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Do We Know the Real Causes of the Asian Crisis?

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Global Financial Turmoil and Reform:

A United Nations Perspective

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Do We Know the Real Causes of the Asian Crisis?

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Introduction

It is now more than a year since several economies in Asia began to melt. Hundreds or thousands of papers, analyses and comments have been made, attempting to unravel the causes of the Asian crisis. This is not unexpected. Even now, some experts are still trying to explain the great depression of the 1930s.

At the risk of falling into "another one of those", this manuscript is intended to explore alternative explanations of the Asian crisis. It is argued that the region's "fundamentals" did not indicate fragility. The weak banking system, which indeed existed in most of the countries, also by itself could not be blamed for triggering the crisis. It is the contagion, channelled especially through huge shifts in financial flows, that may be able to explain the episode.

Yet, the severity of the crisis remains unexplained. By using the case of Indonesia, which happens to be the most serious casualty so far, it is argued that distinct political factors in each country may help clarify why the crisis ended

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up more severe in one country than in another. In the last section, issues of banking reform and debt resolution are discussed.

The fundamentals

Before the crisis kicked off, the affected countries—Indonesia, Malaysia, Republic of Korea, Philippines and Thailand—appeared quite robust in terms of several indicators. Most of the countries produced remarkably high economic growth. The only exception was the Philippines, which during 1991-1995 posted a mere 2.2 per cent annual growth rate. But even that number was higher than the annual rate of 1.8 per cent during the preceding decade.

Inflation trends were also quite positive. All affected countries managed to keep inflation at one-digit rates, although there was a slight increase in 1996. Indonesia, traditionally having the highest inflation rate, even managed to reduce the rate to 6.5 per cent in that year.

One of the factors behind the low inflation has been the management of the government budget. Practically all the countries had a budget surplus, a very different situation than that in the Latin American countries which experienced crises in the 1980s.

Export performance of the Asian crisis countries had also been relatively strong and the current-account deficits manageable, although the situation deteriorated and 1996 was a year of concern in terms of both indicators, above all for Thailand (see Islam, this volume, table 1).

One factor offered as an explanation of the current-account situation was the appreciation of the real exchange rate in the years leading up to the crisis (see ibid., figure 1). Each country had a fixed or semi-fixed exchange rate that was pegged, in essence, to the United States dollar and the dollar had strengthened during 1996 relative to other major currencies.

However, an appreciation of the exchange rate is not the same as having an overvalued exchange rate and thus the precise status of the exchange rate prior to the crisis needs to be looked at more closely. In this regard, Chinn (1998) found that even when overvaluation of the exchange rate was detected using a model that estimated the purchasing-power-parity exchange rate, the size of the overvaluation in crisis-stricken countries was smaller than that in crisis-free countries. For example, the Singapore dollar was found to be overvalued by 45 per cent, whereas the size of the overvaluation was much smaller in Indonesia, Malaysia and Thailand (see table 1).

Moreover, each of the South-East Asian crisis countries had relatively large holdings of foreign-exchange reserves. As shown in table 2, the recorded foreign reserves were 5, 4 and 3.5 months of imports in Indonesia, Malaysia and

Table 1. Deviations of exchange rates in East Asia from purchasing power parity (PPP)
(Percentage[a])

	January 1997	*February 1995-January 1997*
Indonesia	0.9	4.7
Malaysia	2.0	0.5
Philippines	-24.6	-26.4
Republic of Korea	-12.3	-0.5
Singapore	35.4	45.4
Taiwan Province of China	7.6	12.8
Thailand	2.0	3.7

Source: Chinn (1998).

a. Global currency overvaluation (+) or undervaluation (-) relative to PPP.

the Philippines, respectively. In Thailand, the number was highest among the four at 6.3 months.

On the basis of other indicators, however, the official reserve situation was less favourable. For example, one may contrast the stock of liquid monetary assets, which residents could some day try to convert into foreign exchange, with the capacity of the central bank to intervene to meet that demand were private suppliers of foreign exchange to withdraw, as during a speculative attack. One indicator that has been suggested in this regard is the ratio of broad money (M_2) to foreign reserves. The higher the ratio, the more vulnerable will be the country to speculative attack.[1] On the basis of such a ratio, table 2 reveals that in 1996 Indonesia was the most vulnerable, followed by the Philippines. Thailand had the smallest ratio. Even when a narrower measure of money is used (M_1), the ranking alters only slightly. Thailand continues to have the smallest ratio.

