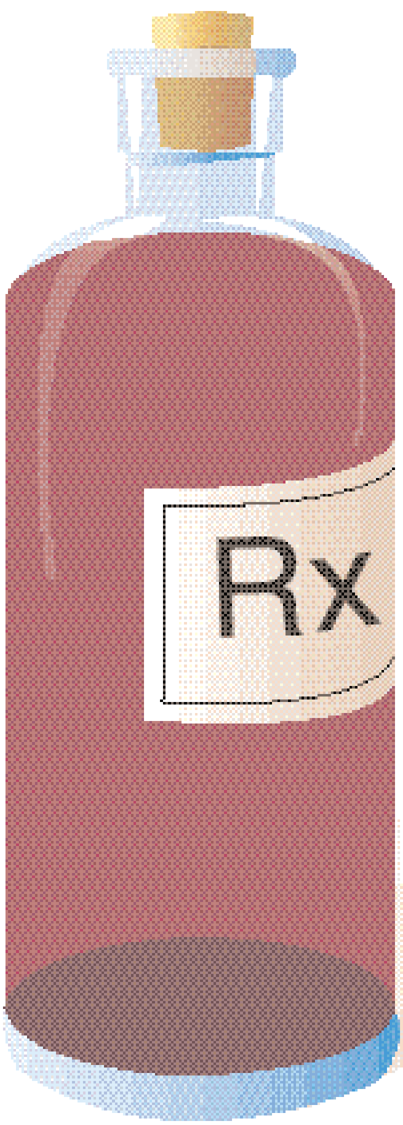
The Asian Crisis
Causes and Remedies

Until their sudden fall from grace in 1997, the countries hit hard by Asia's financial crisis—Indonesia, Korea, Malaysia, and Thailand—had been widely admired for their economic achievements and much favored by foreign investors. What happened, and is there a prescription for reducing the risk of future crises?

Bijan B. Aghevli



FOR THE THREE decades before Asia's financial crisis, Indonesia, Korea, Malaysia, and Thailand had an impressive record of economic performance—fast growth, low inflation, macroeconomic stability and strong fiscal positions, high saving rates, open economies, and thriving export sectors. It is therefore not too surprising that no one predicted the Asian crisis. Now that the crisis has unfolded, it is, of course, much easier to identify the problems that led to it. In fact, there is a consensus on the causes of the crisis, in sharp contrast to the diversity of views on the remedies.

What happened?

To a large extent, these countries were the victims of their own success. Because of their strong economic performance throughout the early 1990s, the Asian countries were in denial when problems began to surface. Believing they were immune to the type of crisis that erupted in Latin America in the 1980s because they did not have the large fiscal deficits, heavy public debt burdens, rapid monetary expansion, and structural impediments that had made Latin America vulnerable, the Asian countries did not deal in earnest with their emerging problems until too late.

Thailand's story is very telling in this regard. The problems in Thailand started in 1996. The IMF warned the authorities in early 1997 of the impending foreign exchange crisis, but it was difficult to convince them of the seriousness of the emerging problems. The warning was not made public, of course, given the strong risk that such a move could precipitate the very crisis it was intended to avoid.

Moreover, the IMF was not aware of the full extent of Thailand's problems at the time, because the baht was initially supported by heavy intervention in the forward market. Not knowing that virtually all of Thailand's international reserves had already been committed in the forward market, the IMF believed they were adequate—until mid-1997, when the country's usable reserves were nearly depleted and the authorities came to the IMF for help. Similarly, the IMF was not aware that Korea's foreign exchange reserves had been virtually used up until it was called to the scene.

The underlying causes of the Asian crisis have been clearly identified. First, substantial foreign funds became available at relatively low interest rates, as investors in search of new opportunities shifted massive amounts of capital into Asia. As in all boom cycles, stock and real estate prices in Asia shot up initially, so the region attracted even more funds. However, domestic allocation of these borrowed foreign resources was inefficient because of weak banking systems, poor corporate governance, and a lack of transparency in the financial sector. These countries' limited absorptive capacity also contributed to the inefficient allocation of foreign funds.

Second, the countries' exchange rate regimes—exchange rates were effectively fixed—gave borrowers a false sense of security, encouraging them to take on dollar-denominated debt. Third, in the countries affected by the crisis, exports were weak in the mid-1990s for a number of reasons, including the appreciation of the U.S. dollar against the yen, China's devaluation of the yuan in 1994, and the loss of some markets following the establishment of the North American Free Trade Agreement (NAFTA).

The massive capital inflows and weakening exports were reflected in widening current account deficits. To make matters worse, a substantial portion of the capital inflows was in the form of short-term borrowing, leaving the countries vulnerable to external shocks.

It is clear, with the benefit of hindsight, that this situation was "just a big accident waiting to happen"; the only question was what would trigger it. Once the crisis broke out in Thailand in July 1997, the Asian countries were all vulnerable. And the markets overreacted. The thinking was that if this could happen in Thailand, it was bound to happen in other Asian countries facing, to varying degrees, the same problems —weak financial and corporate sectors, a large current account deficit, and a heavy external debt burden. Creditors withdrew funds from the region, and the crisis spread.

