CHAPTER 3

EAST ASIAN CRISIS

3.1 Crisis Overview[1]

During the 1980s right up to mid 1997, the world watched in wonder as Asian nations, one after another, began posting up highly impressive economic growth. But who could have predicted that Asia, which was being used as the model for developing economies the world over, seemingly strong and invincible was indeed quite fragile.

On the surface, it would be easy to assume that the crisis occurred as a result of the devaluation of the Thai Baht on 2nd July 1997, after a series of speculative attacks on the currency. But could that event have caused the whole Asian crisis on its own? After the devaluation of the Baht, contagion spread rapidly to other economies around the region that were stronger and had been performing better than Thailand. But they all suffered the same fate, and when South Korea was finally hit with the crisis, people around the world started wondering how the crisis had developed and devastated these model countries so easily. The similar features that most of the affected Asian economies have in common are their weak financial system, large external deficits, inflated property and stock market values, the maintenance of relatively fixed exchange rates and over-dependence on misallocated short term capital flows, which usually end up as non-performing loans, NPLs. Other common features were found in the financial institutions included lack of transparency and adequate prudential supervision of the financial institutions, excessive lending of high loans to connected parties, and the failure to recognize and provide for deterioration in loan quality. These features are attributed as the real reason how contagion spread like bushfire among the once invincible Asian economies. But they are just one part of the equation, the other part, which is deeper rooted, was the forced appreciation of the Japanese Yen.

And once Japan had to appreciate her currency, she was no longer competitive in the world market, as they had been before the appreciation, and hence her companies had to relocate elsewhere to regain their competitiveness. This led to an increase in Japanese investments in other regions, especially Southeast Asia where labor was still relatively cheap. These large inflows of capital investment prompted

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[1] The Individual Country Analysis can be found in Appendix B

the developing economies of Southeast Asia to open up their doors and economies and embrace trade liberalization, eventhough some of them were not really ready to do so. And it is these large influx of foreign capital that led to the problem, as the crisis was characterized by weak financial systems, which was typical of the affected economies. And although these investments were undoubtedly the driving forces behind the phenomenal growth of the Asian economies, the fragility of the situation could no longer be disguised and it ended up with the financial crisis of 1997.

The final word is though, that the current financial crisis started in Thailand, after she unsuccessfully trying to defend the value of their currency against foreign speculators, which by the time the government announced the decision to float the Baht, about half of the total foreign reserves, US$20 billion, had been lost. The crisis spread quickly to the neighboring ASEAN countries, when foreign investors immediately and simultaneously withdrew their capital. By September 1997, the Philippines peso, the Indonesian rupiah, the Malaysian ringgit all lost between 18 to 25 percent of their value against the US dollar, and even the strong Singaporean dollar was affected too, depreciating by about 7 percent. The region's stock markets also took a tumble, which by November, loosing about 20 to 50 percent of their pre-crisis values[2].

By 1998, a year after the outbreak of the crisis, many countries were still under the dark clouds of the crisis. Indonesia was among the most seriously affected country, and joining her were Malaysia, South Korea, and Thailand, where the whole ordeal had started. The Indonesia rupiah had lost about 90 percent of its value relative to the US dollar since the crisis, and the currencies of Malaysia, South Korea and Thailand lost about 40 percent of their value. The stock markets of these countries also suffered severely, with the Indonesian stock market loosing about 90 percent of its value, while 70 to 75 percent were lost in the stock markets of Malaysia, South Korea and Thailand. In 1997 alone, Japanese investment trusts withdrew US$1 billion from Southeast and East Asia, while the US mutual funds and global offshore funds withdrew US$1.8 billion and US$1.9 billion, respectively making the crisis one of the largest destruction of wealth in the world[3].

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[2] Tan, Gerald, "the end of the Asian miracle?", p.355

[3] ibid. p.370

3.2 Measure and Response to the Crisis

Total currency meltdown of the Southeast Asian countries such as Thailand, Indonesia, the Philippines and Malaysia were the immediate casualties of the financial crisis, and when joined by South Korea, were the 5 Southeast Asian countries hardest hit by the crisis. Their currencies collapsed against the US dollars, with the value of the Thai Baht falling some 107%, the Philippines Peso 69%, the Malaysia Ringgit 83%, and the Indonesian Rupiah feeling the most damage, fell an astonishing 258% [4]. To make matter worst, the crisis prompted a contagion effect when foreign investors rapidly withdrew their investments, resulting in the sharp fall of the stock markets all over Asia. Asia is noted for their unity in diversity, and this was also the case with the crisis, as different country faced up to the crisis in their own ways. Some chose to line themselves up with the IMF's resolution, while other took the unorthodox methods, as a result, their outcome varied greatly and some may have been more successful than others at tackling their problems. And at the moment, when all the crisis-hit country are making a strong rebound from their nightmare, it might be useful to take a look at their initial measures to address the crisis.