A complementary picture is given by a different external liquidity indicator, the ratio of short-term foreign debt to reserves. Obviously, the greater the ratio, the more vulnerable to speculative attacks a country will be. The last column of table 2 shows that the countries with the worst economic situation—Indonesia and Thailand—were precisely those that had ratios above one.[2]

A related indicator was the rapid growth of foreign debt itself, and the high and increasing share of short-term debt in the total (see Islam, this volume, table 2). However, the ratio of short-term debt to reserves did not rise

1 Calvo (1995) and Sachs et al. (1996) used a similar indicator in tests of the vulnerability of a country to speculative attack in the wake of the 1994-1995 Mexican peso crisis.

2 The Republic of Korea's short-term debt was more than twice its foreign reserves.

Table 2. Indicators of pre-crisis foreign exchange reserves in South-East Asia

	Foreign-exchange reserves (billions of US dollars)	Import coverage of reserves (number of months)	Liquidity indicators (ratio to reserves)		
			M_2	M_1	Short-term foreign debt[a]
Indonesia					
1992	10.2	4.5	5.7	1.3	1.7
1993	11.0	4.7	6.2	1.5	1.7
1994	11.8	4.4	6.6	1.6	1.8
1995	13.3	3.9	7.1	1.5	2.1
1996	17.8	5.0	6.5	1.2	1.9
Malaysia					
1992	16.8	5.2	2.6	0.8	0.2
1993	26.8	7.4	2.0	0.7	0.3
1994	24.9	4.9	2.6	0.9	0.3
1995	22.9	3.6	3.4	1.1	0.3
1996	26.2	4.0	3.8	1.2	0.4
Philippines					
1992	4.3	3.3	4.5	1.1	0.7
1993	4.5	3.0	4.9	1.1	0.5
1994	5.9	2.9	5.4	1.1	0.5
1995	6.2	2.7	5.9	1.2	0.7
1996	9.9	3.5	4.5	0.9	0.8
Thailand					
1992	20.0	5.9	4.1	0.5	0.8
1993	24.1	6.3	4.1	0.5	0.9
1994	28.9	6.4	3.9	0.5	1.1
1995	35.5	5.9	3.7	0.4	1.2
1996	37.2	6.3	3.9	0.4	1.2

Source: Data of IMF and the Bank for International Settlements.

a. Debt to private creditors maturing in one year or less.

significantly through 1996, which reflected the strong growth in reserves themselves. In fact, there were heavy pressures on the central banks to purchase foreign currency, especially in 1996, owing to massive inflows of capital into the region and the commitment to maintain fixed exchange rates or exchange-rate bands. By the same token, each of the countries saw rapid increases in domestic credit, fed in part by the foreign fund inflows and this should have been taken as an early warning of danger ahead.

Impact of capital inflows

By the late 1980s, most South-East Asian countries had liberalized their financial sectors, albeit to different degrees. Theoretically, the aim of financial liberalization is a more efficient financial system, from which borrowers and savers would reap the benefits. In this region, it was associated with remarkably high capital inflows (and not all of this capital was invested in the most productive sectors).

One problem for policy makers was the upward pressure on the exchange rate created by the inflows. The potential damage of appreciation on export competitiveness led the monetary authorities to purchase large amounts of foreign funds (boosting reserves), but that also added significantly to the domestic money supply. That could be inflationary, which left the authorities with an impossible dilemma.

Like anything else, the "Asian way" was to opt for a middle ground. While the Thai baht was perhaps the most stable currency in the region until 1996, in Indonesia, Malaysia and the Philippines, the selected middle ground was to manipulate the exchange-rate band by widening it when there were pressures to do so. At least until early 1997, the effort appears to have worked fairly effectively.

But high capital inflows have a far more serious impact than pressuring the exchange rate, namely their effect on the growth of bank credit and on domestic interest rates. That is, when a central bank buys foreign exchange (when it adds to foreign-exchange reserves), it pays with domestic money that thereby enters into the economy and into the domestic reserves of commercial banks; and on this basis, the banks extend more credit. However, if the monetary authorities simultaneously withdraw reserves from the banks, they may be able to sterilize the credit-expansion effect of the inflows. The problem is that to the degree that the excessive capital inflows were initially attracted by high domestic interest rates, those interest rate might well be unchanged at the end of the exercise and so the capital inflow would continue.

