THE EAST ASIAN FINANCIAL CRISIS: BACK TO THE FUTURE?

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An earlier version of this paper was presented at a seminar on 'Impacts of the Asian Currency Crisis on Europe's Growth Prospects', European Institute for Asian Studies, Brussels, 20 January 1998. The opinions expressed do not necessarily reflect the views of the UNCTAD secretariat, and the designations and terminology used are those of the author. This paper owes a great deal to discussions with Jan Kregel, Andrew Cornford and Richard Kozul-Wright.

A. The nature of the crisis

The world economy is experiencing perhaps the most serious financial crisis since the breakdown of the Bretton Woods system in the early 1970s, in terms of both its scope and its effects. Its impact is much more global than that of the financial crises we have seen in the past two or three decades, including those in Latin America. Today, global financial integration is much more pervasive, and the East Asian countries have a much higher share of world trade and production. For the first time, a financial crisis in the South has had a profound impact on capital markets in the North. It is also expected to cause a significant drop in global growth.

Regarding the causes and consequences of the crisis, there is a tendency among the commentators to lump together the East Asian countries which are directly or indirectly affected by the current financial crisis. This is particularly notable among those who consider the crisis as the end of the 'Asian model of development'. However, those who are more familiar with the region know that there are considerable variations among these countries in the policies pursued, the institutions established, and the level of development reached. There is at least a distinction between the first-tier newly industrializing economies (NIEs), that is the so-called four tigers (Hong Kong, the Republic of Korea, Singapore and Taiwan Province of China), and the second-tier NIEs (Indonesia, Malaysia and Thailand). Again, among the first-tier NIEs Hong Kong is distinguished by its laissez-faire policies, while the others are known to have followed a more interventionist, dirigiste approach. Of these, two dirigiste economies, Singapore and Taiwan Province of China, are so far virtually untouched by the crisis. In South-East Asia too the problems faced by Indonesia and Thailand are quite different from those in Malaysia, which has again pursued somewhat more interventionist policies than the former two.

The crisis in South-East Asia did not come to us as a complete surprise. In its analysis of East Asia, the 1996 Trade and Development Report made a clear distinction between the first- and second-tier NIEs in their policies, performances and prospects. While praising the successful policies of the second-tier NIEs which have helped establish competitive resource- and labour-intensive industries, the Report
pointed out that the easy stage of export promotion was coming to an end, and that these countries could suffer from loss of competitiveness. The Report sounded a clear warning, noting that growth in the region relied excessively on foreign resources, both labour and capital:

“Thus, the second-tier NIEs may be unable to sustain large current-account deficits over the longer term; they need to reduce their trade deficits so as to minimize the risk of serious balance of payments problems and a sharp slowdown in growth. Much will depend on their success in enhancing their export potential through upgrading... The fact that in Malaysia and Thailand wage pressures can only be mitigated by large-scale immigration suggests that these economies may be having difficulty in achieving the necessary upgrading... Without upgrading... FDI will remain footloose and the economy would be highly vulnerable to interruptions of capital inflows. Concerns over such a possibility have been growing in Thailand and even more in Malaysia in view of their large current account deficits. (i)”

However, the Korean crisis is more surprising. With hindsight, we seem to have overlooked the significance of three important trends that were under way, which were eventually responsible for the crisis: first, the sustained appreciation of the currency; second, massive short-term borrowing abroad by the private sector; and finally excessive investment in a number of industries. A stable real exchange rate was always a main policy objective in post-war Korea and the recent appreciation constitutes a major departure from that policy. Again, the Republic of Korea tapped external finance in its post-war industrialization primarily through borrowing from international banks, but this was almost always subject to government approval and guarantee. Finally, while private investment was the driving force of Korean industrialization, policy always played a major role in coordinating investment decisions in order to avoid excessive competition and capacity creation as well as to benefit from scale economies.

Departure from such practices during the past few years partly reflects the pressures of globalization. For instance, as the Korean firms became multinationals, their activities became less transparent and more difficult to monitor, a factor which appears to have played a major role in over-borrowing and over-investment as well as risky financial operations by some firms. But of much greater significance, a more liberal stance towards finance over the past few years has meant abandoning many checks and balances which had underpinned the Korean success.

