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FINANCIAL AND ECONOMIC CRISES IN ASIA

Review of *The Asian Financial Crisis: Causes, Contagion and Consequences*, edited by Pierre-Richard Agénor, Marcus Miller, David Vines and Axel Weber (1999), and *The Indonesian Economy in Crisis: Causes, Consequences and Lessons* by Hal Hill (1999).

Since the breakdown of the Bretton Woods system of fixed exchange rates in 1971, crises in the world of international finance seem to be growing in frequency and effects. In 1982, Brazil's default on its foreign debt obligations resulted in a lost decade for the whole Latin-American continent. The 1990s witnessed the near breakdown of the European Monetary System, the Latin-American Tequila crisis following devaluation in Mexico, and most recently, the sudden reversal in the fortunes of Asia. After decades of buoyant growth, the plunge of the Thai Baht in July 1997 quickly evolved into a financial crisis in the region and arguably, the gravest global economic crisis in a half-century. In 1998, for the first time in its 31-year history, the economy of ASEAN contracted, by about 5 percent.

Naturally, crises of this nature are the bread and butter of economists. In the wake of the Asian crisis, an enormous debate has emerged and with the usual lag, an expanding number of academic publications. The questions to be answered are simple: why did the crisis happen and why was it so severe? Was it a logical consequence of the previous growth boom, or did it reveal flaws in the international financial architecture? Why did it spread like wild-fire from country to country? What was the role of the International Monetary Fund (IMF) in fighting the crisis? How can further crises be prevented? Explanations are found *ex post* as few, if any, analysts foresaw the depth of the melt-down. In fact, domestic macro-economic policies and fundamentals were basically sound with low government deficits, low inflation rates and a long period of high growth. Therefore there is no doubt that the origins of the crisis were closely connected to the increasing amount, and increasing volatility, of international capital flows to emerging markets. Consequently, explanations have to go beyond domestic and regional factors and have to address the larger question of whether our globalizing world is becoming increasingly unstable.

Studies on the subject can be positioned between two poles. At one side are studies, mainly of theoretical nature, in which the Asian turn down is seen as yet another, albeit different, example of a financial crisis in line with previous crises such as the debt-crisis in the 1980s and the Tequila crisis of 1994. Typically, the Asian region is treated as a homogenous entity and the analysis starts at the beginning of the 1990s. At the other extreme are studies which are much more descriptive in nature and focus in depth on a particular country, with an emphasis

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on the longer development process. In this article I review two books representative of both ends of the spectrum. Pierre-Richard Agénor, Marcus Miller, David Vines and Axel Weber (1999) edited a volume of papers mainly from the first type, whereas the study of Indonesia by Hal Hill (1999) is a perfect example of the second type. As discussed below, both approaches are highly complementary. Together they deliver deeper insights into the causes and consequences of the crisis, and offer suggestions for prevention of another in the near future. It will be argued here that dramatic events do not lend themselves for uni-dimensional explanations. Economic theories deliver part of the answers, but a considerable role must be reserved for factors of ultimate causality such as the development of the political setting and the institutional framework—which severely lags behind the development of (global) private markets.

Vulnerability and the Asian Financial Crisis

A complete account of the Asian crisis must deal with the following "stylized facts" (Alba *et al.*, 1999; Corsetti, Pesenti, and Roubin, 1999; Hill, 1999).

- There were large intra-regional variations within Asia, ranging from very mild recessions such as in China, India and Taiwan, to severe contractions in Malaysia, the Philippines, South Korea, Thailand and especially Indonesia. For the latter countries, Table 1 provides some evidence of the severity of the crises.
- The crisis started out as a currency crisis with large devaluation of the domestic currencies, but quickly evolved into a financial crisis in which banks were unable to repay their foreign debts. In turn, this led to an economic crisis as domestic firms were starved of credit and went bankrupt: illiquidity turned quickly into insolvency. This eventually led to a social crisis with massive unemployment, rising insecurity and associated social unrest, all of which fed back into the previous stages of the crisis.
- The crisis was completely unforeseen and, equally important, was not the kind of crisis governments and international agencies in Asia were accustomed to.