At a certain point, the monetary authority would have to give up sterilizing the inflows (alternatively, the strength of the inflow could overwhelm the sterilization capacity of the central bank). The story then becomes one of greater-than-desired increases in bank deposits and bank reserves, and excessive increases in domestic bank credit to the economy. Studies by Glick and Moreno (1994) and Chinn and Dooley (1995) showed that relationships of this sort existed in Indonesia and Malaysia. Indeed, table 3 shows that the four crisis countries of South-East Asia had very high credit growth. It continued

Table 3. Growth of credit to the non-government sector in South-East Asia[a]
(Annual percentage change)

	Indonesia	*Malaysia*	*Philippines*	*Thailand*
1992	18.3	14.2	21.8	31.6
1993	23.9	11.5	34.7	23.8
1994	22.8	19.6	25.2	29.8
1995	22.6	30.3	41.6	24.2
1996	21.7	28.0	50.1	14.3

Source: International Monetary Fund, *International Finance Statistics.*

a. Credit in local currency extended by commercial banks and the central bank to private and financial sectors (excluding commercial banks).

through 1996, except in Thailand, where policy tightening was necessitated by already-visible signs of difficulty.

This notwithstanding, it is one thing to detect rapid credit growth and massive capital inflows. It is a different thing to conclude that those factors *per se* explain why the crisis reached such high proportions in East Asia. It is absolutely an oversimplification, in other words, to assert that the culprits of the crisis were credit expansion and capital inflows, especially when most of the "fundamental" variables did not show any sign of trouble. Two questions suggest themselves: how was the credit used and why did the financial inflows change direction more or less simultaneously.

A weak banking system

Having found no robust explanation of the source of the crisis in the standard macroeconomic fundamentals, some analysts turned their attention to microeconomic issues, the most prominent of which is the region's weak banking system. Following deregulation of the banking sector throughout the region, the number of banks and other financial corporations grew rapidly. Many big conglomerates set up new banks, primarily to serve their own often-risky projects. Despite regulatory measures formally imposed by the monetary authority (for example, legal lending limits, capital adequacy ratios), weak enforcement impeded the development of a healthy banking sector.

Too often, Governments in the region played favourites. A few highly leveraged and well-connected groups were given special, often non-transparent access to credit. These private businesses could obtain loans from state banks without difficulty at interest rates that were much lower than the market rate and under more lenient conditions. This spelled trouble for the lending banks, as the probability of default on such loans was relatively high.

"Corruption, cronyism and nepotism", popularized as CCN, was already taking place in the 1980s, precisely the period during which the region performed its "miracle". Commenting on the Indonesian case, Hill (1998) remarked, "As long as growth was delivering benefits to practically everyone, CCN could be tolerated as annoying but not fatal." Also, as long as the volume of such practices was confined to a limited number of business deals, there was no serious threat to the economy. But as more and more public activities and state-owned enterprises were privatized, the cosy crony deals became widespread. Such practices peaked during the first half of the 1990s and coincided with the period of massive inflows of foreign capital.

The combination of CCN and cheap credit resulted in misallocated credit, as funds went to projects with the best connections, rather than those with the best economic prospects. Loans were advanced on the basis of inadequate project appraisals, many of them to the real estate sector. Indeed, average returns on capital fell sharply in the region during the 1990s, most dramatically in the Republic of Korea, Malaysia and Thailand.

Even when funded projects proved profitable, debt repayment could be slow and arduous, aggravating the problems faced by the banking sector. Indeed, dodging regular repayment to the state banks was not uncommon and the burden of missed payments was consequently transferred back to the public sector. Thus, privatization increased instead of decreased the public sector burden!

Central banks in the region were increasingly willing to become involved in efforts to bail out not only state banks but also selected commercial banks, typically those with well connected owners. The goal was to avoid the disruption that could be caused by banking defaults. But avoiding default in the short run, in effect, increased the probability of larger default in the future, as the source of weakness was not removed.

Policy errors were also made in efforts to address the problem. In particular, the policy reform advanced by the International Monetary Fund (IMF) in October 1997 in response to the weakness of Indonesia's banking system contained a miscalculation. After a frustrating two weeks of discussions with the Fund, the Indonesian Government agreed to a set of policy measures, which were to be supported with a US$43 billion international credit package. One step in the agreement was to liquidate 16 Indonesian banks, some of which were owned by well connected businessmen and members of the Suharto family. As there was virtually no deposit insurance system, the outcome could have been expected: even with 15 to 20 per cent higher interest rates in the remaining local banks, most depositors went in a panic to the foreign banks operating in Jakarta. Only in May 1998 did the IMF recognize that its demand to close

the insolvent banks backfired and caused a panic.[3]

Meanwhile, confidence in the domestic financial sector continued to erode in South-East Asia. More banks lost deposits, bad loans mounted, banks called loans, companies went bankrupt, good loans went bad. Lenient disclosure rules and poor banking regulations aggravated bad credit analysis and distorted investment decisions. This in itself was enough to make the entire financial sector falter.

