Three Stages of Asian Recovery

When a financial panic hits, all macroeconomic systems go awry. Since lenders demand immediate repayments on short-term loans, credit dries up entirely. Most firms are completely cut off from further borrowing, while market interest rates soar to the stratosphere. Cash-strapped enterprises, pressed to repay foreign debts that are being called, try to buy up dollars at any price. The exchange rate therefore collapses, reaching absurdly depreciated levels. The banking system becomes illiquid. Not only are domestic banks unable to open letters of credit on behalf of exporters (since foreign banks no longer trust the liquidity or solvency of the domestic banks), but they are unable to borrow from each other. If the central bank is playing by IMF orthodox rules, it too will not provide emergency credits to cash-strapped commercial banks. Even the fear of central bank orthodoxy can trigger a banking panic, as the bank's creditors try to escape before the onset of illiquidity, thereby triggering the illiquidity that they fear.

The overall result is economic collapse. Production ceases because of the lack of working capital. Illiquid firms become insolvent as production and sales collapse, while bad debts pile up. The banking sector itself is destroyed as a result of creditor panic, a loss of depositor confidence, and a explosion of bad loans.

Economic recovery, as a result, displays three fairly distinct phases. The first phase is the end of panic. This comes faster than expected by most observers. The idea is simple. The huge panicked outflow of capital comes to an end after a few months, for a combination of three reasons: some of the short-term debts are repaid, some are rescheduled, and some are simply defaulted upon. In any event, the panicked outflow ceases. When this occurs, several healthy developments ensue. The exchange rate strengthens from its absurdly depreciated levels. Interest rates come down from the heavens. And working capital begins to flow again, at least moderately, to cash-strapped firms. We see this first stage well underway in Asia. Since the past summer, interest rates have indeed returned to more normal levels, while exchange rates have strengthened, even in countries such as Indonesia and Malaysia, where political risks are still very high. Panic had pushed the exchange rates and interest rates to such absurd levels that a rebound to more normal financial market prices was likely.

The second stage of recovery is much trickier. The financial panic leaves a legacy of bad debts throughout the economy, which must be cleared up. The banking sector is usually in deep trouble. Bank capital is wiped out by non-performing loans, and perhaps by exchange rate depreciation. (If the banks have borrowed in dollars and lent in domestic currency, they are caught in a whipsaw of currency depreciation). Domestic non-bank enterprises also tend to be in trouble. Months of high interest rates, shortages of working capital, and depressed domestic markets lead to a buildup of unpayable debts. Foreign creditors are often left with a large stock of non-performing loans, so that debt workouts require agreements not only with domestic creditors but also foreign creditors, thereby adding to the administrative and political complexities of the needed adjustments.

All of these problems need to be addressed through a series of debt writeoffs or stretch outs. The banks must be recapitalized, usually through an infusion of public funds (e.g. a takeover of bank capital), followed by a privatization of the public sector's new stakes in the banks. The corporations must renegotiate with their creditors. Debts can be rescheduled, or partially reduced, or swapped for equity (in which case the creditors become part or full owners of the enterprises). These renegotiations can happen informally, or in the context of formal bankruptcy procedures. Unfortunately, most of the Asian countries lack adequate bankruptcy legislation and procedures to ensure that the process can run smoothly and efficiently. Until these debts are written down, one way or another, economic performance will continue to be deeply impaired. Companies with a large stock of debt will be unable to get adequate working capital, much less capital for needed long-term restructuring. The banking sector will remain in a shriveled state, unable to serve as an effective financial intermediary because of inadequate bank capital and a loss of confidence on the part of the banks' depositors and creditors.

The third stage of the crisis – after the end of panic, and the cleanup of debt – is to raise long-term competitiveness. Part of the solution to long-term competitiveness is solved by a turn to flexible exchange rates (thus, ending a period of currency overvaluation), but this is rarely enough. Governments must worry about the effectiveness of basic political and economic institutions – for example, they must control corruption, improve financial market oversight, and reduce the chances of a future bank panic through improved risk management (for example, through a better capitalized banking sector). Even more fundamentally, they must work to improve the quality of the human and physical capital in the economy. Is the education system adequate to keep pace with global technological innovations? Are the country's scientific and technological institutes of sufficient caliber? Is the country stuck in a unproductive export niche (and thereby subject to growing international competition from low-wage economies) or is it able to establish competitiveness in new sectors? As we've noted, the Asian economies were only marginally above average in overall competitiveness even before the onset of the financial crisis. They clearly had lots of work to do in institutional improvements.

Prognosis for Selected Pacific Asian Countries

Before assessing the economic prospects of selected Pacific Asian countries, it is important to note that there have been at least four financial panics in the in the first half of the 1990's: Argentina in 1995, Mexico in 1995, Turkey in 1994 and Venezuela in 1994. Part A of Table 1 shows the GDP growth rates of these economies for the period covered by two years before the panic and two years after the crisis (except for Venezuela which shows three years after the crisis). In three of the four cases of Argentina, Mexico, and Turkey -- the financial panic caused a sharp drop in output for one year, followed by a sharp rebound. The result was a V-shape movement in GNP.

Table 1: Financial Panics and Real GDP Change
(in percent)

Part A: The Precedents

	T-2	T-1	T	T+1	T+2	T+3
	(T=year of panic given next to country)					
Argentina, 1995	5.7	8.0	-4.0	4.8	8.6	
Mexico, 1995	2.0	4.5	-6.2	5.2	7.0	
Turkey, 1994	6.4	8.4	-5.0	6.7	7.3	
Venezuela, 1994	7.3	0.3	-2.9	3.4	-1.6	5.1

Part B: The Pacific Asia Cases

	1995	1996	1997	1998
Indonesia	8.2	8.0	4.6	-15.3
Malaysia	9.5	8.6	7.7	-7.5
South Korea	8.7	7.3	5.5	-7.9
Thailand	8.8	5.5	-0.4	-8.0

(The 1998 growth rates are IMF projections released in December 1998)

Part B of Table 1 shows a similarly sharp output decline for Indonesia, Malaysia and South Korea in 1998 following a slowdown in growth in 1997. If the previous experiences of Argentina, Mexico and Turkey apply to Malaysia, South Korea and Thailand (three countries that are not embroiled in severe political crises like Indonesia), we expect their output collapses to be short-lived. The IMF has, in fact, predicted in December 1998 that Thailand would experience positive growth of 1 percent in 1999.