It is notable that these departures from post-war practices coincided with Korea's bid for the membership of OECD. Far from being considered as policy errors by the orthodoxy, they were recommended as necessary if Korea was to adapt to a globalizing world. Even now, complete removal of barriers against access of the private sector to international financial markets is advocated as a solution to the crisis. On this view, the problem is not liberalization as such, but the absence of effective prudential regulation and supervision of the banking system.

There can be little doubt that prudential limits on bank lending, capital adequacy requirements and currency matching conditions for assets and liabilities that are properly enforced can help prevent excessive risk-taking by banks, thus containing the adverse effects of widespread defaults. However, it is not clear how domestic credit expansion could be prevented when capital inflows lead to a rapid liquidity expansion. Unless the central bank is willing and able to sterilize the impact of foreign capital inflows on domestic liquidity, there will be an increase in domestic lending which will eventually spill over from the financing of safe and productive investments to risky and speculative assets. The lending spree in turn raises the collateral values of assets financed by such lending, thereby encouraging belief in the appropriateness of these values. Such a process of Minskyan endogenous fragility (2) was experienced not only in East Asia but also in the banking system in Mexico in the early 1990s and in the US in the 1980s.

This process contains a major contradiction. As the investment bubble continues, growth remains strong, eventually leading to a deterioration in the external balance. An unstable dynamic is created in which increasing domestic interest rates to slow the economy and improve external payments serves to attract additional capital inflows and expand bank liquidity and lending further. But eventually loans become non-performing and banks are weakened. Thus, deterioration of the external balance and
weakening of the financial sector are two sides of the same process of excessive capital inflows. The basic problem is not in the control and supervision of the banking system, but in the absence of instruments to restrict capital inflows and contain their impact on macroeconomic and monetary conditions. But these instruments are usually discarded with the adoption of liberalization designed to remove 'financial repression'!

Furthermore, domestic banking regulations cannot prevent excessive non-bank private sector borrowing abroad. This is not always appreciated, even though in East Asia an important part of private borrowing from international banks is by non-bank firms: one-third in the Republic of Korea, around 60 per cent in Malaysia and Thailand, and even more in Indonesia. (3) Control over such borrowing would call for various restrictions, including (Chilean-type) non-interest-bearing deposit requirements - something that qualifies as 'financial repression' rather than prudential regulation. (4) On the other hand, it is not clear whether the Anglo-American type of corporate governance based stock-market discipline could prevent excessive borrowing and risk-taking by non-bank private business - witness the experience of the US in the 1980s, where firms accumulated large stocks of debt to acquire highly risky assets. Nor do international financial markets impose the right kind of discipline over private debtors in emerging markets. All too often they manifest herd-like, pro-cyclical behaviour in both giving and cutting back loans. Indeed, until the turmoil in the currency markets, East Asian banks and firms enjoyed very high marks from Western rating agencies and banks.

What we have in East Asia is a typical private sector external debt crisis, very much like the so-called Southern Cone crisis in Argentina, Chile and Uruguay in the late 1970s and early 1980s. As will be recalled, these countries too had allowed the private sector unrestricted access to external finance in the belief that, for private firms, the difference between domestic and external debt was not significant, since they were expected to assess carefully the costs and benefits on which their survival depended. The experiment ended with private sector over-borrowing, subsidized debt servicing via preferential exchange rates and eventually the nationalization of private external debt and a de facto socialization of the banking system. (5)

It also appears that the so-called non-debt-creating financial inflows, that is acquisition of property and securities by non-residents, have also played some role in sustaining speculative bubbles in equity and property markets in South East Asia. Indeed increased access by non-residents to securities markets (as well as greater access by residents to dollar assets) tends to establish a close link between the two inherently unstable markets, namely currency and equity markets. This generates destabilizing feedbacks: a currency crisis could easily lead to a stock market collapse, while a bearish mood in the equity market could easily translate into a currency crisis. Again, one may need more direct measures to control such destabilizing linkages, including restrictions over foreign acquisition of domestic securities. (6)

Recent experience shows that almost every domestic financial crisis (asset-price deflation or banking crisis) in developing countries tends to translate into a currency turmoil, payments difficulties and even an external debt crisis. Similarly, in such countries reversal of external capital flows or attacks on the currency almost invariably threaten the domestic financial system. By contrast, currency turmoil in industrial countries do not usually spill over into domestic financial markets (e.g. the 1992-93 EMS crisis); nor do domestic financial disruptions necessarily lead to currency and payments crises (e.g. the S&L crisis and the 1987 stock-market collapse in the US). External indebtedness, together with dollarization of the economies in the South, accounts for much of this difference.