But that is not the whole story. A more serious blow came from another front. The huge build up of short-term foreign debt of the private sector that was noted above had to be repaid. As the debt-service burden mounted, expectations of currency depreciation grew, raising the degree of nervousness among local corporate sectors. These companies then scrambled to buy dollars to meet repayment obligations, which worsened downward pressure on the exchange rates. Currency devaluation, inevitably came, which only worsened the problem.

In other words, a weak banking system was indeed a serious trouble spot in the region. However, to say that it was the source of the crisis is incorrect. The system was already weak even long before the crisis began. Furthermore, it is not too difficult to find other countries with much weaker banking systems that are not in crisis. This is not to say that the weak banking system did not contribute to the crisis. It did. But other factors must have been playing a more critical role. Something else provided the spark and fanned the flames.

Contagion

From the time that the Thai crisis first spread to neighbouring countries in July 1997, attention has been directed towards understanding the process of contagion. Unfortunately, this is an area where economists are not known to have a solid theory.

One hypothesis is that the more a country is financially integrated with a country where a crisis occurs, the more likely it is that the crisis will be transmitted to the first country. Hence, as regional integration intensified in the 1990s, including among the member countries of the Association of South-East Asian Nations (ASEAN), the vulnerability to contagion was reinforced.

Because a sharp U-turn of foreign capital marked the start of the crisis in South-East Asia, it would be reasonable to look at the behaviour of financial

3 While closing insolvent institutions is legitimate, i.e., "free exit" must accompany "free entry", the closure of an entire bank—forcing blameless workers to be laid off—can be questioned if instead it is possible to punish only the owners and the bank's management. In either case, a policy to minimize the ripple effects of bank closures should be in place to avoid panic in the entire financial market.

variables. The stock market return is one such variable. We can measure the extent to which stock market returns in the country where a crisis originated correlate with the returns in neighbouring countries. Hence, a correlation of, say, weekly stock market returns in Thailand with returns in Indonesia, Malaysia and the Philippines would indicate whether private investor behaviour in Thailand contaminated investor attitudes in the other three countries.[4]

Another potential line of contagion is external trade. The most forceful argument pertains to what is known as "competitive devaluation". After China devalued its currency in 1994, currency pressures were detected throughout the region, especially in those countries that have similar trade patterns as China. This strand of argument suggests that the collapse of the Thai baht might have been a form of contagion from the yuan devaluation, and the subsequent collapse of the rupiah, peso and ringgit could be the result of contagion from the baht's devaluation.

The key factor in the trade-and-exchange-rate argument is the similarity of economic-*cum*-trade structures. Singapore was not infected by the contagion because it has a markedly different economic structure than the other ASEAN countries. Moreover, even if two countries export similar commodities, they may ship to different destinations. If most of Indonesia's resource-intensive products were exported to Japan, the contagion pressures from Thailand would be less to the degree that most Thai resource-intensive exports were instead bound for the US market.

Attempting to measure those two types of contagion processes, Fratzscher (1998) found that the financial markets of most economies in the region are indeed highly integrated with Thailand, causing the financial channel of contagion to be strong. Fratzscher also found most regional economies to be close trade competitors in terms of the similarity of export structures and export destinations (including intra-regional trade). However, the size and significance of the coefficients in his econometric equations suggest that the financial link was the most important channel of contagion in the Asian crisis.

The study also found little support for the hypothesis that countries with weak fundamentals and low reserves, per se, were more vulnerable to contagion. However, such countries were found to be more vulnerable to contagion

4 Obviously, other factors (for example, fundamentals and incentive policies) have to be taken into account first in order to correct for their influence on investors' decisions

if, in addition, domestic credit had expanded rapidly prior to the crisis.[5] It is thus the credit boom and the composition of capital inflows—facilitating the sharp switch from high inflows to high outflows—that mattered most in making the East Asian countries vulnerable to crisis contagion.

In sum, unlike economic fundamentals and a weak banking system, we probably can be more certain about the role of contagion in triggering the regional crisis following the baht collapse. However, even if we know a sufficient amount about the "what" (integrated financial market), we do not yet know enough about the "why". Moreover, detecting the importance of the swing in capital movement in generating a crisis, from massive inflows to huge outflows, does not itself explain what factors fund managers look at before a "stay or exit" decision is taken or how the decision is really made. Rational or irrational, such behaviour is important for policy makers to comprehend in order to be vigilant and better able to anticipate future shocks.

Finally, while the above study sheds some light on the causes of the crisis, there are limitations to such econometric exercises. One is the exclusion of possibly relevant variables. In Thailand and Indonesia, for example, the severity of the crisis has been raised significantly by political factors, operating during the early and later stages of the crisis, respectively.