To anticipate the detailed discussion, we are, on the whole, optimistic about the return of economic growth to the Pacific Asian countries in 1999, especially in the second half of the year. However, while the region is moving beyond the panic stage, and thereby poised for the start of economic recovery, the pace of recovery is still open to question, because of remaining uncertainties about the clean up of debt and of long-term institutional reforms. It should also be noted that our optimism is conditional upon the United States and western Europe continuing to ensure sufficient liquidity in world financial markets by cutting interest rates as necessary; and to keep their domestic markets open to imports despite the left-of-center character of their governments.

In the discussion that follows, we begin with the two largest countries of the region, China and Japan. Even though these countries did not experience panic, each faces a very tricky situation in 1999. We then proceed to the panic cases of Korea and Southeast Asia.

China

China's GDP growth has been slowing every year since 1992, declining to the still enviable rate of 7.8 percent in 1998. Inflation has been wiped out, and retail prices have actually been falling for over a year. The slowdown in the 1993-1997 period was part of a deliberate policy action aimed at denying loss-making state-owned enterprises (SOEs) their accustomed allotments of credit in order to force them to improve their efficiency, and to change their ownership forms if necessary. The safety valve of this strategy of restructuring the inefficient SOE sector through tight credit policy was the export market. Exports grew 20 percent in 1997, helping to provide sufficient aggregate demand to keep growth in 1997 at 8.8 percent.

Now, the strategy is under threat. The negative growth in many Pacific Asian countries in 1998 rendered China's export growth in 1998 to be zero.[3] In response to the unexpected sharp drop in external demand in mid-1998, China greatly increased the scale of the reflation measures that had began in early 1998. The big expansion in bank credit and state investments raised the GDP growth rate from 7.0 percent in the first half of 1998 to 7.8 percent for the whole year.

[3] Omitting Hong Kong because of its entrepot character, 33 percent of China's exports in 1996 went to Indonesia, Japan (which alone took 20 percent), Malaysia, Philippines, Singapore, South Korea, Thailand and Taiwan.

There is, however, considerable skepticism about the official 1998 growth rate, largely, because of the unusually low electricity usage and low volume of goods transported in that year. The actual growth rate could very plausibly be about 1 percentage point lower than the official rate.

Has China managed to avoid, or merely postponed, being part of the Asian financial crisis that has been marked by a severely devalued currency, a collapsed banking sector, and a large output decline? A large speculative run on the Renminbi (RMB) is clearly not possible because of capital controls. Furthermore, China's external short term debt is less than US$30 billion while its nongold reserves stands at US$144 billion; most of the foreign funds in China are tied up in physical investments; and foreign participation in China's stock market has been limited to trade in B-shares which are denominated in US$ and whose ownership are restricted to foreigners.

Some China watchers have claimed that bank depositors are, or will soon be, worried by the large amount of nonperforming loans (NPLs) in the state banks, and that a bank run is inevitable. The result would be a bank crash followed by an output collapse. We find such a scenario implausible despite the high NPL ratio (possibly one third of all loans) because we think that the depositors regard the NPL problem to be one that the government is financially and technically capable of solving. The fact is that if the government is to assume all of the NPLs of the state banks, this would raise China's public debt-GNP ratio to about 50 percent which is still much below the U.S. federal debt-GNP ratio of 70 percent, and which in turn is among the lowest of the G7 countries. Nonetheless, the fiscal costs of the coming bank restructuring will be very large, and tricky to carry out.

China's capital controls have made the current account balance the primary determinant of the equilibrium exchange rate. Although China's trade account balance stood at the all-time high of US$45 billion in 1998, devaluation pressures would be hard to resist in 1999 if there is a significant drop in exports due to displacement in North American, European, and Japanese markets by Korean and Southeast Asian products. Premier Zhu Rongji has pledged that there will be no renminbi devaluation in 1999, and behind that pledge are:

- an assessment that the crisis countries will recover soon, and China's exports to them will increase substantially, ensuring that China's total exports will drop only slightly despite displacement of China's exports by Southeast Asian and Korean exports in the markets of developed countries;
- an assessment that international financial markets will not have calmed down sufficiently in 1999 to absorb a Chinese devaluation without setting off another round of region-wide devaluations; and
- a decision to compress imports by nontariff barriers if a significant trade deficit threatens to appear.

Even though the validity of the first two assessments can be questioned, the fact that China is willing to use administrative means (which have included stripping the military of its large business empire) to curb imports may mean that a renminbi devaluation will be postponed to 2000 -- even though it may be economically more efficient for China to devalue than to resort to temporary protectionism. Furthermore, GDP growth in 1999 is likely to be between 7 to 8 percent because the strong reflationary dosage administered in the last quarters of 1998 should carry into the first half of 1999, and the government appears ready to inject additional liquidity to ensure this outcome.

We see China's biggest challenge to lie not in warding off a dramatic financial crisis but in choosing the correct tradeoff between maintaining low urban unemployment and continuing to move decisively on systemic reforms. The choice is between short-term political comfort but future crisis versus short-term political conflicts but future stability. The latest example of this policy dilemma was the fast expansion of credits in the last half of 1998 to the banks' traditional client base, the state-owned enterprises (SOEs), in order to boost production. Because of the enormous pressures on the bank managers since 1994 to prevent a worsening of the NPL ratio, the only way that the central bank could induce the banks to lend more to the SOEs was to implicitly guarantee that the bank managers would not be punished if these new loans were to become nonperforming.

Many of China's structural problems like the stagnation of agricultural productivity, the slowdown in the growth of rural enterprises, the continued inefficiency of the SOEs, and the large NPLs at the state banks can only be solved by promoting normal forms of private ownership, e.g. partnerships, cooperatives and shareholding corporations. Until land truly belongs to the peasants, the local cadres in many areas will continue to appropriate agricultural land at will for other uses and to redistribute land every four or five years despite the mandated tenure of 30 years. Until the peasants have constitutionally secured tenure rights on the land, they will not make the investments in the land that are necessary to raise agricultural productivity.