Most analyses of the crisis focus on its international dimension. Just after the onset of the crisis, the debate hovered around two extreme points of view: the financial panic and the moral hazard interpretation. The financial panic interpretation was defended most vigorously by Steve Radelet and Jeffrey Sachs (1998). In their view, the Asian countries were struck by herding behavior of international investors which resulted in a massive flow of capital out of the region after a decade of booming inflows. As can be inferred from Table 1 (panel (c)), net capital inflows into the affected countries of more than US$75 billion in 1996 turned into outflows of more than US$20 billion in 1998. A critical element of this view is that herd behavior produced a self-fulfilling prophecy due to a vicious circle. The withdrawal of international credit became a reinforcing spiral with increasing amounts of non-performing loans of domestic banks. Devaluation and the international credit squeeze made it increasingly harder for domestic banks to roll over debt, which was mainly short-term, denominated in a foreign currency and unhedged. The resulting bank defaults reinforced withdrawals by foreign

TABLE 1

ECONOMIC INDICATORS OF FIVE CRISIS-AFFECTED ASIAN COUNTRIES, 1995–2000

	Indonesia	South Korea	Malaysia	Philippines	Thailand
(a) *GDP index at constant prices (1996=100)*					
1995	93	94	91	94	94
1996	100	100	100	100	100
1997	105	105	107	105	98
1998	91	98	99	105	88
1999	91	108	105	108	92
(b) *Monthly average exchange rate, local currency per US$ (June 1997=100)*					
1997 June	100	100	100	100	100
1998 June	553	157	159	153	164
1999 June	300	131	151	144	143
2000 June	352	126	151	162	152
2000 Oct	364	126	151	182	168
(c) *Net capital flows (billion US$)*					
1995	10.3	17.3	7.6	5.3	21.9
1996	10.8	23.9	9.5	11.1	19.5
1997	–0.6	1.9	2.2	6.6	–4.3
1998	–9.6	–3.4	–2.4	1.5	–9.7
1999	–5.9	2.4	–6.6	–1.0	–7.9
(d) *Monthly average stock market prices (June 1997=100)*					
1997 June	100	100	100	100	100
1998 June	59	46	44	65	55
1999 June	94	126	71	86	99
2000 June	69	128	77	55	65
2000 Oct	59	87	68	47	52

Source: Asian Development Bank, Asian Recovery Information Centre, November 2000 and IMF, Balance of Payments Yearbook 1999.

lenders. In this view it is not denied that there were some serious weaknesses in the domestic financial system of the Asian countries. Financial market liberalization in the 1990s may have been too fast and not matched by enough changes in the institutional framework. As a result, financial markets were poorly supervised and regulated, for example with respect to an orderly work-out of bankruptcies. However, this fragility of the financial system, once tipped, should have led to modest adjustments rather than the excessive slowdown of economic activity witnessed in the past years.

Others, including the IMF, use a different paradigm and stress fundamental weaknesses in the Asian region which promoted moral hazard (Dooley, 1997; Krugman, 1998; Corsetti *et al.*, 1999). The moral hazard problem arises when there is an implicit or explicit public guarantee of bank or firm debt. As debtors will be bailed out in case of failure, investors are diverting credit to overly risky ventures and the overall profitability of investments declines. It is argued that governments in Asia created many opportunities for moral hazard due to close links between government, banks and firms and many instances of personal and political favouritism (crony-capitalism). A policy of quasi-fixed exchange rates compounded the problem by minimizing exchange rate risks. Dooley puts it most strongly. He argues that the large capital inflows into Asia reflected investors' confidence not in economic performance of the recipient countries, but in the ability of their governments to guarantee abnormal rates of return for a limited but predictable period of time. In this environment, investors will set up enough projects with negative expected returns to walk away with the state's capacity to pay out rewards. When that happens, a crisis occurs.