The East Asian crisis can be described either as excessive borrowing abroad by the private sector, or as excessive lending by international financial markets. In any case, there is a failure of free capital markets to produce an optimal global allocation of capital. As pointed out by Alan Greenspan, it is clear that more investment monies flowed into these economies than could be profitably employed at modest risk. In this sense, it is a global crisis with a regional trigger. Perhaps one can also fault East Asian governments for failing to prevent market failure - an approach that underpinned successful policy intervention in post-war East Asia.
For the first time a major disagreement has emerged among mainstream economists over the appropriate policy response to a financial crisis in developing countries. The policy package to be adopted can be expected to address two problems: first, it should help restore confidence, thereby halting the turmoil in the currency and asset markets; second, it should correct the underlying fundamentals.

There is a growing concern that IMF policies are not helping to restore market confidence. A factor contributing to the continued market volatility and yo-yo movements in exchange rates and equity prices is no doubt lack of consensus among mainstream economists about the appropriateness of the orthodox policy package. But nor do markets appear to have been impressed by the policies promoted so far. For example, although Indonesia and Thailand have kept their interest rates higher than Malaysia, they have experienced greater difficulties in their currency and stock markets. By the same token, strict adherence to the orthodox programme has not protected the Philippines against contagion.

Regarding fundamentals, there was certainly a need for correction in exchange rates and external balances. However, so far declines in the currencies in the region have more than corrected the earlier appreciation; baht, won and rupiah have certainly overshot the levels that can reasonably be considered as compatible with sustainable current-account positions. There is not a strong case for a drastic reduction in domestic absorption and growth to bring about the adjustment needed in external payments. Indeed, many prominent mainstream economists have criticized the IMF programmes of fiscal austerity and tight money, arguing that, while these could be appropriate under conditions of monetary and fiscal disequilibrium, this is not the case in East Asia. It is rightly argued that targeting very low inflation when currencies have lost half of their value could simply drive these economies into deep recession. Furthermore, voices are increasingly heard from the region that conditionality is abused, promoting the bilateral interests of the major industrial countries in areas which have very little to do with the management of the crisis, and drastically restricting national autonomy and raising the danger of political backlash.

A useful lesson on what needs to be done under conditions of debt deflation can be drawn from recent US history. As will be recalled, recovery in the US during the 1980s was driven by spending financed by increased indebtedness relative to income. Business firms, consumers and the Government all raised their indebtedness to unprecedented levels, while financial institutions increased their lending against risky assets including real estate, and financed mergers and acquisitions. These meant that both corporate and household incomes and spending became increasingly sensitive to interest rates. The Fed started tightening after the 1987 crash in order to check asset-price inflation, and this policy was complemented by tax increases and less expansionary fiscal policy. The result was one of the deepest post-war recessions. However, in reaction to the weakness in the financial system and the economy, the Fed started to reduce short-term interest rates in the early 1990s, almost to negative levels in real terms, thus providing relief not only for banks, but also for firms and households, which were able to ride the yield curve and refinance debt at substantially lower interest servicing costs. This eventually produced a boom in the securities market, thereby lowering long-term interest rates, and helping to restore balance-sheet positions, producing a strong recovery at the end of 1993. Clearly, the US economy is unlikely to have enjoyed one of the longest post-war recoveries if the kind of policies advocated in East Asia had been pursued in the early 1990s in response to debt deflation.