Until the rural enterprises that are registered as collectively owned are reorganised to become normal corporations whose shares are freely traded, they will find it hard to raise funds to expand their operations, and to be free from the interference of the local cadres. Similarly, until the state banks and SOEs are also converted into shareholding enterprises, losses will continue to grow. Of course, the clarification and protection of property rights over land, rural enterprises, banks and SOEs require for their success:

- the development of a modern legal framework (as stressed by Barry Metzger in this volume) to lower the cost of economic transactions; and
- the transparent distribution of these property rights to the local communities in order to prevent social outrage over embezzlements that occur under the guise of reforms.

Japan

Japan's economic recovery in 1999 still hangs in the balance. As Richard Mattione makes clear in this volume, the traditional instruments of macroeconomic policy -- interest rate cuts and fiscal expansion -- are not available to undergird the Japanese economy. Interest rates are already nearly zero, while fiscal deficits are approaching a remarkable 10 percent of GDP! Neither instrument offers much scope for maneuver. Not is all lost, however, because other more novel forms of policy change could be effective in stimulating Japanese growth. They are, at least partly, being implemented.

Japan's aggregate demand is weak on several fronts. Business investment and consumer spending have both been hit hard by a loss of confidence in the economy; and exports have been hit hard by the fall in incomes in the rest of Asia. Small and medium-size businesses in Japan are suffering from a squeeze on lending, as Japan's sick banks have cut back on loans as part of their attempts to reconstruct their capital bases. Unfortunately, the increasingly aggressive supervision of banks (including the closure of major Japanese financial institutions) has had the short-run effect of intensifying the credit squeeze.

So where, then, can Japanese growth come from in 1999? The first step, without question, would be the implementation of a major reorganisation of the banking system, built around a huge infusion of public funds to re-establish capital, to finance orderly bank closures and mergers, and to prepare the sick banks for eventual purchase by other domestic and (especially) foreign investors. The Diet voted for several initiatives in the past year to use public funds to support the rehabilitation of the banking sector. One key measure is the budget support of 57 trillion Yen (approximately US$475 billion) for bank restructuring. This step is almost surely the *sine qua non* for effective growth in the medium term.

A second area for growth would be an export recovery to parts of Asia, based on two factors. First, at least some of the East Asian crisis countries, especially Korea and Thailand, are likely to rebound from deep recession, and these will provide some lift to Japan. Second, and perhaps more important, Japan could provide substantial credits to the hard-hit countries of Asia to finance purchases of Japanese output. This idea is embodied in the Miyazawa Plan, which envisages a greatly expanded level of Japanese financial support to the region, with an estimated price tag of roughly US$30 billion. To be really effective both for Asia and for Japan itself, the program should be even larger, around $60 billion. These funds could come both in the form of grants (for example, in the case of Indonesia, the hardest hit country in the region) and in the form of loans. It is estimated that the loss of East Asian markets cost Japan perhaps 1.5 to 2.0 percentage points of GDP in 1998. A combination of Asian recovery plus an aggressive assistance program could reverse those losses in 1999.

A third instrument of growth should be monetary expansion. This may seem odd, since there is so much talk about "liquidity traps" in the air, a theory which holds that Japan has done all that it could with monetary expansion. It is true that Japan's nominal interest rates cannot be much lower, but Japan could still accomplish several important things by a further aggressive increase of the money supply. First, with a dose of money-induced inflation (e.g. around 3 to 5 percent per year in the next few years), land and other asset prices in Japan would stop falling and perhaps begin to rise, thereby easing the problems of bad debts in the banking system. Second, real interest rates (that is, nominal interest rates *minus* inflation) would be reduced, even if nominal interest rates did not fall more. The upshot would be easier borrowing terms for business and households, and thereby a stimulus to investment and consumption demand.

The next effect of monetary expansion would be a further depreciation of the yen. This is perhaps the reason that the Bank of Japan does *not* carry out a more aggressive monetary expansion, but the reasoning is wrong. The U.S. is, inappropriately, against a further yen depreciation, even though the chances of a vigorous Japanese recovery at 110-120 Yen to the dollar is very low. *Japan needs a further depreciation of the yen.* As the IMF acknowledges in its December 1998 *World Economic Outlook*, the recent yen appreciation, from around 140 yen per dollar to around 120 yen per dollar, "represents a tightening of monetary conditions that could, on its own, reduce GDP by about 1 percent over a one- to two-year period."

The U.S. fears a more aggressive monetary expansion because it believes that a significant yen depreciation (e.g. to 150 yen per dollar) would trigger protectionism in the U.S. and adverse consequences in the rest of Asia. Both fears are misplaced. First, monetary expansion would increase Japan's imports as well as its exports. While the yen would depreciate, thereby boosting exports, the concomitant boost in consumer and investment spending would draw in imports. The effect on net exports would be very small, and not enough to trigger a serious protectionist backlash. Second, the effects on Asia could be undone, in most cases, by a slight further depreciation of other currencies in Asia (such as the won and baht) vis-a-vis the U.S. dollar.

It is notable that the U.S. has pushed repeatedly for Japan to expand fiscal policy rather than monetary policy. Unfortunately, these pressures have greatly exacerbated Japan's long-term fiscal problems (especially the heavy burden of future social security expenditures with a rapidly aging population) without providing real stimulus in the short term. It seems that as the government has reduced its own saving (in fact, increased its dis-saving), households have increased their own saving. Without wanting to claim that all fiscal instruments are exhausted -- since a reduction in *marginal* income tax rates, and an investment tax credit for investment could both help to stimulate aggregate demand -- the fact is that the deficit is now so large as a percent of GDP that any more talk of outright Keynesian fiscal stimulus should simply be dismissed.[4]

In short, Japan has the makings of a gradual recovery in 1999, if large-scale banking rehabilitation, significant foreign assistance to Asia, and aggressive monetary expansion are combined. These measures would re-establish working capital flows; boost domestic prices, thereby easing the bad debt problems; and invigorate exports. Japan could begin a recovery by the second quarter of 1999, but with a yen value closer to 140-150 yen per dollar than its current value of 110-120 yen per dollar. It could be possible to see GDP growth of 0.5 to 1.5 percent, contrary to the IMF's current forecast of -0.5 percent for 1999.

Note, finally, that in any circumstances -- even with the most brilliant and determined reforms -- Japan will not be able to recreate the high-growth era. Because Japan is now a mature economy, per capita growth rates of 1.5 to 2.0 percent per year are the highest that could be expected on a long-term basis. So, with a population growth rate of around 0.2 percent per year, Japan will experience medium-term growth of perhaps 2.0 percent per year.[5]

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[4] Ironically, if the U.S. had not unwisely pushed Japan towards fiscal stimulus in earlier years there would be more fiscal room for maneuver today.

