Asia's Crisis
A Market Perspective

Recent events in Asia have posed a particular challenge for international capital markets. How can net private capital flows best be restored?

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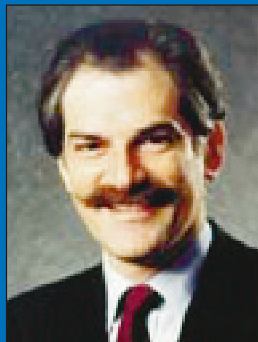

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ASIA'S CURRENCY CRISIS—the opening act of which was the July 2, 1997 devaluation of the Thai baht—dampened significantly the prospects for global growth while unsettling financial markets. Even today, the fragile situation in Asia constitutes a potential systemic threat, despite the progress that has been wrought through the unprecedented efforts of the past months. In less than one year, Asia has been transformed from the world's fastest-growing into its slowest-growing region. At the same time, the region previously considered by many investors to offer the most attractive business opportunities was converted almost overnight into a net capital exporter.

The Asian crisis has attracted a wide range of commentary. Reviewing key aspects of the crisis remains worthwhile, however, since many of the conclusions reached by observers of recent events warrant closer examination. In particular:

- Clear-cut warning signals of a potential Thai crisis were recognized widely, but the specific policy actions that precipitated the baht's collapse—and critical data—were hidden from public view.
- The virulence of the crisis, and the speed with which it spread throughout the region, was unanticipated, indicating that the importance of preexisting regional linkages was not adequately recognized.
- The economic damage and financial disorder resulting from the crisis were not inevitable and were exacerbated by policy errors that sapped investor confidence.
- The role of fixed or pegged exchange rate policies in precipitating the currency crisis has been exaggerated. The critical failure in the crisis countries was in following inconsistent policies—albeit in difficult circumstances—that progressively lost credibility.
- The catalytic role of external capital flows in triggering the crisis has been overestimated—in essence, treating symptoms of deeper problems as if they were the problems themselves. At the same time, the critical importance of capital flight from the crisis countries has been underestimated.
- The reluctance of the crisis countries to tighten their monetary policies to stem capital flight—and their attempts to shield domestic firms and wealth holders from the impact of market discipline—proved to be self-defeating. Stabilization efforts did not gain credibility until policies were tightened—although this occurred in most cases only after a lengthy delay, and at a substantially greater cost.
- Asia's financial turmoil in large part has been tamed for the time being, but the risks of renewed problems remain substantial. Asia's 1998 economic growth outlook appears more subdued today than consensus views indicated previously, even at the peak of the crisis in late October-early November.
- The economic and financial challenges differ substantially from country to country. The Japanese economy's stagnation throughout the 1990s, the Chinese economy's transformation, and the maturing of the Association of Southeast Asian Nations

(ASEAN) economies all represent distinct—although linked—issues, requiring individually tailored approaches.

• Much of the criticism leveled at the official responses to the unfolding crisis seems misguided. The international financial institutions are not dealing with the crisis countries in a "one size fits all" fashion—a claim repeated widely—nor are stabilization programs "causing" the economic downturns now afflicting the crisis countries. At the same time, international officials did not always anticipate accurately financial market problems.

• Any solution to the ongoing crisis necessarily will rely on private funding. Thus, restoring investor confidence is a paramount challenge. Recurring, large-scale provision of public funding simply is not a practical alternative to capital market stabilization—while strengthening the crisis countries' financial markets will contribute substantially to rebuilding confidence.

• The securitization of international finance will accelerate as the crisis abates. The Mexican peso crisis of 1994–95 and the 1997–98 Asian currency crisis underscore that the current international financial system does not provide clear delineation of responsibility for liquidity and solvency in a world increasingly dominated by securitized cross-border finance. In these circumstances, the IMF has been assigned an impossible mission of achieving instant stabilization.

• Moral hazard risks are important in considering the future design of the international financial system, but their role as a driving force in the current crisis has been exaggerated.