It is true that monetary relaxation did not make much dent in the Japanese case, but largely because Japan was too hesitant in pursuing a similar policy for fear of creating another bubble. It was also unable to put together a financial restructuring package or address its structural problems through appropriate measures to deregulate the economy. (7)

It is often suggested that easy money is not a policy option in East Asia since asset price deflation is associated with currency turmoil. However, high interest rates are not securing stability in the currency markets. Indeed, they are actually undermining a positive response to the recent shift in exchange rates
owing to their effects on the banking sector and companies’ capacity to meet their financial obligations. The credit crunch seems to be so deep that, despite favourable exchange rates, firms are unable to export as their access to trade credit is curtailed. Thus, an important part of the improvement in the current-account balances of the Republic of Korea and Thailand so far seems to have been due to import cuts rather than export expansion. Provision of adequate external liquidity to support the exchange rate would have avoided such an outcome by allowing these countries to pursue a more accommodating monetary policy to deal with debt deflation.

C. Global implications

The developing countries in Asia have become major actors in the global economy, playing a crucial role in generating global demand. A sharp decline in their growth rates and a reduction in their contribution to global demand will make it especially difficult for industrial economies, in particular Europe and Japan, to expand at rates needed to reverse the upward trend in their unemployment rates.

There can be little doubt that the crisis will have serious consequences for the regional growth dynamics and integration in East Asia. These are built on the so-called flying geese process, whereby countries at different levels of industrialization and development move together on the basis of a progressive upgrading of their industries. Intra-regional trade and investment both play a major role in this process by helping to locate production according to comparative advantages determined by relative levels of productivity and wages. A stable pattern of exchange rates throughout the region is absolutely essential for this process to be driven by the real economic forces of thrift and productivity.

These foundations of the flying geese process have been shaken by recent shifts in the exchange rates among the currencies of the region through what look like competitive devaluations. Currency instability causes unexpected shifts in the relative positions of individual countries, and creates considerable uncertainty regarding the competitiveness of various industries across the region, thereby undermining investment in tradeables, including intra-regional investment. If restrictive policies are pursued to restore stability, the overall speed of regional growth will be reduced.

Regarding the global impact of the crisis, there has been a certain degree of ambivalence. While on the one hand it is increasingly argued that we are now all living in a global village as a result of significantly increased integration of markets and interdependence of economies, it is at the same time maintained that the impact of the East Asian crisis on the global economy can be expected to be negligible since their share in global trade and production is small. However, greater realism appears to have started to influence the views of major international organizations, which have come to recognize that the global impact of the crisis will be serious, leading to a significant loss of growth, as much as even more than one percentage point from the baseline.

But what is less appreciated is that this is coming on top of existing imbalances in the world economy. Indeed, on the eve of the crisis, there was already a major inconsistency: virtually all major industrial countries except the US were expecting faster growth on the basis of increased exports, while the contribution of the US to global demand was expected to slow down. The surplus countries (Europe and Japan) were employing restrictive fiscal policies and attempting to increase their export surpluses to preserve growth. By contrast, with the notable exceptions of China and Taiwan Province of China, the fast-growing economies of East Asia were major contributors to global demand, running large deficits financed by private capital inflows. However, as the US and European interest rates had started to edge up, capital flows were expected to be diverted from developing countries, forcing them to cut their external deficits and hence contribution to global demand.

Perhaps the single positive contribution of the East Asian crisis is that it has halted the moves towards monetary restriction and higher interest rates in the US and Europe. This emerged when the crisis led to a global stock market break in October, and has been motivated primarily by concerns over the possible impact of higher interest rates on financial markets in industrial countries. Moreover, the slump in East Asia appears to have eased the preoccupation of central bankers with the risk of inflation, and has even raised some concerns about deflationary pressures.
However, the crisis has done nothing to reduce global imbalances; indeed, it has tended to worsen them. Although exchange rates have now turned more favourable, firms in East Asia also face a greater need to earn foreign exchange in view of cutbacks in lending and the prohibitive cost of foreign borrowing. Furthermore, the rise in domestic interest rates has increased their domestic debt servicing while, together with fiscal retrenchment, depressing domestic demand. Consequently, East Asian firms can be expected to pursue an aggressive export strategy in markets where they have already gained competitiveness - namely, in the US, Europe and Japan. Although the expected export boom is not yet in sight because of their credit crunch, it should not come as a surprise if these countries eventually succeed not only in eliminating their external deficits, but also in creating large trade surpluses, not as in Latin America in the 1980s through drastic import cuts, but by rapid increases in exports. The tighter the domestic policy stance, the greater the tendency to seek markets abroad in industrial countries.