[5] Note that with the U.S. population growing at around 0.9 percent per year, the U.S. will have 0.7 percentage points higher overall GDP growth than Japan even when per capita growth rates are the same.

South Korea

The panic phase is over for South Korea, and it is well into the debt workout phase. The won-dollar exchange rate has dropped from its historical high of 1,962 won/US$ on December 23, 1997 to 1,201 won/US$ on December 30, 1998. Interest rates, which once topped 35 percent, now stand below 10 percent. The stock market index on December 30, 1998 was 49.5 percent higher than a year ago. The nation's nongold foreign exchange reserves stood at US$45 billion in mid-October 1998 while short-term foreign debt was about US$38 billion. Thus, the overhang of short-term debt relative to reserves was eliminated in 1998. Moreover, the ratio of short-term debt has dropped to 25 percent of total debt compared to more than 60 percent a year ago. The default ratio of commercial bills has now fallen to the level before the crisis. Even long-term foreign capital appears to be returning to Korea: the amount of FDI in the first eleven months of 1998 was US$6.9 trillion compared to US$5.9 trillion in the same period of 1997. In addition, a reflation program has been implemented since September 1998, and the main ingredients are expansionary monetary and fiscal policies. South Korea looks like that it has already, or will soon, hit the bottom, and that recovery will occur in 1999.

However, there is a good case for a cautious assessment. In the paper on South Korea in this volume, Jong-Wha Lee questioned the effectiveness of the stimulus package. He reported that banks still appeared very reluctant to lend money to the firms because of pervasive uncertainties in the economy. He pointed out that the banks have been buying government bonds rather than making loans to the firms. The result was that even though the growth rates of the money supply (M2) have been around 20 to 27 percent, loans by deposit monetary banks showed negative growth rates in September and in October 1998. This led Lee to predict that recovery will not happen until more economic restructuring has been achieved.

The picture of recovery, in short, is mixed. There is a wide range of predictions of the GDP growth rate in 1999.[6] These different predictions emerge primarily from differences in assessments on three issues:

- consumption and investment spending, and export performance in the medium-term;
- political instability from, and labor unions' reaction to, the social dislocations generated by economic restructuring; and
- speed in which the debt workouts and corporate restructuring will be completed.

Consumption, investment and exports: Private consumption declined by an annualised 12 percent in the first nine months of this year, and equipment investment dropped by an annualised 47 percent. Exports have not responded to the huge exchange rate depreciation. The $US value of exports actually declined by an annualised 1.9 percent in the first nine months of 1998, even though overall export volume had increased. Will the negative trends in these three key components of aggregate demand soon reverse themselves?

A large part of consumption and investment behaviour reflects, first, the existing economic conditions, and, second, anticipations of future economic conditions. On the basis of the latest data issued by the National Statistical Office on December 29 which suggest an economy on a course of moderately strong recovery since September 1998, we think that consumption and investment spending might have stopped falling in the last quarter of 1998.

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[6] The optimists are the Korean Development Institute, J.P. Morgan and the Pacific Economic Cooperation Council who predicted a 1999 growth rate of 2.0 percent, and the Political and Economic Risk Consultancy (Hong Kong) who predicted 1.5 percent. The pessimists, those who see negative growth in 1999, seem more numerous, e.g. Goldman Sachs (-2.7 percent), HBSC Markets (-2.0 percent), the Economist Intelligence Unit (-1.1 percent), and the International Monetary Fund (-1.0 percent). We note that among the pessimists who make frequent adjustments to their predictions, the Economist Intelligence Unit had revised its forecast of 1999 growth from negative 2.3 percent

The seasonally adjusted industrial output index, which peaked at 118 in September-October 1997 and fell to 100 in June-July 1998, recovered to 116 in November 1998. The average operating ratio of manufacturing plants, which fell from about 80 percent in September-October 1997 to 63 percent in August 1998, had recovered to 69 percent in November 1998.

The composite of leading indicators in November 1998 seems to indicate that this recovery in production is likely to be sustained. The index of leading indicators had climbed to 103 in November 1998 from the trough value of 98 reached in August 1998. However, the fact that the November 1998 value is still below the 1997 values suggests that while the recovery will be sustained, it is unlikely to be a strong one. On the whole, we think that expectations of renewed growth will help prevent private sector spending from falling in 1999.

The drop in export growth in the first nine months of 1998 despite the large devaluation of the won was largely caused by the cutoff in trade financing by foreign creditors (the panic factor) and by overly tight credit policy (the IMF factor). Now that the international credit markets have calmed down, Korea's exports should grow in line with the resumption of trade credit from foreign banks. and increased liquidity at home.

- <u>Political stability and labor militancy</u>: The ruling coalition of the National Congress for New Politics (NCNP) and the United Liberal Democrats (ULD) now commands a majority in the Parliament, thanks to defections from the previous ruling party, the Grand National Party. The ability of President Kim Dae-Jung (head of NCNP) to pass legislation on economic restructuring has been increased.

However, policy paralysis still cannot be ruled out if labor unions strongly oppose economic reforms that temporarily increase unemployment. The unemployment rate was over 7

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in its 1998:3Q issue to negative 1.1 percent in its 1998:4Q issue, while the IMF has reiterated in December 1998 its negative 1.0 percent forecast made in October 1998.

percent in November 1998, and the real wage fell an annualised 8.4 percent in the first half of 1998. On the whole, the labor unions have not mobilised strongly against the layoffs, possibly, because they attributed a large part of their plight to the external nature of the shock. While it is conceivable that labor militancy could increase sharply when unemployment rises with the promised reorganisation of the *chaebols*, one should note that Kim Dae-Jung has long maintained strong political ties with the labor unions when he was in the opposition.

Overall, it looks like that the Korean political situation will not worsen and derail the budding economic recovery.

<u>Debt workouts and corporate restructuring</u>: The large amount of nonperforming loans (NPLs) in financial institutions is one of the most serious obstacles to their ability and willingness to extend credit. To speed up the recapitalisation of the banking sector, the government has now passed legislation that would allow foreigners to buy Korean banks. Korea First Bank which went bankrupt and was taken over by the government in late 1997 has just been sold to the US group Newberg-GE Capital.

