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***M.L. Lapishko**, Candidate of Economic Sciences, Lviv Banking Institute;*
***Zb. Klimiuk**, Doctor of Economic Sciences, The Higher School of Management and Enterprise named by Yansky (Warsaw, Poland)*

ANALYSIS OF EAST ASIA' CRISIS: PRECONDITIONS AND RESULTS

The article analyses the causes of the crisis in Eastern Asia, among them: liberalization of foreign exchange accounts, reduced possibilities of financial flows regulation, government intervention, growth of corruption, production and democratization. The article shows how the liberazation of foreign currency accounts and the low level of foreign currency reserves have created the conditions for the emergence of the crisis of a new type.

Key words: crisis in Eastern Asia, liberalization of foreign currency accounts, management of financial flows, corruption, production, democracy.

East Asian Growth Model. What is left of it after the crisis

The sustained, rapid economic growth, structural transformation and industrialization were becoming a trademark of East Asian region from the 1980s to the mid 1990s. The region in question was perceived then as an economically uniform area and such perception was not degree unjustified by the actual situation. This phenomenon was also accompanied by certain intellectual framework, which essentially boiled down to an simplification of a kind, one attributing the same nature and background to the economic growth in an entire region. Hence, the tendency to use general and all-inclusive terms such as, "Far East" "Pacific Asia", "yen bloc", tiger to mention just few of the expressions coined in relation to the more complicated phenomenon than vernacular used to described it implied.

Of the eight highly performing East Asian economies (acronym HPAEs) World Bank had identified in its study "The East Asian Miracle", Indonesia, Malaysia and Thailand as a model to be implemented by other developing countries. Even previously there had been studies (Yoshihara 1988) in which it was argued that South-East Asian economies implied certain ersatz Capitalism, because of the inferior position of the state and lack of significant success in establishing better technological potential. In 1997 in the study Jomoet al., there was another critique of Word Bank's approach, related to the latter perception of South-East Asian Economies as a paragons of economic virtue to be emulated by other states.

High esteem, in which East Asian economies were held, disappeared with the coming of the East-Asian crisis and financial turbulence of 1997-1998 period. The highest degree of criticism was heaped on the problem of mutual relation between business sector and governmental institutions, previously regarded as the cornerstone of the economic success of the East Asia. These previously highly praised interconnections suddenly became to blame not only for the surfacing of the crisis itself but also for its depth. Such a line of thought is present in the studies conducted by Backman in 1999, by Clifford and Engardio in 2000, while works of Jomo in 1998, Furman and Stiglitz in 1998, Radlet and Sachs 1998, Krugman 1999 as well as Bhagwati 1998) attributed the crisis to the international financial liberalization and its effects of easily reversible international capital flows. The second set of analyses proved to be highly critical in evaluation of the IMF's policy prescriptions and conditionalities blaming them for making the crises even more pronounced.

I would like to present the case of four East Asian economies that were the main victims of the turbulence in 1997/1998. Among them were all so-called second-tier newly industrializing countries, namely Indonesia, Malaysia and Thailand and South Korea that is newly industrialized economy.

Meaning of success – the East Asian way

Back in 1993 World Bank has presented its publication "The East Asian Miracle Study", which constituted an attempt at explaining all the developments characteristic for East Asia in the period of over three decades to that date. Following the Asian crisis, the popularity of that document has been waning, and nowadays certain people at the World Bank would like to forget about that particular publication. Some analysts ascribe this document to the impulse coming from Japanese government's representative on the World Bank's board, who contrasted the situation in Asia with poor results of adjustment programs in other regions

(Latin America, Africa and other locations). According to the Japanese expert World Bank should learn from the experience of East Asian countries, which at the beginning of the 90's decade had been posting rate of growth in excess of over 6 per cent for at least 25 years. It was the Japanese government responsible for financing such a study.