Political factors—a case study of Indonesia

When economic factors leave unanswered questions, one tends to shift to non-economic factors, more particularly to political ones. On this subject, however, each country has a uniquely different set of events and a case study approach is unavoidable. Let me now shift to the particular situation of Indonesia, where the relationship between the financial crisis and the political crisis cannot be more obvious.

When President Suharto cancelled his scheduled visit to the ASEAN summit in Kuala Lumpur, and subsequently to his wife's grave in Solo (only 35 minutes flying time from Jakarta) in early December 1997, many perceived it as a serious sign of illness. In late December, there was another rumour that Suharto had had a stroke and that there would be a military coup. In no time, the stock market tumbled and the exchange rate fell to over 5,200 rupiah per US dollar.

Entering 1998, the situation worsened. The way the 1998/1999 budget was announced on 6 January did not satisfy the market. The number of laid-off

5 This was the only result in which the null hypothesis could be rejected at the 10 per cent level and it held both for Latin American and Asian crisis countries studied. Other tests, in particular for the relevance of exchange-rate overvaluation, did not find a significant relationship (Fratzscher, 1998).

workers continued to increase, adding to the already high open unemployment. The stock market plunged again and the rupiah hit an "insane" level of over 11,000 per US dollar. Pandemonium set in when on 8 and 9 January, people went on a buying spree to hoard foodstuffs.[6]

Meanwhile, perceptions spread that Suharto had lost his touch. A popular revolt gained strength and public attacks on the Government and Suharto's leadership rose. Fearing that tensions in Jakarta could degenerate into anarchy, the armed forces were put on special alert. Investors became jittery; the stock market tumbled.

Only then did the world begin to react with serious concern. The potent mixture of continuing market panic and political uncertainty led an array of heads of state—from Washington, Tokyo and Canberra—to phone Suharto. High ranking US and IMF officials rushed to Jakarta to consult with him and to press for urgent reforms.

The revised budget, announced after the President met with the Managing Director of IMF, assumed a 20 per cent inflation rate and zero GDP growth. A controversial item in the budget was the petroleum subsidy, amounting to Rp10 trillion (US$2.5 billion). The cutbacks of monopolies, special treatments, subsidies and tariffs that were contained in the "Letter of Intent" to IMF signed by Suharto received a subdued reaction and both the rupiah and the stock market continued to slip. The market seemed to be waiting to see the extent to which the proposed policies would actually be implemented.[7] Far more importantly, the political factor had now come more forcefully into play.

After mounting pressures from Government critics who demanded economic, legal and political reforms, which also meant the removal of Suharto, Indonesian politics reached a turning point. It started on 12 May when a bloody incident took place in one of the private universities in Jakarta (Trisakti). Four students died when real bullets hit them during demonstrations. On the next day, larger demonstrations spread across the nation. All this occurred while Suharto was in Cairo attending the summit of the Group of 15.

6 For several weeks there was also confusion because Suharto had indicated that a currency board system (CBS) would be implemented. The argument was as follows. A considerable amount of private debt matured early that year. In such a situation, a proposal that would guarantee a peg of the rupiah to the US dollar would be appropriate. Hence, the proposal for setting up a CBS seemed to make sense to some policy makers and to the heavily indebted private sector. Yet, the requirements for a CBS to work effectively with minimum adverse repercussions were not yet present in Indonesia (e.g., unfinished banking reform, which was part of the conditionality for IMF assistance).

7 The coincidental timing of Standard & Poor's announcement to downgrade 15 Indonesian banks was also not helpful.

On 14 May, there was mob violence and more than 500 people were killed, many of them looters burned to death. From that one-day tragedy alone, the material loss was estimated at about US$250 million.[8] In this chaotic situation, the stock market plunged and the rupiah weakened to 11,500 to the dollar.

Upon his return from Egypt, Suharto tried to respond by proposing two things: revise the planned increase of fuel and electricity prices and reshuffle the cabinet. The students and the public did not receive the decision with enthusiasm.

On 18 May, the wave of students protests escalated. Thousands of students managed to enter the parliament compound, demanding an immediate special session of the People's Consultative Assembly (MPR) and Suharto's resignation.[9] Once again, investors and the market faced a lot of uncertainties. However, there was one certainty: Suharto's era was over. It was only the exact time and the mode of transition that remained uncertain.[10]Opinions seemed to polarize in response within the pro-reform groups: one group strongly rejected the proposed scenario, while another saw it as a sufficient starting point and a

8 This is the official figure, which I think is underestimated. Around 5,000 buildings were damaged or burned, close to 2,000 vehicles were torched, no less than 220 bank branches were destroyed, and about the same number of automatic teller machines were damaged. Many stores were closed for several days, as were businesses and banking operations. It is estimated that the money transactions affected by bank closures in Jakarta alone reached some US$3 billion each day. The impact across the country was devastating, as the economies of many regions outside Jakarta are significantly dependent upon money flows from the capital city.