When these countries approached the IMF for assistance, the most pressing issue initially was to provide them with adequate financing to deal with the liquidity crisis created by the sudden flight of capital and the collapse of their currencies, and to give confidence to the market. The IMF provided the biggest loans in its history, while arranging for additional financing from other countries in the region as well as from the Group of Seven countries.

Monetary policy

Given that the first manifestation of the crisis was the collapse of the currencies of the Asian countries, monetary policy was a key element of their reform programs. Ironically, the programs have been criticized from both ends of the spectrum: some critics believe that the countries should have raised interest rates even higher in defense of their currencies, while others have argued that the rise in interest rates was the main source of subsequent problems. A number of academics have made the point that, in a recession, the orthodox policy would be to lower interest rates and allow the exchange rate to slide to boost economic activity. But currency depreciation during the crisis was dramatic—for example, the Korean won dropped from less than 1,000 to nearly 2,000 to the dollar in only one month. In such extreme situations, the first priority has to be the stabilization of the exchange rate before a vicious inflationary cycle sets in. If domestic prices are allowed to skyrocket, the monetary tightening required to reestablish price stability is extremely costly.

The strategy pursued by the Asian countries was to raise short-term interest rates to arrest the deterioration of their exchange rates and then to gradually reduce interest rates as the exchange rates stabilized. In fact, the initial rise in interest rates was moderate and short lived: in Thailand, short-term rates rose to a peak of 25 percent, and in Korea, to 35 percent, and they stayed at these peaks for only a few days before declining rapidly to their precrisis levels. Furthermore, given the impact of sharp currency depreciation on inflationary expectations, the increase in interest rates was significantly lower in real terms than in nominal terms. Real interest rates (based on the consensus forecast of inflation as a measure of inflationary expectations), which were in the range of 7–8 percent before the crisis, rose briefly to 20–25 percent before dropping sharply. In both countries, real rates were above 15 percent for only two months, and they are presently about zero. At the same time, both the won and the baht appreciated substantially after the initial crisis.

By contrast, Indonesia's initial efforts to stabilize the rupiah failed. But this is the exception that proves the rule. During the first week of Indonesia's program, the authorities engaged in unsterilized intervention and allowed short-term interest rates to double to 30 percent. As a result, the rupiah appreciated sharply. But within two days, contrary to the country's understandings with the IMF, Bank Indonesia cut interest rates back to their initial levels. The subsequent expansion of liquidity, together with strong signals from the highest levels of the government that commitments under the IMF program would not be respected, precipitated the rupiah's plunge. The resulting high inflation necessitated much higher interest rates to reestablish financial stability. The cost of adjustment would have been dramatically lower had the government persevered with its original program.

To be sure, the weakness of the banking and corporate sectors in the Asian countries did constrain the scope for raising interest rates. However, while many critics have pointed to the adverse impact of higher interest rates on domestic borrowers, they have neglected to take into account the impact of currency depreciation on holders of external debt. A precipitous drop in a currency's value raises the burden of external debt on the banking and corporate sectors to an intolerable level and undermines financial stability. Thus, the trade-off between depreciation and interest rate increases shifts drastically in the presence of exchange rate overshooting. Currency depreciation would have a particularly adverse impact for Indonesia and Korea, which have a high ratio of external debt to domestic credit.

The liquidity squeeze in these countries was not just a consequence of high interest rates, because the banks have been reluctant to roll over their credits, given the large volume of their nonperforming loans and the weak position of the corporate sector. It is instructive to note that the credit squeeze has not been alleviated even as interest rates in Korea and Thailand have fallen to well below their precrisis levels. (A clear example of this phenomenon is Japan, where short-term interest rates have been zero for some time, while the economy has been facing a credit crunch.)

Fiscal policy

Initially, the Asian countries had strong budgetary positions. Their original fiscal targets envisaged a small surplus to help external adjustment and provide a cushion for financing the substantial cost of financial sector restructuring. However, as economic conditions deteriorated, these initial fiscal targets were adjusted to allow for the working of automatic stabilizers and to finance additional social spending to protect the country's poor. In fact, given the fiscal conservatism of these countries, in some cases the IMF found itself in the unusual position of trying to convince them to undertake fiscal expansion. The fiscal targets in all of these countries now show substantial deficits. Thus, the criticism that growth slowed in the Asian countries because of fiscal tightening is largely misplaced.

The IMF could, of course, be faulted for not having accurately predicted the depth of the recession, but there was no systematic bias in the IMF's growth forecasts, which were broadly in line with the consensus forecast. It is perhaps too early to know definitively why no one foresaw the severity of the recession, but there are some possible explanations. First, when boom-bust cycles are superimposed on a very weak financial system and highly leveraged corporate sector, the amplitude and duration of the cycle are much more pronounced. Second, until mid-1997, it had appeared that Japan was finally pulling out of its prolonged recession. But these hopes were dashed when Japan's economy plummeted, deepening the recession in Asian countries with close ties to Japan. Finally, the fact that several Asian countries were in crisis at the same time undermined general confidence and caused domestic demand to contract far more sharply than had been expected.