Many critics of Korean industrial organisation have attributed the depth of the Korean collapse to the excess capacity and the over-stretched management in the over-diversified *chaebols*. Under government pressure, the biggest five *chaebols* have promised to reduce their activities to about five industries by the middle of 1999. The government has taken an active monitoring and enforcing role in consolidating products under fewer *chaebols*. For example, Arthur Andersen was commissioned to study how the electronics industry should be restructured, and Arthur Andersen recommended that the electronics branch of the LG *chaebol* be merged with the electronics branch of Hyundai. When LG resisted handing over its electronics branch to

Hyundai, the government called upon Korean banks to limit loans to the LG *chaebol.* The LG *chaebol* soon capitulated to the government's wishes.

Another important factor to sustained economic recovery in Korea is to relieve viable firms of their over-indebtedness. Debt reduction schemes such as some combinations of debt-forgiveness and debt-equity swap have to be implemented more rapidly and pervasively, and this appear to be happening.

In our opinion, GDP growth in 1999 is likely to be 0 to 1 percent. Part of the reason why it will not be a sharp V-shape recovery as in Mexico and Argentina is because the early credit squeeze greatly exacerbated the collapse and has contributed to the mountain of non-performing debts. We agree with Jong-Wha Lee's conclusion that once economic restructuring is completed, Korea would "certainly grow at a 4 percent range, above those of more mature OECD countries."

The Southeast Asian Crisis Trio

Thailand not only precociously fell victim to the Asian financial crisis, in mid-1997, but also suffered, according to estimates by IMF and HBSC Markets, a larger GDP decline in 1998 than Malaysia and South Korea.[7] The good news is that there is wide expectation that positive growth will occur in 1999. The Pacific Economic Cooperation Council has projected 1999 GDP growth to be 0.5 percent, the IMF 1.0 percent, and Credit Lyonnais Securities Asia 2.4 percent. This expected phenomenon of "first-in first-out" is in line with the conclusion from our theoretical framework that countries hit by financial panics tend to display a V-shape for their GDP movements.

Most signs of future growth prospects are positive. The present reformist government has increased its support in parliament after attracting more parties to join the ruling coalition. Short-term trade-related capital has returned, and as a result, exports have soared in the last few months. The current account surplus in 1998 is expected to be about US$14 billion, which is roughly 12 percent of GDP. Longer term foreign capital has also come in. For example, foreign investors bought most of the assets of the 56 closed finance companies that have been sold in the two auctions held before December 1998,[8] and the Electrical Generating Authority of Thailand has successfully borrowed, with guarantees on debt-servicing given by the World Bank, US$300 million from the international markets. These positive developments on the current account, the capital account, and the political front have helped to strengthen the currency to 36.7 baht/US$ on December 30, 1998 from 47.0 baht/US$ a year ago. Interest rates have dropped sharply as well. The short term interest rate has fallen to 7.25 percent on December 30, 1998 from 25 percent on September 24, 1997.

The only significant indicator that may suggest continued output decline is the stock market index, which stood at 355.6 on December 30, 1998 compared with 372.7 on December 31, 1997 and 547.0 on September 24, 1997. Given the conflicting signals, caution is certainly merited in forecasting a return to growth. Our assessment is that there is enough strength building up in the economy to produce a 1999 GDP growth rate of 1-2 percent. Frank Flatters, the author of the Thailand chapter in this volume, is more cautious. He finds most of the current forecasts of recovery "to be overly optimistic ..[and that] there is still a long way to go."

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[7] The IMF predicted in December 1998 that 1998 GDP growth would be negative 8.0 percent for Thailand, negative 7.9 percent for South Korea, and negative 7.5 percent for Malaysia. HBSC Markets predicted negative 8.0 percent for Thailand, and negative 6.3 percent for South Korea and Malaysia.
[8] Four more such auctions have been scheduled.

Thailand is now well into the second stage of the recovery process: the stage of working out the NPLs of the banks, and the debt overhang of the corporations. Right now, it appears that the government will aggressively push the banks to write off the bad loans, to write down the capital base, and to commit to new lending to firms before public money is used to re-capitalise the banks. The determination of the government to address the debt issue decisively has produced the ironical phenomenon of "strategic NPLs" whereby good firms refrain from servicing their bank debts in anticipation of their "defaulted" loans being written off by the banks because of government pressure to do so. But this strategic behavior will not pay off for the firms if the government is diligent in auditing the bad corporate debts that it takes over from the banks.

Once beyond the financial crisis, Thailand's competitiveness will depend crucially on the removal of several well-known obstacles to its long-term, growth: inadequate physical infrastructure, low level of human capital, and corrupt administrative structure. Unless these long-term development challenges are met, Thailand will find it difficult to maintain its previous growth rate of approximately 7 percent.

Beginning in 1998:3Q, Malaysia has sought to fix its collapsing economy with reflation carried out behind temporary capital controls. Banks have been assigned an 8 percent credit growth target, bank prudential standards have been relaxed, and government spending has increased. Since the decline in output was caused by a fall in aggregate demand and not by a destruction of productive capacity, these policies had a positive impact by offsetting part of the continued drop in consumption and investment spending. However, these expansionary macroeconomic policies by themselves cannot ensure a sustained recovery unless private investment spending recovers and foreign capital inflow resumes.

The main obstacle to both of these outcomes is confidence regarding political and social stability in Malaysia. Anwar Ibrahim, who was dismissed as Deputy Prime Minister in September 1998 and is now facing trial on various charges, has many loyal supporters in the Malay-Malaysian community, which controls all branches of the government. The great concern is whether one side in the intra-Malay conflict might provocatively widen the conflict by playing the race card vis-à-vis the Chinese-Malaysian community. If the intra-community conflict were to degenerate into an inter-community conflict, an economy implosion would be inevitable. Luckily, the impulse to fling down the race card has not happened, and is now increasingly unlikely to happen.