<u>The IMF Response</u>

After the onset of the Asian financial crisis, the International Monetary Fund, IMF, was brought in to assist and perhaps help resolve the situation. The IMF reacted immediately, and the restoration of confidence to the affected economies was set as the first priority. This was to be achieved by, first helping to arrange programs of economic reforms that could restore confidence in the 3 most affected countries, Indonesia, South Korea and Thailand, as well as approving and extending financial support to them. Other immediate efforts to recall confidence included; the introduction of exchange rate flexibility where it did not already existed, a temporary tightening of monetary policy to stem pressure on the balance of payments and structural reforms to remove features of the economy that had become impediments to growth such as monopolies, trade barriers, and non-transparent corporate practices, and to improve the efficiency of financial intermediation and the future soundness of the financial system. Other measures included efforts to assist in the reopening or maintaining lines of external finances and since the financial sector problems were the major causes of the crisis,

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[4] Cabulu, Helen p.327

comprehensive reforms of the financial system was in order. This included the closure of unviable financial institutions, the re-capitalization of undercapitalized institutions, closer supervision of weak institutions and increased potential for foreign participation in domestic financial systems. IMF might have acted a little too quickly and have since been under fire and had been criticized heavily for their measures and their secrecy in carrying out their reforms, and the IMF had admitted that they made a mistake in Asia.

3.3 Lessons from the Crisis

While most of the Asian economies are on the verge of recovering from the nightmare of the crisis, many lessons have been learnt, which will undoubtedly be important for the prevention of future crises. One of the most important lessons is the need for the strengthening the architecture of the international financial systems to lessen the frequency and severity of future disturbances. The IMF had identified six major areas that should be strengthen which includes[5];

1. More effective surveillance over countries' economic policies and practices, facilitated by fuller disclosure of all relevant economic and financial data. The IMF has established and will further improve data standards to guide members in releasing reliable and timely data to the public. It has also recognized, over the course of the crisis, the importance of gross reserves and is working out a way for countries to report their data effectively.
2. Financial sectors need to undergo major reforms, such as better prudential regulation and supervision, and are working with respected organizations such as the Basle Committee on Banking Supervision and the World Bank to develop and disseminate a set of "best practices" in the banking areas.
3. Fostering of orderly and properly sequenced capital account liberalization, which should be supported by a sound sector and appropriate microeconomic and exchange rate policies in order to maximize the benefits from and minimize the risks of free capital movements.
4. Promoting regional surveillance.
5. Introducing and promoting good governance and fight against corruption stance including the adoption of the IMF's "Code of Good Practices on Fiscal Transparency – Declaration on Principles" to serve

[5] Internet -- International Monetary Fund

as guide for members, and to enhance the accountability and credibility of fiscal policies as a key feature of good governance.

6. More effective structures for orderly debt workouts, which includes better bankruptcy laws at the national level and better ways at the international level of associating private sector creditors and investors with official efforts to help resolve sovereign and private debt problems.

Clearly these lessons learnt from the mistakes and experiences during the Asian financial crisis will be important factors in helping to prevent future repeats of these incident, but in order for it to be effective all parties concerned will have to dedicate themselves to the cause as well.

3.4 Crisis Prevention

The crisis reflected the region's weak financial structures and regulations, and stressed the need for an international financial control standard to be introduced. Furthermore, the fact that the current crisis occurred within the private market and was driven by private capital flows must not be allowed to hide the fact that financial crisis will continue to occur as a result of microeconomic mismanagement as well. As a result, ways to discourage short-term private capital flow, which contributed greatly to the crisis, have to be found. Furthermore, the crisis also outlines the fact that the International Monetary fund is really not well funded to provide efficient and sufficient liquidity in future situations as dire as the Asian financial crisis. Hellieiner(1998:233) suggested that the IMF should play more of a leader role, and less of the financier role. It is also clear that the creation of an international institution that can provide information, supervision and regulation should be encourage, as it will be a useful instrument in helping to prevent future crises. These institutions should also be transparent and sincere in their efforts.