Three years after the start of the crisis, in a second round of the debate, there is an emerging professional consensus on the key causes and mechanisms. The book edited by Agénor *et al.* (1999) provides a good flavor of this consensus. According to the synthesized view, the Asian crisis resulted from the interaction between domestic structural weaknesses and the volatility of the international capital market. Aspects of both views are blended into the concept of vulnerability. The focus of analysis shifts to the build up of the vulnerability of the Asian region. In an intriguing chapter, Corbett and Vines try to pin down this concept which essentially means "that if something goes wrong, then suddenly a lot goes wrong". Vulnerability can be located in multiple equilibria; if participants in some shared activity (e.g. being bank depositors) expect a good outcome, then they may do things which bring this good outcome (no bank run). But if they expect a bad outcome (bank run), then they may do things which bring that about.[1] Clearly this blends the idea of moral hazard, which determines the "width" between the good and bad equilibria, with the self-fulfilling characteristic of financial panic. Put simply, vulnerability of the Asian region was heightened in the 1990s as foreign capital inflows boomed, the exchange rate was (quasi-) fixed and the financial sector was too quickly liberalized. However, what was the triggering mechanism which put the downward spiral in motion?

In the early 1990s, Thailand loosened its banking license policy, hoping to become the region's financial hub. Off-shore banking facilities were quickly established. However, rather than acting as intermediary for foreign borrowers and lenders, these banks turned into domestic credit providers, fuelling a real estate and financial asset bubble. Slowly it became clear that Thailand could not maintain its support for a fixed exchange rate. Speculation added to the pressure and the Baht gave way[2]; contagion set off a string of devaluations and stock market collapses in neighboring countries.

Masson (1999) defines contagion as a phenomenon where an economy has multiple equilibria, both good and bad, and an external event triggers a move from a good to a bad one. He conceptually distinguishes pure contagion, which involves changes in expectations, from "monsoonal" and spillover effects. Monsoonal effects can be defined as major economic shifts in industrial countries that trigger crisis in emerging markets, such as rising global interest rates or stagnation in Japan, the region's would-be locomotive. Spillover effects result from interdependence among developing countries themselves, for example through trade links. Pure contagion, on the other hand, involves changes in expectations that are not related to changes in a country's macro-economic fundamentals. Arguably, the pure contagion effect was most important in the Asian crisis. Some argue that otherwise the crisis would have been confined to Thailand only (Corbett and Vines, 1999). The devaluation of the Baht was perceived as a wake-up call leading

[1]Examples of these so-called second generation models of financial crises can be found in Part Two of the book.

[2]See stylized chronology of events in Thailand in Corbett and Vines (1999, pp. 99ff).

to a generalized re-evaluation of investment prospects in the whole region. The fact that different countries borrowed from the same creditors was instrumental and the suddenly increased risk premiums became a self-fulfilling prophecy along the lines described above.

International Finance Crisis

The IMF has been an important player in the Asian drama from the beginning. There is no doubt that the crisis has enormously damaged the Fund's credibility and authority. Professional opinion is divided on the overall contribution of the Fund to the crisis.[3] Its early approach to the crisis clearly appeared to be based on mis-diagnosis. Its heavy emphasis on fiscal discipline, which was important in earlier crises based on runaway budget deficits, actually backfired in the Asian case. Particularly in the Asian region, resentments against the IMF have grown. Conditions were seen as much too encompassing, including all kinds of reforms not directly related to a restoration of market confidence.[4] To many, it also seems that the IMF interventions, which mainly bailed out foreign investors, did little to relieve moral hazard problems in the international credit community.

While few in the economics profession would deny the benefits of globalization, including globalizing capital markets, the costs of this development are also becoming clear. As a result, there is an increasing call for reforms in the current international financial architecture. Joseph Stiglitz (1999), then Chief Economist and Vice-President of the World Bank, argues that financial markets, which are essentially concerned with information, are imperfect and need some kind of regulation. This is especially true with respect to short-term "hot money" and the development of procedures for orderly work-outs in case of bank failures. Given increased international volatility, the net benefits of financial openness for individual countries can also be doubted. Countries like China and India have nearly closed capital markets and remained unharmed during the crisis. Malaysia, which decided in an early stage of the crisis to close its capital market, against IMF advice, also contained the backwash effects of the crisis.[5]