The IMF has predicted that the reflation package will not prevent GDP from falling in 1999. Of the five Asian countries – Indonesia, Malaysia, South Korea, Singapore and Hong Kong -- that the IMF expects to show negative growth rates in 1999, Malaysia is expected to outperform just Indonesia![9]

The vital signs of the Malaysian economy appear to us to be more robust. The sharp drop in interest rates has provided sufficient credit to the exporters to take advantage of the depreciated Ringgit, and the revival of the stock market has seemed to stop the fall in asset prices and in consumption spending. At the end of December 1998, the government borrowed US$1.35 billion from a consortium of twelve foreign banks at 8.2 percent interest rate – which is equivalent to a "double A" rating by international agencies. The current rating of Malaysian government bonds is "triple B," which is just a notch above the rating for junk bonds, and which

[9] Malayisa's 1999 GDP growth rate has been forecasted to be negative 2.0 percent by the IMF, negative 2.9 percent by EIU (1998:4Q) and negative 6.2 percent by Credit Lyonnais Securities Asia. The IMF forecasts for 1999 growth was negative 3.4 percent for Indonesia, negative 1.0 percent for South Korea and Hong Kong, and negative 0.8 percent for Singapore.

currently requires an interest rate of around 15 percent. All in all, provided that the political situation in Malaysia remains stable, we expect Malaysia to grow about 1 percent in 1999.

Malaysia wants to quickly solve the NPL problems of the banks and the heavy debt burdens of the corporate sector, but it has not been able to do so because the capital controls have made borrowing large amount from foreign credit markets difficult. Bailouts with public money have been Malaysia's primary method of solving these financial problems. This pervasive use of bailouts definitely strengthens the moral hazard problems that already exist. For example, the bailout of Bank Bumiputera *is the third* in its thirty-two years of history. The chief reason why the government is moving ahead decisively with the bailouts is because Malaysia's race-based policy of increasing the Malay community's share of corporate assets was carried out to a large extent through bank loans to Malays to buy corporate shares, which would then be used as collateral for the loans. The result is that the fluctuations of the stock market have come to exert disproportionate influence on the politics within the ruling Malay party (especially when there is an internal power struggle such as now). The collapse of the stock market after 1996 created margin calls on many influential Malays who at the same time found that the lower profits generated by the economic slowdown were not sufficient to service their debts. The good news is that debt workouts will be completed soon, but the bad news is that they are likely to create more debt workouts in the future through the moral hazard mechanism.

The Industrial Coordination Act (ICA) of 1975 requires that all enterprises with equity above a certain amount sell 30 percent of their shares to Malays. These designated Malay shares are usually sold at a significant discount to Malay individuals or Malay organisations selected by the government. The evidence shows that the most internationally competitive manufacturing sectors in Malaysia are the sectors that have been exempted from the ownership requirements and are dominated by foreign direct investors. The bulk of the import-substituting light industrial firms are owned by Chinese-Malaysians, and the evidence is that few of them ever grew large enough to start exporting. The dilemma faced by such firms is that if they grow larger, they become subject to the rules of the ICA, but if they do not become larger, they are not likely to be able to export. As a result, it looks like that the incentive structure rooted in the ownership legislation has inhibited the development of an export capacity among import substituting light manufacturers.

There are two fast-acting solutions to the present economic malaise and to the long-run problems of maintaining high growth and increasing international competitiveness:

- relax the ownership restrictions of ICA to enable the needed recapitalisation of the banks and large firms; and
- institute a weeding out process within its infant industry program to prevent high-cost inputs from undermining international competitiveness by including expiration dates for state subsidies and import protection.

These are extraordinary times in Malaysia, and extraordinary political leadership is required. Part of extraordinary leadership is the political courage to assess objectively whether the continuation of the race-based programs and the industrial policies has more to do with political patronage than with providing "infant industry protection" to Malay professionals and businesses. If the answer is the former, then the economic costs from a rigid ICA are not serving the social justice motivation behind the race-based policies. A fast growing and internationally competitive economy will do more to enrich the Malay community than state-generated rents can ever hope to do.

Indonesia came close to a complete meltdown in 1998. GDP fell 15 percent and is expected to fall another 3 percent in 1999. Only agricultural output did not experience a decline (0.15 percent growth), industrial output fell 19 percent and service output fell 17 percent. The real wage dropped about 50 percent, and the greatest job loss appears to have occurred among rural professionals and urban professionals[10] – two politically vocal groups. The crisis has certainly wiped out a part of the progress against absolute poverty achieved in the last thirty years, raising the official poverty rate from 11 percent in 1996 to 40 percent in 1998. Riots in the first half of 1998 ended the 33-year reign of President Soeharto, and burnt down Jakarta's Chinatown. Since then, inter-religious and inter-island conflicts have surfaced occasionally, and there are continuing breakdowns in basic law and order on personal safety and protection of property rights. The erratic downward course of the exchange rate reflected, and contributed, to the instabilities and fragilities of the Indonesian situation. The end-of-year Rupiah-US$ rate went from about 2,400 in 1996 to 4,650 in 1997 and then to 8,050 in 1998 – but not before collapsing to 16,000 in May 1998, around the time of Soeharto's resignation..

The new Habibie government appears to have been able to present the main opposition groups (except for the students) with what seems to be acceptable parameters on political discourse and change: direct parliamentary elections in June 1999, indirect presidential elections in November 1999, increased regional autonomy, and a reduced presence of the military in the new parliament. The financial panic has subsided, but has not vanished as a result of continued uncertainty about social instability, and because Indonesia's short-term foreign debt is probably still greater than its non-gold foreign reserves. Nevertheless, interest rates have fallen, and the stock market has made substantial gains in the last months of 1998.

[10] Iwan Azis, "Outlook of the Indonesian Economy and Strategic Issues," Cornell University, December 1998.

In the Indonesia chapter in this volume, Steve Radelet identifies the two most important economic problems faced by Indonesia to be "the malfunctioning banking system and the huge debt burden on private corporations." The Indonesian Bank Restructuring Agency (IBRA) was established in January 1998 with wide powers to restructure the banking sector. IBRA has proceeded with increasing assertiveness in addressing the banks' problems. For example:

- 52 problem banks have either been taken over or been placed under supervision;
- 4 state banks will be merged;
- some of the biggest private banks have agreed to convert part of their debt to the central bank into equities; and
- the government will re-capitalise the viable banks in cooperation with the existing owners by putting in 80 percent of the new capital.

Possibly, the biggest setback to IBRA to date is the suspension of the October 1998 law, which allowed foreign banks to acquire 100 percent ownership of local banks, in the face of strong nationalistic objections.