• At the end of the day, fundamentals remain fundamental. Sustained good economic policies produce superior results, while clarity in the assignment of risks in market-driven financial systems helps to avoid crises.

• The proposals currently under consideration by the IMF regarding the implementation of capital market liberalization as a long-term goal for possible incorporation into the IMF's Articles of Agreement could provide a powerful aid to future crisis prevention.

"The crisis countries' central banks failed to provide a clear rationale for their decision to float their currencies."

Thailand's unexpected aftershocks

Officials and financial markets alike had been aware of the risk that the Thai baht would be devalued. The classic warning signs of an external payments crisis had been present in abundance for at least a year: slowing export growth, a currency that was appreciating in real effective terms, a growing current account deficit financed increasingly by short-term capital inflows, rapid domestic credit growth, a speculative real estate boom, and rising domestic inflation.

What was unknown was how the Thai authorities would respond. In the event, the provision in June by the Thai central bank of large-scale emergency funding to the domestic banking system provided the key signal to domestic investors that it was time to move their liquid funds out of the baht, while supplying the liquidity to finance capital flight. When the Thai authorities hid the ensuing loss of international reserves through the use of forward exchange contracts, collapse of this house of cards became inevitable.

It seems less obvious, however, how the predictable Thai devaluation became the trigger for a system-threatening, region-wide economic and financial crisis: Thailand is a relatively small country whose external trade and international financial flows represent a modest proportion of international—or even regional—transactions.

The principal surprise in the aftermath of Thailand's currency devaluation was the lack of contingency planning by the country's ASEAN partners—in particular, Indonesia, Malaysia, and the Philippines—which were confronted almost immediately with intense speculative pressures. Investors identified a regional pattern of slowing export growth, rising current account deficits, and weak banking systems. Market participants suspected that concerns about relative competitiveness eventually would cause these countries' currencies to move in tandem, since they compete in the same export markets.

A long tradition of regional exchange rate stability had encouraged domestic investors to assume significant currency risk, mainly via unhedged foreign currency borrowing. In several cases, new investment increasingly was focused on real estate and other activity in the nontradable sector, reflecting the region's diminished export competitiveness in the wake of the renminbi's 1994 devaluation and the yen's weakness vis-à-vis the U.S. dollar.

The subsequent abrupt withdrawal of East Asian central banks from the foreign exchange market—with the apparent encouragement of international financial institutions—left many borrowers with large foreign exchange losses and unhedged exposures. As local businesses scrambled to hedge their foreign liabilities, pressures on the region's currencies intensified.

The decision by the crisis countries not to defend their currencies reflected a variety of pragmatic considerations, including the elimination of easy targets for speculators. Ironically, the result was tremendous uncertainty, which only fueled speculation and sapped investor confidence. The crisis countries' central banks failed to provide a clear rationale for their decision to float their currencies, nor did they articulate an alternative policy regime to guide market expectations.

Regionalization's object lesson

The conventional wisdom is that the 1990s has been "the decade of globalization." In fact, during the past decade, regional economic links have intensified more than extra-regional ones. Although short-term interest rates have shown no sign of

converging among Germany, Japan, and the United States (the Group of Three), they increasingly have moved together at the regional level. Trade among industrial countries has declined in relative terms, while the linkages between developed and emerging market economies within regions have increased.

Intraregional trade among emerging market countries has been the fastest-growing category of all: Asia provides the most clear-cut example of the regionalization of trade and investment (see table). Despite strong export growth to non-Asian trading partners, intra-Asian trade has grown even more rapidly. The increased openness of the Chinese economy has encouraged the growth of intraregional trade, as neighboring countries have shifted labor-intensive manufacturing activities to low-cost Chinese sites. Somewhat paradoxically, the instability of the yen/dollar exchange rate in the 1990s also encouraged the expansion of intra-Asian trade flows: the early 1990s rise in the yen encouraged Japanese firms to expand their Asian manufacturing facilities.