In the report, eight economies were identified as high-performing – Japan, Republic of Korea, Taiwan, Hong Kong and Singapore, as well as Malaysia, Indonesia and Thailand (the last three forming so-called second-generation NICs). From the perspective of mathematical probability it has to be stated that likelihood of eight relatively contiguous economies growing at such a fast pace for a long time amounts to less then 1/60000.

Publication of the report in question symbolized the World Bank's transition from espousing neo-liberalism (as in the decade of 1980s) to the less orthodox position - one recognizing the role of the state in the economic development. Further advances along this line of thinking are evident in the publication of 1997 World Development Report, in which authors lean more towards effective state than towards lessair-fair concept.

In the report under discussion here, World Bank recognized 6 types of state intervention, that have important place in the development of East Asian countries. Of that types bank approved only 4, recognized as ones of a functional nature (ones serving to ameliorate the market's deficiencies) and questioned the remaining two as being of strategic character and leading to distortions of market operations.

Among the interventions, that met with the Bank's approval were state activities aimed at:

1. Ensuring macroeconomic discipline and balances.
2. Providing both physical and social infrastructure.
3. Providing good governance.
4. Raising savings and investment rates.

The East Asian crisis

In spite of the presence of critical opinions on the economic developments in East Asia there had been not a single analysis containing prediction of what was about to happen in 1997 and 1998. A single work was lacking to analyze – in the scope of financial liberalization taking place across the globe – the growing role of foreign capital in that particular region. Jomo in 1998 affirmed that the leading position of foreign multinational corporations (MNCs) in manufacturing sector (particularly in hi-tech industries) made domestic capital subordinated to the strength and influence of financial capital regardless of the latter's place of origin. The owners of that particular strain of capital, who established the system of mutually beneficial interrelations with the people who had influence in political matters. Such connections were later to be called "crony capitalism", but such a term wasn't in use until after the crisis had erupted. Financial circles of the region did not stand idly by, when threatened by financial liberalization, but sought for – and of course found – venues of benefiting from the process (via tapping into arbitrage opportunities and employing other mechanisms and techniques).

The close cooperation taking place between financial and political circles served to promote liberalization of financial markets, though the process of such liberalization wasn't completed fully due to certain differences of interests of domestic financial capital on one hand and international one on the other. Certain countries learned the historic lesson well – as exemplified by Malaysia where crisis in the banking sector that had taken place in the 1980s led to the establishment of systems of checks and balances (such as prudential regulations), while other countries e.g. Thailand haven't created such safeguards. In both countries inflow of capital from abroad was needed to cover current account deficits, growing imports of consumer goods, fuel speculative activity on regional stock exchanges and boost output of the real estate sector. It can be argued that capital inflows were more instrumental in engineering bubbles in the prices of assets than in contributing greatly to the acceleration of GDP growth. The surfacing of the crisis, with all of its consequences, precipitated the bursting of the above-mentioned bubbles.

How the disease spread?

The Bank of Thailand decided – on July 2nd 1997 – to float the national currency, and the bath had quickly lost in value. The decision to float was preceded by months of speculative attacks on that currency. Similar situation – decisions to float currencies – leading to falling of exchange rates was taken in Indonesia, Malaysia and Philippines. In the months that followed currencies and stock prices in the region were under pressure from the panic driven outflow of short-term capital. After the withdrawal of the official support – the same fate was to befall Korean won, despite the country's different economic structure, compared to the countries mentioned previously. Direct (attack on the Hong Kong dollar) or indirect (actions aimed at maintaining competitiveness against the devalued currencies) pressure mounted on majority of economies in East Asia.

Up to date – there is no universally accepted line of explanations or even descriptions of the crisis, even that the business media and International Monetary Fund tell us otherwise. There was a debate in which IMF's programs for the Republic of Korea, Thailand and Indonesia were questioned and criticized. The crisis called into doubt the validity and universality of well-established economic theoretical frameworks and systems. Though financial media (dominated by western circles) ascribe the eruption of the crisis to the actions of "crony capitalists", there is an agreement among analysts that we had witnessed a crisis of new type. The consensus starts to encompass increasing number of experts, that what started as a currency crisis quickly exacerbated and transformed into financial crisis, later on spilling over into the real economy through the reduced liquidity in the financial sector, inappropriate policy response and the significance of psychological factors.