The Indonesian Debt Restructuring Agency (INDRA) was set up in June 1998 to help the nonbank corporation in dealing with their foreign debts. After creditors and debtors have reached agreement on the restructuring of the loans, INDRA acts as the intermediary to receive rupiah payments from the debtor and to make dollar payments to the creditor. INDRA protects the debtor from future depreciation of the rupiah by guaranteeing an exchange rate value that is close to the existing value. However, not a single private corporation has used INDRA's facilities because:

- many creditors have resisted writing down their loans. Radelet points out that "Japanese banks hold about 38% of the loans outstanding to Indonesia, and because of their own fragile condition they were simply in no position to offer significant debt relief."
- in the absence of exceedingly generous debt relief, many debtors are still insolvent at the current exchange rate, and so a guarantee against future rupiah depreciation is irrelevant. Furthermore, there is wide expectation the rupiah would appreciate in the future after political order has been clearly established.

The fact is that political stability and not economic restructuring is the over-arching factor in restoring economic growth and determining future international competitiveness. Without resolution of the big political questions, economic reforms not only cannot proceed rapidly, they also cannot produce benefits that are close to their potential levels. Since presidential elections will not be held until November 1999, we are unlikely to see either decisive economic reforms or a spectacular output rebound of the V-shape genre.

IV: The Seven Pillars of Reform

Our analysis of the Asian financial crisis indicates the clear need for important reforms in many areas including domestic markets, domestic institutions, international organisations, and international financial architecture. We drew upon the analysis here and the analyses in other chapters to propose thirty specific policy actions that cover seven issues:

- the financial and non-financial sectors of developing countries;
- the International Monetary Fund;
- the international monetary system;
- the design of international "rescue" packages;

- the regulation of international capital markets;
- short-term Pacific Asian financial management;
- long-term Pacific Asian institutional reform.

Financial reforms within developing countries

The institutional weaknesses of domestic corporations (both financial and non-financial) render them susceptible to creditor panic. In order to increase the resilience of the financial sector and the non-financial corporate sector to external creditor shocks, and to enable these sectors to recover rapidly after the occurrence of such shocks, we propose eight reform measures in this area:

> Proposal 1: Financial institutions should more quickly adopt internationally accepted accounting standards. Major international accounting firms should work together with the international agencies to increase the standardization of accounting practices in the emerging markets.
>
> Proposal 2: The supervision of financial institutions must be enhanced and BIS-style prudential ratios must be enforced on the financial institutions. As part of this process of improved supervision, there should be:
> - much wider membership of developing countries in the Bank for International Settlements;
> - an intensive international effort to upgrade the technical capacity of banking supervisors; and
> - new BIS standards that are appropriate for the volatile conditions of emerging markets.
>
> Proposal 3: The ownership structure of the banking sector in emerging economies should be diversified to include foreign ownership, in order to reduce the risks of systemic banking collapse, and to generate demonstration effects to the domestic banks regarding efficient operations and prudent risk management.
>
> Proposal 4: The development of the non-bank financial sector (e.g. equity and bond markets) should be promoted because the over-reliance on bank credit in many developing countries has made them excessively vulnerable to financial panics.

Proposal 5: The legal underpinnings of corporate governance should be clarified, especially to protect minority shareholders. Part of the vulnerability to financial panic arises from the lack of clarity of property rights within the emerging market economies.

Proposal 6: Modern bankruptcy law should be introduced in order to forestall creditor panics (or "grab races") in the event of financial distress.

Proposal 7: Financial institutions should be required to file more frequent reports on their portfolios and their exposure to sectoral and currency risks, in order to allow better oversight by shareholders and the regulatory bodies.

Proposal 8: Short-term foreign borrowing by domestic banks should be tightly limited as a matter of prudential policy. Excessive short-term foreign debts of Asian, Russian, and Brazilian banks contributed to the onset of financial crises in all of these economies.

Reform of the International Monetary Fund

Grave flaws in the IMF's procedures and policy recommendations have become apparent in the course of the crisis. Each of the IMF's major packages in the past two years has failed to meet its targets, and many of the programs (for example, Korea, Russia, and Brazil) have collapsed within weeks of their approval. In order to improve international management of future crises, and to renew legitimacy of the international financial system itself, we propose four reform measures in this area:

Proposal 9: The international community should establish an IMF External Review Commission to review the functioning of the IMF in various of its major recent activities: its handling of the international financial crisis; its policy advising to developing countries; and the IMF's structural adjustment programs in the poorest countries.

Proposal 10: Archived IMF materials should be made public to allow outside surveillance of the institution.

Proposal 11: IMF voting powers should be reformed in order to give greater representation to developing countries, which, after all, constitute eighty-five percent of the world's population, and which bear the burden of failed IMF strategies.

Proposal 12: The functioning of the IMF Executive Board should be over-hauled, including: public hearings; opportunities for outside parties to submit evidence to the Board; and solicitations of professional opinions by the Executive Board from beyond the IMF staff.

Reforms of the international monetary system

The third set of reform recommendations arises from the deep instabilities in the international financial system. The events in East Asia, Russia, and Brazil, demonstrate the instability of short-term capital flows, and their tendency to oscillate between waves of euphoria and waves of panic. These instabilities have been exacerbated by systems of pegged exchange rates, as were used in Thailand, Korea, Russia, and Brazil. We recommend three main reform measures in this area:

> Proposal 13: In general, countries should pursue flexible exchange rate arrangements (e.g.wide crawling bands, open floats). In every case of serious financial crisis -- including Mexico in 1994, Argentina in 1995, Korea and Thailand in 1997, Russia in 1998, and Brazil in 1999 – the country pursued a fixed exchange rate policy in the years leading up to the crisis, and the system of fixed rates clearly contributed to the onset of the crisis.
>
> Proposal 14: Because the IMF is not (and can not) be a true international lender of last resort, there is no justification for the monopoly position of the IMF as the sole international arbiter of monetary affairs. Regional monetary bodies, for example within Pacific Asia, or within other emerging market regions, could provide mutual support in the event of a financial crisis hitting one or another member country.
>
> Proposal 15: An international bankruptcy system should be established in order to accelerate an orderly workout of international debts when a developing country falls into an extreme indebtedness crisis.