As a result of this intensifying regionalization, the effects of the Thai devaluation spread much more rapidly throughout Asia than officials had expected. Moreover, Asia became engulfed in a financial and economic conflagration before the rest of the world seemed to take much notice. Similarly, Asian policy decisions aimed at halting the crisis appear to have been addressed principally from the perspective of individual countries, rather than in a regional context.

The failure of individual country authorities and international institutions to examine policy options—and to act—on a coordinated, regional basis no doubt added to the virulence of the crisis. The image of countries reacting to market pressures on an individual—essentially piecemeal—basis drained investors' confidence. Capital flight became generalized throughout the region, while external lenders—many of whom were relative newcomers to the region, and whose exposure was primarily through short-term lending—became reluctant to roll over maturing credits or to extend new ones, adding substantially to the crisis atmosphere.

Rather than accept the monetary policy straitjacket imposed by their fixed exchange rate regimes—and to absorb the implied losses by domestic banks and financial entities—authorities in the ASEAN countries tried to shield their private sectors. Concerns about weaknesses in the balance sheets of companies and banks made the region's central banks loath to tighten liquidity after the Thai devaluation. More common was the provision of subsidized credit to financial institutions. Even those Asian countries that raised rates initially when their currencies came under pressure were quick to ease at the first sign of diminishing market difficulties. Protecting the domestic banking system appeared to take precedent over restoring investor confidence, as if the two were mutually exclusive.

Trade among developing countries

(intraregional exports as a percent of total exports)

	1989	1996
Within Asia	31.4	40.4
Within Latin America	15.3	20.3
Within Europe	31.2	36.3

Source: IMF, *Direction of Trade Statistics.*

As it became apparent that initial efforts to stem the crisis were failing—including the announcement of IMF stabilization programs that seemed short on policy details or lacked the clear-cut support of the local authorities, or else simply were overtaken by events, the crisis took a serious turn for the worse, as the pressures spread to north Asia.

On October 17, the authorities of Taiwan Province of China unexpectedly implemented a 10 percent depreciation of the New Taiwan dollar, despite massive foreign exchange reserves and little evidence of serious market pressure. With this act, developments in Asia took on the aura of competitive devaluation, with no limits to its potential scope. For example, pressure on the Hong Kong dollar intensified immediately, despite that currency's long-standing peg to the U.S. dollar, Hong Kong SAR's large stock of foreign reserves, and the authorities' determination to defend the peg.

In this context of spreading turmoil among closely linked economies, but in the absence of any decisive policy response in the larger ASEAN countries, the subsequent impact of the disorder in East Asia on the financial markets and economies of Japan and Korea was not surprising. However, once these large economies had been drawn into the crisis, stabilization efforts became much more complicated. Even the promise of massive external funding being made available—on a scale unprecedented in previous IMF stabilization programs—failed initially to stem Korea's market weakness. Only the implementation of tighter fiscal and monetary policies—together with a commitment to significant structural reforms—eventually proved successful at heading off further market weakness.

Public officials have been reluctant to acknowledge the catalytic role played by capital flight in the virulence and persistence of the region's recent difficulties. This disinclination is natural, because the actions of domestic wealth holders in shifting their funds out of local currency reflected loss of confidence in the local markets—and in local policymakers' ability or willingness to stabilize markets.

Halting capital flight

Halting and eventually reversing capital flight is a difficult task even under the best of circumstances but, unless the underlying problem is recognized, there is little chance that policy actions can succeed in restoring financial stability. Moreover, without action to end large-scale capital flight, the provision of new external capital alone—even in large doses —is unlikely to prove effective in ending a financial crisis that is, at heart, a crisis of confidence.

In particular, monetary policy tightening effectively poses a dilemma for flight capital, while underscoring the authorities'

effort to stabilize their currency's external value. Specifically, higher rates signal to holders of flight capital that they cannot expect simultaneously to convert their liquid assets into foreign currency while maintaining control over the domestic assets that these funds had financed.

In these circumstances, therefore, vociferous opposition is to be expected from domestic wealth holders in response to a monetary policy tightening in support of a stabilization program. Of course, the impact of policy tightening will be to create new strains for the domestic economy. The alternative to decisive action likely would be more painful, however, especially if capital flight continues. The best way to avoid this sort of unpleasant policy choice is to avoid a crisis in the first place: once a crisis erupts, hard choices are inevitable.