9 By 3:30 pm, under massive pressure, the Speaker of the House, Harmoko, flanked by two deputy speakers, announced that the top leaders of the parliament were calling on Suharto to step down for the sake of national unity. The students cheered the announcement, but the hope quickly faded when in the evening of the same day at 8:00 pm the armed forces commander, General Wiranto, said that Harmoko had spoken as an individual and his call for the President's resignation had no legal power.

10 After a meeting with Islamic and community leaders, Suharto announced that he would not step down immediately. Instead, he promised to revise political laws through a reform committee, the members of which would include representatives of the student movement. The cabinet would be reshuffled immediately in order to handle the deep economic and political crisis better. Then, new elections would be held as soon as possible. However, the most important point of Suharto's announcement was that he explicitly pledged that he would not run in the new elections. Many analysts suspect that such a compromise scenario was the result of a negotiation process, in which General Wiranto was a key player.

Opinions seemed to polarize in response within the pro-reform groups: one group strongly rejected the proposed scenario, while another saw it as a sufficient starting point and a dramatic one too, given that Suharto had never before explicitly said he would not run in the elections. Followers of the first group expressed scepticism and fear that such a deal was a last shrewd political game being played out by Suharto behind the opaque screen of a Javanese shadow puppet play. They even called for mass demonstrations on 20 May, Indonesia's National Day of Awakening, to mark the anniversary of the formation of the country's nationalist movement to fight against the Dutch colonial administration in 1908.

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Then came the historic day, 21 May, when Suharto announced his resignation and Vice President B. J. Habibie replaced him. A surprise? Not quite so. The intensity of the pro-reform movements and the dynamics of high-intensity political struggles during the preceding few months should have been enough to predict the outcome. The nomination of Habibie was not a surprise either, since constitutionally the vice president was next in line.

The social repercussions of the crisis quickly became very serious. The combined forces of declining real wages and unemployment raised poverty dramatically (see Azis, 1998d). This could become a fertile ground for social and political instability.[11]

Another serious blow to the economy was the exit of money and capital, especially owned by Indonesian Chinese—it is widely quoted, albeit with no supporting hard data, that ethnic Chinese control about 70 to 80 per cent of the assets of Indonesia's top 300 companies. The exodus of expatriates and foreigners bruised the country's image and made the prospect for economic recovery gloomier. Meanwhile, the exchange rate and the stock market continued to "go south". On 18 May, the former touched 17,000 per US dollar and the latter came closer to a low of 400 (on the third week of April, the recorded rate and the stock index were still 8,024 and over 490, respectively).

The new Government has thus had no deficit of challenges. The economy had already started to slide in mid-1997, although the worst really began early in 1998. Even without the financial crisis, the country has been stricken by a long drought (related to the El phenomenon), the haze problem caused by forest fires, a fall in oil prices, and a series of diseases that occurred in some parts of the country. The financial and political crisis only exacerbated the situation. The remaining strengths of the

11 The middle income population groups were hardest hit, in particular those in the urban area. The effect of inflation on transportation services was especially devastating. Higher fuel prices and the price hike of vehicle components of up to 300 percent forced many public transport operations to close down. By the end of March, more than 30 per cent of public transport ceased to operate, affecting the mobility of millions of medium and low-income workers throughout the country. In addition, the interregional and inter-island distribution of basic commodities was upset by the limited availability of transport operations. This put further pressures on the already sharply increased prices of many food products.

country—the enormous amount of natural resources, fairly adequate physical and non-physical infrastructure, and a cohesiveness as well as harmony among heterogeneous Indonesian society—remained under threat.

To sum up, in the early stage of the crisis a combination of rampant CCN and lack of confidence over Suharto's Government did nothing to counter the damaging effects of contagion. Then the policy package prescribed by the IMF pulled the economy further down. Prolonged discussions of the possibility of adopting a fixed exchange rate under a currency board system only raised more confusion. In the next stage, repeated violence, looting, destruction and street battles elevated the economic costs further. As Suharto's term neared its end, the political temperature peaked. Financial markets continued to shun Indonesia and the currency plunged, along with the stock market.