What goes up, must go down. Or is there any other way?

Export driven industrialization had brought about rapid economic growth and structural changes in the mid 1980s. Later on the currency devaluation in all three South East (HPAE) countries and modifications of the regulatory framework made it attractive to establish production facilities in those countries, as well as elsewhere in South East Asia and in China. Industrialization, as described here, continued well into the 90s and was paralleled by higher dynamics of both manufacturing services and construction activities. For about a decade things were running smoothly as budgets were in surpluses, monetary expansion and inflation were generally modest (Table 1). Before the year of 1997 all three South East Asian economies posted high and rising savings and investment rates, while high domestic savings were supplemented by savings coming from abroad. Until 1997/1998 budgets were in the black and unemployment was low. That observation doesn't prove that economic fundamentals there were perfect. The rising coefficient ICOR (incremental capital output ratio) shown in the tables proves that before the crisis erupted investments had been less remunerative than previously. Financial system was conducive for "short-term" investments over more productive forms of investments (at the same time more risky ones) in the real sector comprising manufacturing and agriculture. Excessive growth of investments in non-tradeables led to widening of current account deficits. The link property – finance was the most visible in the case of Thailand, making that country prone to unavoidable deflation of the speculative bubble.

Therefore – due to financial liberalization – acceleration in the rate of capital accumulation shifted towards increasingly unproductive activities (as foreigners controlled majority of the region's internationally competitive industries). Thus in the mid 90s rapid growth of the 80s gave way to a number of macroeconomic dilemmas. Foreign Direct Investment and foreign debt – previously used to bridge the gap between savings and investments- led to outflows of investment income and in the 90's it were the short-term capital inflows that increasingly financed the current account deficit. "Confidence building measures" were effective enough in inducing inflows of short-term capital, following periodic outflows, but such an approach wasn't successful in solving long-term problems. In the 90's foreign investment was having growing impact on the regional stock market. Such characteristics of foreign financial institutions as lack of complete information (limited transparency) and short-term time span of investment contributed highly to the spreading of the crisis. The decade of 1990s witnessed growing debt of the private sector as well as increase in the foreign liabilities of commercial banks. Only a small part of lenders financed productive venues, while majority of foreign borrowings was secured by real property and stock.

Another problem stemmed from the fact that borrowings in US dollars were invested in a way which did not generate foreign exchange (so-called "currency mismatch"). Simultaneously high share of foreign borrowings mentioned above was in the form of short-term loans used to finance mid and long – term projects. (such situation is called "term mismatch"). Bank of International Settlements calculated that more than 50 per cent of foreign debt incurred by commercial banks was in the form of short-term loans (figures range from 56 per cent for Malaysia to 68 per cent for The Republic of Korea).

Growing foreign exchange risk made these economies increasingly vulnerable due to maintenance of currency pegs to the US dollar. Though the pegs themselves were not benefiting the economy, they were also responsible for large amounts of un-hedged borrowings made by the influential circles engaged in defending the pegs. Since export – oriented sectors in the South – East Asia were dominated by foreign units, there wasn't strong enough domestic community able to effectively advocate either floating or depreciating South East Asian currencies. Majority of the central banks – especially from the mid 90's on- did not allow their exchange rates to slide down, but such downward adjustment – if allowed than – would have reduced the severity of the subsequent crisis.

Financial liberalization and its fruits

Shortly before the crisis erupted Kaminski and Rinhart presented (in 1996) the study in which they had analyzed 71 cases of balance of payments crisis and 25 banking crisis from the period of 1970-1995. Studying correlations between those crises they found out that of the 25 balance of payments crises between 1970 and 1979, only 3 were associated with the banking crises. In the period of 1980-1995 46 balance of payments crisis "coincided" with 22 banking crises. Such a change was attributed, by the authors of the said publication, to effect of the process of liberalization, as the private lending spree ended up first in the banking crises and subsequently in a currency crises.