This means that a positive adjustment should have two components. First, loans should be rolled over and rescheduled to allow the countries concerned to service them from future export earnings and not through increased external borrowing at penalizing rates. Second, it is necessary to raise global growth to provide markets in which the East Asian countries can earn the foreign exchange needed to pay off their foreign currency debt. Thus, the solution to the problem is not to be found simply in the restructuring of the financial sector of the South-East Asian economies, necessary as it may be, or in their macroeconomic policies. Rather, a crucial component must be removing the deflationary bias in the macroeconomic policies in Japan and Europe. Until these two areas initiate domestic demand-led growth and reduce their external surpluses, the global economy will continue to be vulnerable to the risk of financial instability and recession, and the crisis in South-East Asia will continue to contribute to the decline in global growth and trade frictions.

The crisis will tend to aggravate the difficulties faced by Japan. While the yen has been falling against the dollar, it has appreciated against the East Asian currencies. This means that Japan may not get an additional overall stimulus from shifts in exchange rates, but its trade surplus with the US may grow, triggering reaction particularly if the US economy is slowing and its trade deficit rising. Further declines of the yen to gain competitiveness against East Asian NIEs will also mean declines against the dollar, which can again cause trade frictions. Japanese firms may not be able to respond to loss of competitiveness by out-sourcing through FDI to East Asia as they did previously: the Japanese banks already have large exposure in the area and there is an excess capacity. This means that Japanese profits will be squeezed, putting pressure on wages and unemployment.

It is often held that the EU will be relatively untouched by the crisis since its exports to the region are a small proportion of its GDP. However, for some countries in the EU, exports to East Asia have been the most dynamic component of aggregate demand in recent years. Moreover, it is important to recognize that European banks have larger exposures than Japanese and US banks not only in Asia, but also in Eastern Europe and Latin America, where vulnerability to contagion remains high. Moreover, the crisis can be expected to influence policies in developing countries and transition economies with large external deficits. They may be inclined to restrict domestic demand and cut their imports and external deficits in order to reduce their vulnerability to an interruption of capital flows. This would be deflationary not only for the countries concerned, but also for their trading partners including Europe. Declines in net exports to developing countries, together with restrictive fiscal policies designed to meet the conditions for EMU, may make it more difficult for the EU to halt the rise in unemployment. Growth may further be depressed if the European currencies appreciate vis-à-vis the yen; although the latter may be greeted as a success for the EMU, it would only aggravate the unemployment problem.

The crisis may also pose an additional challenge for the EMU. It is generally recognized that desynchronization of cycles among the participating countries, together with restrictions on individual countries' budgetary policies and the absence of a strong fiscal centre à la US, can cause frictions regarding interest rate and exchange rate policies, particularly since initial conditions with respect to external payments and labour markets differ widely. Such frictions would also emerge if the EMU received asymmetric external shocks that required a different monetary policy response for the different participants. (8) In that respect, the coincidence of the Asian crisis with the launching of the EMU could be a cause for concern.
Another unknown element in the evolution of the crisis is China. While the country itself is not exposed to speculative attacks in the same way as the others in the region, Hong Kong is its Achilles’ heel. Should Chinese exports slow sharply as a result of increased competition from the region and its growth rate fall considerably below the 8 per cent set by the government, markets may try to test the resolve of the government to maintain a fixed exchange rate - very much as they did in France in 1993. Since China cannot politically afford to abandon the peg in Hong Kong, it may chose to devalue its own currency, using the interest rates in Hong Kong to defend the peg. However, if it does not succeed in keeping the peg, the crisis could intensify significantly.

To sum, the East Asian crisis has unleashed forces that tend to aggravate the existing imbalances in the global economy, raising once more the spectre of deflation and protectionism. Certainly, increased trade imbalances and reduced growth will provide humus to protectionist sentiments and such pressures may intensify, as much in Europe as in the US. Moreover, these pressures could succeed in attaining their goals if surplus countries do not pursue expansionary macroeconomic policies as developing countries start cutting their trade deficits.