Although the Agénor *et al.* (1999) volume as a whole contributes to a deeper understanding of various international aspects of the crisis, it neither provides a unified framework of analysis nor conveys a clear message about how to proceed further. This is partly because most analyses in it do not go beyond the world of international finance. The contributors to the volume, as apparently most foreign investors, treat the Asian region as a whole with little explicit attention for idiosyncrasies. Before the crisis, any scholar with more than superficial knowledge of the region would be very hesitant to talk about "the Asian growth model". Similarly, there is no single "Asian crisis", but a large number of country crises each with their own causes, mechanisms and effects, obviously bound by the phenomenon of contagion. This cannot be better illustrated than by the case of Indonesia, arguably the worst affected country in the region.

[3]As witnessed in Part 4 of the Agénor *et al.* (1999) book.

[4]However, the IMF appeared to be a fast learner and requests became less and less restrictive over time.

[5]As a result however, sought-after long-term investors have been scared off as well.

The development of Indonesia since 1966, the year of the installation of the New Order government headed by Soeharto, has been truly remarkable by any account. Considered a "basket-case" in the 1960s, Indonesia managed to accomplish a nearly unique reversal of economic trends, growing for three decades at an annual average rate of 6.5 percent, with social indicators keeping pace. Hal Hill provides a comprehensive overview of this period in his book *The Indonesian Economy since 1966*, sub-titled "South East Asia's Emerging Giant" (Hill, 1996). Tellingly, this subtitle has vanished in the second edition of the book.[6] Rightly so. The devaluation of the Rupiah in 1997 led to a dramatic reversal of the country's fortunes once again. In a more recent publication, Hill provides a careful account of what actually happened to Indonesia in the period from middle 1997 to early 1999 (Hill, 1999).

There is no doubt that the financial crisis in Indonesia evolved into an economic and social one. In 1998, GDP contracted by 14 percent, inflation rose by 65 percent and the Rupiah devaluated 70 percent. Assessments of the social impact of the crisis vary widely due to the slow release of relevant, and reliable data. But from the scanty evidence, it is clear that the current crisis has highly uneven sectoral and spatial dimensions. Generally, a process of "involution" is taking place, for example in the form of transfers to informal sector activities. This process has cushioned the immediate effects of the crisis on poverty incidence, but obviously provides no basis for sustained socio-economic development. Also, it seems hard to deny the spillovers of the crisis into the political realm. President Soeharto was toppled at the height of the crisis, after 32 years in power, and an unstable democracy has emerged. The power vacuum fuelled existing sources of social unrest and separatist actions, in effect putting the existence of the nation state itself at risk.

Taking a much broader perspective than most commentators, Hill's main argument is that it was the conjunction of many factors which caused the crisis. To this end, he makes a distinction between factors influencing pre-crisis vulnerability and the government's management of the crisis once it was triggered from the outside. Pre-crisis Indonesia appeared to be modestly vulnerable to a crisis, but no more so than several of its neighbors. The stock of "mobile capital" was built up quickly but not approaching crisis levels. Macro-economic policies were basically sound. Financial regulation was admittedly poor, but the financial sector was a relatively small direct player as most government and corporate borrowings abroad did not go through the country's banks. There is no doubt that corruption was a serious problem. There was an extraordinary concentration of power and privileges around Soeharto and his family—but corruption has been an ever-present phenomena in Indonesia and did not prohibit growth in previous decades.

Hill emphasizes the need to look beyond the build-up of vulnerability. He focuses on the process of management once the crisis unfolded, where the Indonesian style of "crony-capitalism" led to severely ineffective management. In the first six months, it became increasingly clear that Soeharto's actions were driven

[6]The second edition is not a rewrite of the first. It only includes a postscript which is an abridged version of Hill (1999).

by a desire to protect his family's interests at all costs, rather than seeking a way out of the crisis. This resulted in a general loss of confidence in the regime's motives and management capabilities. Moreover, the sudden closure of sixteen banks, without prior warning, led to dwindling confidence in the entire financial system and marked the beginning of a series of bank runs. Additional factors included a very severe drought depressing food crop production, a depressed regional environment, low oil prices (Indonesia's main export commodity), political turbulence and frequent outbreaks of ethnic and religious violence. This all buttresses the argument that "there was a truly complex set of events, political, social and economic, domestic and international, of varying intensity present in Indonesia during 1997–98" (p. 82). This unique setting led to a crisis which might well mark the beginning of a lost decade for the world's fourth-most populated country.