3.5 Prospect of an Asian Monetary Integration

The topic of an Asian economic integration had been under discussion for a long time and had intrigued the leaders of the Asian countries for decades, but as yet, nothing have materialized. There are many reasons for the delay of the integration, but one of the main reason must be that the stronger union of the region, namely ASEAN, was established not as an economic union, but rather a political union to counter and block the Communist advance into Asia during the Cold War era. Hence, ASEAN's main objectives during the first part of her life was regional security concerns, but since the end of the Cold War, and the eventual collapse of Communist Russia, ASEAN's main objective had become obsolete. So they had to shift their focus, and their objective was then adjusted to the development of the region. But the fact was that ASEAN lacked a leader in the caliber of Germany, in the case of the European Union, or the United States, in the case of NAFTA, a nation who was strong enough politically and economically, to take the helm and lead the charge towards economic integration. But no country in ASEAN had been able to press their claims to match the influence of Germany or the United States, in the region yet, and so the integration attempt of Asia, had been pretty much without a clear and powerful leadership. This is why it is now clear that if the chance and potential of an Asian Monetary Union, or an Asian Economic Integration is ever going to be realized, it has to be achieved on a much bigger ground than ASEAN, and countries such as Japan, China, Korea and Hong Kong have to be brought into the process. Japan and China are especially crucial, as they have the potential to be the leader, as they possess strong economic and political background, as well as commanding respects from the other Asian countries.

But then another problem present itself, and this is the issue of diversity. The economic situation and gaps between the Asian countries are so vast that it had been almost impossible to fill, unlike Europe where eventhough gaps exist between the 15 member countries, it is not so wide, and the members had been trying very hard to close these gaps. If Japan and China are really to take command in the formation of the Asian Economic Integration, it is them, and a few other front runner economies such as Hong Kong, Korea and Singapore, who have to bare the burden of the gaps between themselves and countries such as the Philippines, Vietnam, Laos and Cambodia. This prospect is understandably, not very appealing at all.

Another factor that posed as the obstacle to the formation of an Asian monetary or economic integration in the past was the successes and the rapid growth of the Asian economies. The reason behind this is that prior to the financial crisis, it could be said that most of the countries in Southeast Asia were riding high on the tides of the economic successes, and were indulging in themselves and matters relating to their profit and growth only. In a way, they were also getting carried away by the growth figures, and as a sense of invincibility began to plant itself in the region, the not many took the idea of an economic integration into serious consideration. Furthermore, the fact that most of the products produced by the countries in the region are very similar, it is almost impossible to come up with an arrangement that satisfy all the parties involved. And although there were meetings that were arranged, no plan of actions or any measures were seriously implemented. But Asia received a rude-awakening in the form of an "unexpected" financial crisis, and they had to learn the hard way. And now, since the financial crisis had taken its toll on the Asian economies, in hindsight, it would be safe to say that if there had been an Asian economic union, the effect of the financial crisis, if it happened, would have been absorbed, and the member countries would not be struggling as they are now. Furthermore, it would be safe to say that if there was an Asian economic Union in place, the union's strength could have help prevented the crisis, or at least make light of the situation.

The financial crisis had highlighted the need for the Asian countries to progress onto the world stage, and in the process, they have to make themselves more competitive and efficient in the global context. There is a need for the Asian economies to build and foster a greater intra-regional cooperation, as well as competition, through more vigorous regional integration. And in the long run, the increased productivity and efficiency -resulting from the regional integration- is the only true route to a sustained recovery from the crisis[6]. What is clear is that Asian countries are now shifting their views and are for once, seriously considering the prospect of an Asian Economic Union. What form the Union takes, will be revealed with time, and no doubt it will be very interesting. How successful it will be, depend solely on the commitment of the participating countries. Certainly, for the dreams to be realized, the grouping will have to made up of more than just the ASEAN countries, as throughout their existence, they have shown that they have not got the strength to make it work on their own. They need stronger countries like Japan and China to help them forge this ambitious undertaking. Can an Asian Economic Union be realized? Yes it can, but it will take time, and it will take a lot of discussion. The European Union was not built in one day, or one year. It took a lot of painstaking discussions, cooperation and sincere commitment, for all the potential members to converge their interests and work towards achieving a particular goal. Asia can do it too, the potential is there, but where is the will? Maybe it would make things easier, if Asia have a common goal to work towards, and at the moment, the prevention of another financial crisis is as good a reason as any, and if they stick to that goal, the prospect of an Asian Economic Union will no longer be just an ambitious dream anymore.

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[6] Park, Donghyun, "The Prospect for Further Economic Integration in ASEAN", p.409