According to Montes (1998) South East Asian turbulences were brought by liberalization of domestic financial system and by opening of the capital account. Subsequent study -by Carleton (2000) – of the 57 countries in the period of 1970-1996 shows that currency crises were predated by inflationary economic policy and low volume of foreign reserves. However, since the probability of Indonesia, Malaysia, Korea and Thailand going through a currency crisis in 1997 was calculated by the author to amount to approximately 20 per cent, weak economic fundamentals are less of an explanation than the process of financial contagion.

McKibbin and Montes assert (each of the two researches separately) that investor panic was the main culprit in spreading of the crisis and cronysm (no matter how repulsive it was) is not to blame. Sometimes the macroeconomic fundamentals, as Asia learned the hard way, are not sufficient safeguards against the crises and financial markets are driven not only by statistics but also by sentiments. It is interesting that back in 1995 more severe current account deficits did not spark a crisis.

It is capital controls that make it difficult and costly to rapidly withdraw capital and many governments treat FDI differently than they treat portfolio capital, giving preferences to foreign direct investment.

The competition taking place among foreign banks in the regions in the 90s resembled the 70s when the loans were offered to the third world countries and subsequently – next decade – resulted in the emergence of crises in those countries.

The dominant paradigm among policy makers was to disregard the growth in the private debt, provided that public sector's indebtedness was held in check. At the same time the region's stock markets were attracting foreign investors, with the latter being indirectly encouraged by the World Bank to invest in those markets. But Malaysia hadn't seen the evil coming and did not react properly to waves of speculations on the stock exchange there in 1993-1994 and later on in 1995. Simplistic perception of East Asia by fund managers, who saw the region as more uniform and integrated than it actually was, caused contagion effect. Currency speculators also contributed to the problem's magnitude by reacting to forecasted market trends.

Collapsing currencies caused assets' prices to lose value leading in turn to the contagion's disrespect for national borders. At the same time liberalization of the financial system allowed to make profits on the falling exchange rates – while another aspect of liberalization – this time of the capital account made it easier for foreign capital to flee. Thus the downwards adjustments of the overvalued currencies turned into collapse of these currencies and into deep bear market on the stock exchanges.

Krugman (1998) asserts that the main differences between the developments in Asia and the conventional currency crises were as follows:

- the absence of macroeconomic problems;
- government had no reasons for resigning from the currency peg;
- bursting of the speculative bubbles happened prior to the currency crisis;
- key role was played by financial intermediaries;
- the crisis turned out very severe in the absence of adverse shocks;
- crisis spread very quickly from "the ground zero" (Thailand) to other countries, even to the economies showing little similarities to Thailand.

Since the problem was rooted neither in the in the governmental actions nor in the macroeconomic fundamentals, traditional warning systems failed to predict the crush.

Furman and Stigliz in their study of 1999 compared economic downturns caused by financial crises with ones caused by inventory cycles and concluded that the latter type are decidedly less severe. Companies resort to high financial leverage and high volume of lending as increases in the prices of assets buttress financial stability. Growth in the number of insolvencies impacts the credit system, while unpredicted, significant hikes in interest rates may not only usher in financial crises, but also can lead to economic downturns, as value of banks' assets shrinks and debt saddled companies go under. Authors conclude that in such a case adverse effects can linger pretty long after interest rates came down to more sensible level.

Reversible capital flows – circulation of capital

Such flows are increasingly becoming subject to discussion as a number one of suspects in the eruption of 1997-1998 crisis. The opinion – expressed among others by Jomo (1998) – that the regions national financial systems were not well prepared for international financial liberalization is becoming increasingly respected.