Structural reform

The inclusion of structural reform in these countries' IMF-supported programs has also generated debate. Some critics have argued that the IMF should have focused on macroeconomic policies alone, given that structural reform is a medium-term process. But the main source of the problems in all of these countries was structural—the weakness of the financial and corporate sectors, inadequate governance, and a lack of transparency. And, as the crisis unfolded, markets focused intensely on these problems; it would have been very difficult to regain investor confidence if the countries' programs had not included initiatives to address them, even if they could not be solved overnight. The governments needed to show that they were aware of the size of the problems and were committed to correcting them.

In addition, the authorities themselves were keen to take advantage of the crisis to push through important reforms—ironically, criticisms of proposed reforms were voiced mainly by outsiders. This was particularly true in Indonesia. Unfortunately, the country's economic authorities were undermined by groups and individuals who were threatened by the proposed reforms and a government that failed to take decisive action.

Bijan B. Aghevli, former Deputy Director of the IMF's Asia and Pacific Department, is Director of Asia Economic and Policy Research at Chase Manhattan Bank.

Where do things stand?

The situation has turned around in Korea and Thailand, although the crisis is not yet over. Exchange rates have appreciated considerably, and interest rates have already declined to below precrisis levels, which will allow investment and growth to resume. But the period ahead is still likely to be very difficult. The important task now is to manage the situation carefully so that unemployment problems do not get out of hand. Both of these countries will emerge from the crisis considerably healthier as long as they maintain their resolve to carry out their financial and corporate sector reforms.

The case of Indonesia, however, has proved to be much more complicated because of the volatile interaction of political and economic problems. In June 1998, the government of President Habibie renegotiated the country's IMF-supported reform program, which aims to reverse the serious economic deterioration that has occurred since the crisis erupted, prevent inflation from spiraling out of control, and extend the social safety net to cushion the impact of the crisis on the poor.

The success of the Asian countries' reform programs will depend to a great extent on the external environment. One factor in their favor is the continuing strength of the United States, but, unfortunately, Western European economies are showing signs of gradual weakening. The situation in Japan is worrying; it is essential that Japan rehabilitate its financial system and provide adequate fiscal stimulus to kick-start its economy, or the recovery of the crisis countries may be jeopardized. The crisis in Russia and its repercussions in Latin America are also worrying, although they have as yet had little impact on the Asian countries.

Dealing with future crises

Crises are inevitable. As long as there are financial markets, there will be boom and bust cycles. But vulnerability to crises can be limited.

First, better information is needed so that situations can be monitored and actions taken in a timely fashion. Had the rest of the world known how weak these countries' financial systems were, something could have been done sooner. Similarly, had the IMF known how rapidly international reserves were falling in Thailand, and subsequently in Korea, policy adjustments could have been made earlier.

Second, the financial sector plays a critical role in all boom-bust cycles—in developed and developing countries alike. It is essential that appropriate prudential and supervisory procedures be in place and that banks be in a position to assess risk. Financial sector reforms are therefore extremely important.

Third, one very important lesson that has emerged from this crisis is that it is a mistake for a country to have a fixed exchange rate unless its authorities are prepared to do what it takes—that is, in addition to pursuing sound macroeconomic policies, it needs to have a healthy banking system and a strong reserve position that can withstand a defensive rise in interest rates to fend off speculators. But few countries can maintain a fixed exchange rate when things go wrong.

Fourth, capital market liberalization must be undertaken with care. The problem in the Asian countries was not that they liberalized their capital accounts but that the sequencing was wrong and that liberalization was only partial. Most of these countries liberalized short-term capital inflows before foreign direct investment, when they should have done it the other way around. Furthermore, although capital inflows were liberalized, the financial system remained closed to competition from outside. The combination of partial liberalization and structural rigidities meant that capital was invested without due regard to risk.

Would it be appropriate to impose capital controls to avoid future crises? This would be like closing the door after the proverbial horse has bolted. Furthermore, capital controls are much less effective in stemming outflows than inflows. It would be more effective to deal boldly with the underlying problems in the financial and corporate sectors and to create the right environment so that when capital inflows resume they can be used productively. After all, these countries' easy access to foreign capital before the crisis contributed significantly to their rapid growth. Even if output in the Asian countries declined by, say, 10 percent, their growth over the past twenty years would still be impressive. What is important is the appropriate sequencing of capital liberalization, to ensure that a country's financial system is capable of channeling capital into productive investment. F&D

This article is based on a speech delivered by the author at a conference in Chicago, "Asia: An Analysis of Financial Crisis," cosponsored by the Federal Reserve Bank of Chicago and the International Monetary Fund, October 8–10, 1998.