Reforming international "rescue" packages

The IMF has launched five major "rescue" packages in the past two years: Thailand (August 1997), Indonesia (November 1997), Korea (December 1997), Russia (July 1998), and Brazil (December 1998). None of these packages succeeded in re-establishing market confidence, or in reducing the adverse macroeconomic effects of international financial panic. Indeed, all of these packages quickly collapsed and required renegotiation. This suggests that there have been major flaws in the design and implementation of these policy packages. We have identified at least three areas of needed change:

Proposal 16: Debt relief often needs to be an integral component of "rescue" packages in order to encourage creditor-debtor bargains to stretch out loans, convert debts to equity, and occasionally a permanent write down of claims.

Proposal 17: IMF programs must not be designed to defend pegged exchange rates (as in the Brazil and Russia programs) because, at best, such IMF programs promote sharp recessions, and at worst (as in Russia and Brazil) the currency collapses anyway.

Proposal 18: Rescue packages should "bail in" (rather than "bail out") the international private investors by insisting that the private creditors bear the major burden for renegotiating the timing and repayment terms on existing debts when a financial crisis emerges. For example, the private creditors may be called upon to roll over existing claims, as occurred in the case of Korea in December 1997.

Regulatory reforms of international capital markets

The fifth set of reform recommendations addresses the dangers of premature capital account liberalization in emerging markets before the necessary supervisory and regulatory standards are in place. Because short-term capital movements can destabilize an economy, and force a government into an expensive financial bailout of the banking system, we recommend four reform measures:

Proposal 19: Controls on short-term capital inflows into emerging markets can help to maintain macroeconomic and financial stability. But while controls on short-term capital inflows may be advisable in many countries, controls on capital *outflows* should almost always be avoided, since controls on outflows tend to undermine government credibility and provide an inducement towards irresponsible policies.

Proposal 20: While short-term capital inflows should be discouraged, long-term capital inflows (especially foreign direct investment) should be promoted. There are still major strides to be taken in many developing countries (e.g. in areas of telecoms, banking, and other modern services) in allowing foreign investors to gain ownership over domestic enterprises.

Proposal 21: There should be informative and timely disclosure of hedge funds, cross-border lending, and derivatives transactions to enable policy makers in the developed and developing countries to know the external financial exposures of their national financial institutions.

Proposal 22: There should be greatly enhanced regulation of highly speculative activities such as highly leveraged hedge funds.

Proposal 23: The international community should immediately constitute a working group on international capital flows, including representatives of the developed countries, the developing countries, the major international institutions (IMF, BIS, WTO, UNDP, WB, and others), as well as private-sector observers, to report to the respective international institutions within one year on improvements in the oversight and regulation of cross-border capital flows.

Short-term financial measures to restore growth in Pacific Asia

The most serious immediate problem of the Asian crisis countries is the tremendous amount of bad debts in the banking and corporate sectors. The answer to the bad debt problems must be a series of negotiations between creditors and debtors to restructure the debts. At the same time, a large-scale infusion of public money to recapitalise the banking systems in Asia is also unavoidable. We make four recommendations for financial workouts in Asia:

Proposal 24: The re-capitalization of banks in Pacific Asia should be accelerated, through a combination of public money, foreign investors, and contributions by existing owners.

Proposal 25: The government should replace the non-performing loans (NPLs) of the banking system with government bonds, and in return the bank owners should agree to repay the government bonds over a set period, or to convert the government bonds into bank equity if the banks can not service the bonds.

Proposal 26: Having acquired the banks' NPLs at a discount, the government should give debt relief to the firms based on their capacity to pay, and specifically:

- debt relief should be concentrated on small and medium-sized firms because they have been hit the hardest by the credit crunch; and
- debt write-downs for the larger corporations should be conditional on debt-equity swaps, in which the government gains some equity share in the corporations. This equity share would later be auctioned as a form of "re-privatization" of the government's stakes.

Proposal 27: The barriers to entry by foreign banks should be lowered to provide the competition that is needed to prevent domestic banks from imposing wide spreads between deposit and lending rates in order to earn their way out of the crisis, but at disastrous costs to domestic corporations.

Long-term measures to enhance Asian competitiveness

In our opinion, the greatest long-term challenges to Pacific Asia lie not in financial regulation, macroeconomic stability or exchange rate management but in "social software," such as the quality of education, the overhaul of public institutions, the enhancement of science and technology, and increasing the democratization of political structures.

The annual *Global Competitiveness Report* (GCR) gives some clear and quantifiable evidence of the shortcomings in these areas. While the Asian manufacturing countries (China, Indonesia, Japan, Korea, Taiwan, Malaysia, Thailand and the Philippines) achieved an average overall ranking of 21st out of 53 countries in the 1998 GCR rankings, and a particularly high ranking of 9th on fiscal management, these countries scored a surprisingly low rank of 30th in technology, and 34th in quality of governmental institutions.

While it is now increasingly recognised that the enrichment of the domestic scientific base is crucial for sustaining high economic growth, it is less recognised that Asia's flawed social infrastructure and inadequate political institutions – which have allowed for too much corruption and mismanagement – are a cause for serious concern. In a world of growing international competitiveness, when foreign direct investors are courted not just by Asia but Central Europe and Latin America, the concerns over governance are bound to grow, and to weigh increasingly heavily on the unreformed countries of Asia. In short, the long-term competitiveness of Asia rests as much on "getting the institutions right" as on "getting the prices right."

We make three very general recommendations to address fundamental problems of harnessing technology and skilled manpower, and establishing adequate social infrastructure for sustained economic development.

> Proposal 28: The Southeast Asian countries should make a determined effort to raise the standards of science and technology within their societies. Among other steps, this will require much greater support for higher education, as well as encouragement of much closer links between universities and the private sector, such as the collaborative relationships found especially in the high-tech areas of the U.S. economy (such as information technology and biotechnology).

> Proposal 29: In enhancing the quality of public institutions, appointments and promotions should be based primarily on merit and not on, say, ethnic identity or ideology.

> Proposal 30: Pacific Asia must launch a concerted effort to upgrade its public institutions particularly its civil service and its judiciary system. For example, according to the 1998 GCR, Indonesia was ranked 53rd out of 53 countries regarding the independence of the judiciary, with Malaysia, Thailand, Korea, China, Taiwan, and the Philippines all ranked worse than 30th.

As explained earlier, these problem areas are not by themselves the cause of the current crisis. After all, these areas have been rather well understood as problems of Southeast Asia for years, and did not deter the sustained rapid growth until recently. Yet they almost surely played an *indirect* role in the onset of the crisis, and will be a major drag on growth in future years unless they are more successfully addressed by current and future governments.