Since majority of the financial systems hit by the crisis was more bank-centered than financial market-centered they were exposed to the sharp narrowing of possibilities to secure short-term debt because of the declining confidence in the region on the part of foreign financial circles. Foreign exchange reserves had turned out inadequate to cover payments due abroad, and governments were forced to search for provisional financing to finance debt incurred chiefly by the private sector.

From the Bank of International Settlements' data it can be inferred that banking sector was responsible for majority of short-term debt and its growth in the periods of soaring stock market prices indicates that much of the debt in question was caused by other factors than the credit expansion alone.

Malaysia had curtailed the growth of such debt in 1994 by introducing temporary capital controls, but in 1996 and at the beginning of 1997 situation deteriorated again as banks and large private firms were able -thanks to political influence – to disregard guidance given by the central bank.

By the end mid – year of 1997 more than a half of foreign borrowings in Indonesia, Malaysia and Thailand was received by non-banking institutions of the private sector, while 65 per cent of such debt in Korea was incurred by banks (Table 3).

The tables (Table 2) show the growth of foreign debt and the growth of FDI in the early and mid 1990s. FDI growth was the lowest in case of the Republic of Korea, while the transfer of profits from this country was the lowest (contrary to Malaysia). At the same time portfolio capital posted high growth in all four countries.

Another interesting measure – the relation of external debt to export revenues also has shown growth between 1995 and 1996 (from 112 to 120 per cent in the case of Thailand and from 57 per cent to 42 per cent in the Republic of Korea, but declined in Indonesia).

By 1996 foreign currency reserves of Indonesia amounted to 15 per cent of foreign debt while in the case of the Republic of Korea that coverage was at 30 per cent, 43 per cent in Thailand and 70 per cent in Malaysia. By 1997 that ratio declined to 15 per cent in the Republic of Korea, 29 per cent in Thailand and 46 per cent in Malaysia as reserves were deployed, though unsuccessfully to defend the exchange rates of domestic currencies. Of the total external debt, the short term debt portion amounted to 58 per cent in the Republic of Korea, 41 per cent in Thailand, 28 per cent in Malaysia, and 25 per cent in Indonesia. Glance at the table 3 informs us that it were Japanese, German and French banks which led the way in lending to developing countries, while Anglo-American banks were less involved. Such breakdown of loans differs from the situation before the debt crisis of the 1980s.

Malaysia was running current account deficits from the beginning of the decade and investments in non-tradeables there did not contribute to export earnings (there were also problems of previously mentioned "term mismatch").

According to Wong and Jomo (2001) in East Asia foreign capital served rather to supplement than to substitute domestic savings, though the nature of such capital was changing over time. Inflow of foreign capital allowed to finance additional imports but thus contributed to current account deficits. It can be also stipulated that excessive reliance on FDI in gross domestic capital investments had adversely affected domestic entrepreneurship and other economic capabilities of the countries (Jomo et.al 1997).

Since mid-year of 1995) currency pegs started to adversely affect regions competitive position, because yen started to lose in value against US dollar. The speculative attacks on overvalued currencies forced the defense of bhat and ringitt (Malaysia). However, such actions failed to produce the desired results and did not stop the panic from erupting and spreading. Bursting of speculative bubbles in asset prices hit hard banking systems of the four countries, undermining liquidity of the financial systems and leading to recession.

International financial liberalization led to temporary large net inflows of foreign capital to South East Asia, but FDI brought about weakening of domestic industrial companies and contributed to dominance of financial capital over economic policy. Before the crisis erupted, East Asia had experienced financial liberalization – one that had its roots back in the mid 80s – and the process resulted in popularity of both newly emerging stock markets and greater convertibility of capital account.

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Анотація

У статті проаналізовані причини кризи у Східній Азії, серед яких: лібералізація валютних рахунків, зменшення можливості управління фінансовими потоками, урядові втручання, ріст корупції, виробництва та демократії. Показано як лібералізація валютних рахунків та низький рівень резервів в іноземній валюті створили достатні умови виникнення кризи нового типу.