Another potential threat is competitive devaluations. This was a major concern for the architects of the Bretton Woods system, and that concern increased after the collapse of the system in the early 1970s. However, it receded when inflation became a major problem. Because of the implications for price stability, countries were unwilling to use their exchange rates to export unemployment. The threat of competitive devaluations is much more serious now than at any time since then, because the danger now is deflation, not inflation. There were some signs of it during the currency crisis in Europe a few years ago when some countries pulled out of the EMS and devalued to import some demand. If the crisis deepens global deflation, there may be more action of this kind. This is why it is important to have expansionary policies in the countries with external surpluses.

Perhaps the worst scenario is the emergence of redundant capacity on the other side of the Pacific too. In Japan the post-Plaza recovery was based on a very strong investment boom, but only to result in excess capacity subsequently. Again, the current difficulties in East Asia are traced back to excessive investment in the region since the beginning of the decade. Increased trade frictions may become unavoidable should the US investment-led expansion come to an end in the same way.

D. Conclusions

The East Asian crisis shows once more that there are serious systemic problems in the global monetary and financial arrangements. Indeed, it has long been maintained by many observers that it is not possible to speak of a 'system' of international money and finance. The East Asian financial crisis has increased awareness of the need for global governance of finance so as to prevent the recurrence of similar crises. Hopefully, the international community will be forced to reconsider whether or not existing arrangements regarding international payments and finance are compatible with stability and growth.

The main problem is that, even though financial markets are much more integrated than product markets and capital is much more mobile than other factors of production, there is no global governance of international financial transactions analogous to that found in the area of trade. Moreover, the present international arrangements are not only inadequate but also asymmetrical; they are designed to discipline borrowers rather than regulate lenders. This stands in sharp contrast with the way national financial systems are designed. Moreover, international arrangements are designed to manage rather than to prevent crises. And the measures to stave off international banking crises tend to be at the expense of living standards, stability and development in debtor developing countries.

Second, with greater financial integration, the global impact of interest- and exchange-rate policies has become much more important. This is true not only for the major industrial countries but also for many developing countries, where policies are seen to have had serious regional or global repercussions. There is no effective surveillance in these areas and there is no way of preventing 'beggar thy neighbour' policies affecting key monetary and financial variables. Moreover, there is no mechanism for
dispute settlement regarding macroeconomic and financial policies, such as exists for trade policies. If a country puts up its tariffs on imports of cars from its neighbour, the latter can go to the WTO and complain, but no forum exists where a country can make analogous representations about a rise in a major country's interest rates and a consequent increase in its debt burden, or about a devaluation which has the same effect on its exports as higher tariffs.

Third, there are no effective, rule-based and adequately funded arrangements for the provision of liquidity by an international lender of last resort.

Finally, there is a need for a system of orderly work-outs based on rules and bankruptcy procedures governing international debtor-creditor relations.

Several proposals to fill these gaps are worth considering. The international community needs to turn its attention to these issues as part of efforts to improve the governance of international finance.

References


8. See e.g. M. Feldstein, 'The Political Economy of the European Economic and Monetary Union: Political Sources of an Economic Liability', The Journal of Economic Perspectives, Fall 1997, Vol. 11, No. 4.
affirmative action, Asian financial crisis, bank run, banking crisis, bilateral investment treaty, borderless world, Bretton Woods, British Empire, capital controls, Carmen Reinhart, central bank independence, collective bargaining, colonial rule, Corn Laws, corporate governance, corporate social responsibility, credit crunch, Credit Default Swap, currency manipulation / currency intervention, David Ricardo: comparative advantage, deindustrialization, Deng Xiaoping, Doha Development Round, en.wikipedia.org, endogenous growth, eurozone crisis, financial. Despite this evidence, on the eve of the East Asian financial crisis few believed that the region was vulnerable to major financial shocks. The argument as related to the Asian financial crisis is that inadequate prudential regulation prevented risk of bank loans to be evaluated appropriately. Instead of looking at sources of financial weakness, financial fragility or vulnerability could be assessed. Bank balance sheets can deteriorate even without an increase in the number of defaults if the rate of return on bank assets falls short of the rate that must be paid on liabilities. Aside from the currency overvaluation, other indicators in East Asia were concentrated in the financial sector. This indicates that BOP considerations were of less importance in generating weakness in the domestic economy. Data also show that the Asian 5 were running fiscal surpluses at that time (Montes 1998).