A lot of uncertainty remains in the political and economic spheres. This uncertainty is something that investors simply cannot cope with. When investors and the market know what is going on, they vote with their money. But when they do not know, they vote with their feet. Those who were already in the region faced the "exit or stay" choice, and those who originally thought about entering or who were ready to buy cheap, might have become more reluctant to come in while political uncertainty was high.

Bank and debt restructuring

By the second half of 1998, bank restructuring was under way in all the Asian crisis countries. The objectives were clear: return to normal lending and a safer banking system. Learning from recent experience, the key goal of bank restructuring is to protect depositors and the core banking system, but not necessarily the existing owners, managers and shareholders. The main principle is, let the troubled banks not contaminate the healthy ones, and try to revive the country's troubled banks or at least those that could be salvaged.

This meant some combination of merging or selling troubled banks to new owners who would infuse capital as well as new management, and reducing the burden on banks of their stocks of non-performing ("bad") loans. It also meant more of a direct, if temporary, role of government in the banking sector.

In Indonesia, for example, the Government set up the Indonesian Bank Restructuring Agency (IBRA) and by May 1998 it had 54 banks under its control. The agency also took over the management of eight banks, including Indonesia's largest private bank, the Bank Central Asia (BCA). In taking over these banks, IBRA took charge as well of the renegotiation of the nonperforming loans of its debtors. IBRA also guaranteed the deposits held in its commercial banks. Finally, IBRA infused its banks with sometimes large amounts of liquidity obtained from the central bank. Despite these efforts, it had to suspend the operations of some of the banks.[12]

The strategy to sell troubled banks, however, has not worked as well as hoped. Despite the asset price drop (especially as measured in dollars), the response from international investors was lukewarm, primarily because of the severity of the banks' distress. Bad loans were roughly 40 per cent of outstanding bad debts in Thailand and Indonesia.[13] In Thailand, foreign banks had agreed to take majority control of only two local banks more than one year after the crisis began.[14] A similar slow response was also seen in Indonesia and Malaysia.

In a further attempt to lure capital for Thailand's 15 commercial banks—the estimated requirement was 600 billion baht—the Thai central bank made a dramatic announcement in early August 1998. It would basically guarantee through the Financial Institutions Development Fund that foreign investors who bought major stakes in troubled banks and finance companies would receive their money back after five years. This "money back guarantee" system seems attractive, but unless it is combined with other measures, its effectiveness would be questionable.[15]

In part, plans to lure foreign capital have fallen victim to domestic policies and popular sentiment (nationalist outcry). This happened throughout the region and in various sectors. In Indonesia, for example, the plan to sell a stake in a blue-chip telecommunications company had to be scrapped, and the final plan to sell 35 per-cent of PT Semen Gresik, a cement company, to Mexico's Cemex SA also faltered, forcing the foreign stake to be lowered to 14 per cent.[16]

However, when confronted with such disappointments, the Government voiced a more liberal tone. In particular, on 24 August, Indonesia's Minister of Finance announced that the Government would now allow foreign investors to take more than the 50 percent maximum percentage of shares previously allowed foreigners in Indonesian banks. The net result of such developments, however, is that the Government's target of raising US$1.5 billion in the fiscal year ending 31 March 1999 had to be cut to US$1 billion.

12 As of August 1998, seven banks had also received more than US$11 billion in liquidity support (more than 500 per cent of the capital of the banks).

13 The precise figure is actually hard to know; one extreme estimate by Moodys is as high as 75 percent for Indonesia.

14 The Development Bank of Singapore bought a 50.3 per cent stake of Thai Danu Bank and the Dutch ABN Amro Bank acquired a 75 per cent stake in Bank of Asia.

15 One of the suggested measures is to set up a "bad bank" that would manage and sell bad assets. So far, the Government only set up an Asset Management Corporation to take over the bad loans of the 56 finance companies that were shut down in 1997.

16 It is unclear, however, whether objections to the sale stemmed from a grass-roots explosion of nationalism or merely from the management who feared losing control of their enterprise.

A related concern, affecting the capacity of enterprises to service their bank debt, is the treatment of the foreign debt of the corporate (and banking sector). This has been a special difficulty in Indonesia and was the subject of long months of debate and informal negotiations with foreign creditors. Then, on 4 June 1998, an agreement covering US$80 billion in private debt was reached in Frankfurt. As part of the agreement, an Indonesian Debt Restructuring Agency (INDRA) began to function on 1 August, promoting and facilitating the voluntary restructuring of the private sector's foreign currency debt.