Growth and Crisis: the Slow Evolution of Institutions

Not so long ago, a fierce debate took place about the causes of the Asian growth boom. Attention has now shifted toward explanations of the crisis. It seems therefore logical to join the two and ask whether the forces which led to high growth in the past carried the seeds of the crisis. Based on growth-accounting results, accumulationists argued that growth in Asia was mainly driven by high investment in physical and human capital, short-term gains from the temporary demographic advantage of rising labour force participation rates, and a shift out of low productivity agricultural activities (Young, 1995).[7] Assimilationists, on the other hand, maintained that the key to East-Asian growth was the effective way in which new technologies were introduced, diffused and adapted and stress the important role governments in East-Asia have played in this process (Nelson and Pack, 1999). From the first point of view doubts were raised about the sustainability of the past growth path and a slow down was predicted (Krugman, 1994), but a dramatic collapse was not a logical outcome of this line of reasoning.

Commentators on the crisis are largely silent on the question whether previous development policies inevitably increased vulnerability. Only for the case of Korea does there seem to be a consensus that its earlier approach to financial market decision-making and regulation (which was an important part of the government's development policy) left the economy badly exposed to a high risk that financial liberalization would turn out badly. Crafts (1999) argues that "the greatest successes of the managed development approach have tended to come in the context of export-orientated manufacturing and industrialization. In the coming years of de-industrialization, a different model may be more appealing." Corbett and Vines (1999) take this argument further and argue that the crisis seemed to be a logical consequence of the previous growth period and was bound to happen some time along the traverse from a developing to a developed, Western-style, country. It must be noted however, that this argument actually only

[7]The terms East-Asia and Asia are often loosely used, adding to confusion and swift generalizations. Actually, the Asian growth debate is mainly about the East-Asian Tigers: Hong Kong, Singapore, South Korea and Taiwan. Only South Korea reappears in the debate about the crisis, as the other countries remained relatively unharmed.

applies to South Korea. It does not hold for countries such as Indonesia, Malaysia and Thailand which are at much lower levels of development, but were hit by the crisis nevertheless.

What does characterize all crisis countries is that development has taken place rapidly from an initial position of "economic backwardness". This rapidity has generated its own institutional legacy (Crafts, 1999). There is a widespread belief that the development of the domestic financial system in emerging markets has severely lagged behind economic expansion, and requires much more attention. New bank regulations and performance monitors have to be developed. Enforcing existing legislation will be as important as developing new jurisdiction. A recent overview by the Asian Development Bank (2000) shows that in the post-crisis period some progress has been made in bank and corporate restructuring. A large number of banks have been closed and asset management companies have been established for the restructuring of bad debts. Ironically, a period of quick recovery in 1999 has stalled this process as it made painful adjustment measures easier to postpone. As a result, financial unrest has returned and during the last year the sharp rebounds in equity and foreign exchange markets in the region have been seriously eroded, or even wiped out, as can be inferred from panels (b) and (d) in Table 1.[8]

The Asian crises have made it painfully clear that (global) market developments can easily outpace developments of domestic and international institutions. The development of adequate and secure domestic financial systems in the Asian countries, and much-needed reforms in the global financial architecture, are inherently slow processes. In a world with hot money, crises are likely to recur.

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[8]See the Asian Recovery Information Centre from the Asian Development Bank for up to date analyses of the region at http://aric.adb.org. Nouriel Roubini's homepage at http://www.stern.nyu.edu/globalmacro/ provides many links to academic discussions on the causes and consequences of the crisis.

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