Private external finance

The buildup of short-term external debt in the crisis countries during 1995–97 and the sharp swings in private capital flows as the crisis unfolded have led many observers to view these factors as primary causes of the current difficulties of the crisis countries. At the same time, the impossibility of sustained, large-scale public funding of developing Asian countries' long-term capital needs is widely recognized. Thus, a restoration of net private capital inflows to the crisis countries is a sine qua non of their future economic success.

First, the buildup of short-term debts before the crisis reflected in part the perceived increasing riskiness of the crisis countries' situation. In these circumstances, new funds were available mainly at shorter maturities. In this sense, the debt buildup was itself more a warning sign than a direct cause of impending problems. A balanced expansion ultimately will require a broad range of financial instruments, including short-term credits.

Second, structural improvements in the efficiency of the crisis countries' domestic capital markets is imperative if investor confidence—and net capital inflows—are to be restored quickly. Thus, successful stabilization efforts surely will require such reforms. That this effort will be complicated and difficult is clear, given the current state of affairs in the crisis countries with regard to their domestic debt and the weakness of many financial institutions.The experience of the Latin American countries in the 1980s, however, has demonstrated the critical role of strengthened domestic financial systems in improving the efficient use of external funding.

Systemic considerations

Asia's currency crisis has laid bare several critical weaknesses in the current international financial system. First, instability in the Group of Three—Germany, Japan, and the United States—countries creates a substantial burden on the developing countries. For example, the large fluctuation of the yen/dollar exchange rate—reflecting in large part Japan's weak economic growth and the problems of its financial institutions—have added significantly to the region's difficulties. In this sense, the key currency countries have not shouldered their share of the burden in creating a stable economic and financial environment.

International capital markets increasingly are becoming securitized, in that a larger share of long-term, cross-border capital flows are taking place via marketable equities and bonds. This process is certain to accelerate sharply as the current Asian turmoil recedes. Despite the rapid growth of these forms of finance, there is a notable lack of clarity among international authorities with regard to responsibility for the liquidity and solvency of a system based on securitized finance.

In the wake of the 1994–95 Mexican crisis, the IMF was given the lead role in responding to international payments crises. At the same time, there was recognition that the Fund's resources would have to be increased for it to enjoy credibility in this role. The Asian crisis has called these earlier conclusions into question. In a world of mobile, securitized capital, there is little likelihood that the IMF staff will be able to construct a credible stabilization program, including needed structural reforms, under crisis conditions in a matter of days. In the context of growing capital mobility, the IMF is being put in a difficult situation, as rapid action will be needed to halt capital flight in a future crisis. Even the availability of large-scale external public emergency funding will not be sufficient by itself to guarantee success, as became clear in the case of Korea. Thus, structural reforms in the emerging market countries—especially of their financial systems—need to be undertaken aggressively before potential troubles emerge, not after.

Many observers have concluded that direct controls are needed to reduce the risk of destabilizing capital outflows. Chile is often cited as having succeeded in this area by restricting short-term flows. However, it is uncertain how helpful such measures would be if adopted elsewhere in substantially different circumstances. In addition, preventing excessive capital inflows is not at present the most pressing issue facing Asia. Potentially more important would be measures to strengthen financial systems in emerging market countries to clarify the liquidity and solvency risks that investors bear when purchasing securities issued internationally or in other countries.

While such issues are better defined in the case of cross-border bank lending, the same is not true for securitized finance. Regardless, the latter will become increasingly important in the next few years. In this context, the initiative of the IMF's Interim Committee to incorporate capital account liberalization in the Articles of Agreement as a goal of the IMF's members, is highly promising. There is no foolproof system on offer, of course, as moral hazard and other risks can never be eliminated completely. However, clarification of the logical structure and the organizational mechanics of risk bearing in an increasingly securitized international financial system would represent an important contribution to future economic progress. F&D