The basic principle in the Frankfort agreement is to save the Government from having to assume the debt-servicing obligations of the private sector, whose repayment capacity had been eaten up by the collapsing rupiah exchange rate. The plan is self-financing, albeit with some subsidies. The mechanism by which the agreement works is that debtors participating in INDRA make scheduled principal payments on their debt in rupiah, at an interest rate equal to the inflation rate plus 5.5 per cent. As their debt was in foreign currency (mainly dollars), the amount of rupiah to be paid is based on a notional exchange rate, calculated on the basis of agreed rules. This is the subsidy element, as the exchange rate can be higher than that prevailing in the spot market (but never lower). Instalments are made on a monthly basis over the life of the debt, or over a period ending 31 December 2003. Dollars are then bought to pay the foreign creditors according to the rescheduling agreement reached in Frankfort.[17]

The INDRA scheme was not the only way for the private sector to handle its foreign debt and participation is voluntary. The attractiveness to the debtors depends on the exchange rate under the scheme and the market exchange rate. In the final analysis, I suspect that a mixture of actions will have to be taken, for example, allowing the Government to take over some of the debts by using a portion of IMF financing, and permitting other alternatives such as debt buy-backs, securitization of debt and debt-equity swaps.

Why is debt resolution so critical, especially in Indonesia? Aside from the direct role in improving the solvency of the private sector, it would help stabilize the exchange rate. One of the reasons is that every time there is a sign that the rupiah is strengthening, private debtors rush to buy US dollars, seeking to reduce the mismatch in their foreign currency exposure. As long as debt overhang is not resolved, the rupiah is unlikely to get stronger for a relatively long period of time.

17 The restructured debt has an 8 year maturity with a 3 year grace period and carries an interest rate of LIBOR plus a margin not to exceed 3 per cent a year. Short-term inter-bank debt was refinanced over a period of up to 4 years.

Concluding Remarks

The crisis in Asia is dramatic. It is explainable but certainly was not predictable. The verdict that weak fundamentals caused the Asian crisis is clearly misplaced. Even the weak banking system alone cannot explain the depth and severity of the crisis. It was the role of contagion that seems vital. The region's integrated financial sector made the contagion process from Thailand to other countries work very rapidly. Yet, we know little about why the change in perception of fund managers and investors happened so fast and spread so quickly to other countries.

Although the economies in the region are well integrated, each also has a distinct character that affected how the crisis unfolded. For example, political instability clearly had a substantial consequence in the Indonesian case, more so than in other countries in the region.

There have been signs of progress, albeit slow, on the debt front. It is difficult to expect a stable and strong currency when the debt overhang remains unresolved. Bank restructuring is also under way in all crisis countries. Does this mean that there is a light at the end of the tunnel? Yes and no!

The answer is yes if other supporting factors are in place and the external environment is conducive. The answer is no if the social and political repercussions of economic hardship outweigh the impact of gradual improvement on the economic front. Economic stability cannot be achieved in an unstable socio-political environment.

This is precisely the reason why in the second half of 1998 policy makers across the region changed direction. Monetary conditions eased in Malaysia, Thailand and the Republic of Korea, and Indonesia's fiscal deficit was allowed to expand to about 8 per cent of GDP, as output collapsed.

At the same time, however, the policy shift raises serious concerns. To ensure success in a stabilization programme, some basic principles should not be relinquished. An excessive budget deficit is likely to raise inflation (hyperinflation in Indonesia), and too many populist approaches could hinder the process of real recovery by distorting consumption and production.

Also, the state of the global economic environment is less than certain. In 1998 alone, we have seen the Dow tumble, the Hong Kong market slump, markets in Brazil and India feel the tremor, and the Russian Federation plunge. Signs of pressure have also emerged in China, and the prospect of Japan remained worrisome. Japan is to many Asian countries what the United States is to Mexico; and the latter recovered relatively quickly from its crisis in 1994-1995 by getting a strong boost from exports to the United States. Obviously, such a boost is absent in Asia at this moment. In short, there are many fragilities in the world economy and even the risk of a widespread recession is no remote concern. Thus, if the light at the end of the tunnel is dimly perceptı

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The Financial Restructuring and Reform Programme in the Republic of Korea: Progress and Constraints

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The restructuring and reform programme in the Republic of Korea has had financial stabilization as its near-term objective and full liberalization of the economy as its longer-term goal. The programme was formulated in conjunction with the International Monetary Fund (IMF) and supported by $58.35 billion of international funds mobilized under the leadership of IMF in December 1997.[1] It represents an acceleration of the gradual reform and liberalization of the economy that began in the latter part of the 1980s. Indeed, the President of the Republic sees full economic liberalization as a necessary step towards long-term economic development of the country.

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1 See "Letter of Intent of the Government of the Republic of Korea" at http://www.imf.org/external/np/loi/120397.htm.