The Asian Crisis

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Abstract

Over a decade and half, the East Asian economies have experienced rapid economic growth. Nevertheless, such rapid growth and boom conditions masked economic weaknesses which remained hidden so long as the boom continued. With the external environment becoming less favorable, the competitiveness of those economies started to erode which resulted into the evolution of the economic crisis at the beginning of 1997. This crisis situation raised criticism of the ways in which international financial institutions — including the International Monetary Fund (IMF) — do business, and thus calls for changing such ways emerged.

This paper reviews the background to the crisis; the factors that may have contributed to it; the economic policies implemented by the three main crisis countries — Korea, Thailand and Indonesia — in the context of IMF-supported economic programs. In addition, some tentative conjectures about the implications of the crisis and the role of the Fund are sketched along with some preliminary thoughts on the 'miracle'.

ملخص

على مدى عقد ونصف حققت دول شرق آسيا نمواً اقتصاديا سريعاً. ومع ذلك، كان هذا النمو السريع يخفي نقاط ضعف اقتصادية ظلت كامنة مع استمرارية النمو. ولكن بتحول المناخ الخارجى فى اتجاه اقل موائمة، انخفضت القدرة التنافسية لهذه البلاد مما نتج عنه نشوء هذه الأزمة الاقتصادية مع بداية عام ١٩٩٧. وقد كان من جراء هذه الأزمة أن ارتفعت الانتقادات المطالبة بان تطور المؤسسات المالية الدولية — ومن بينها صندوق النقد الدولى — من أسلوب عملها.

تقوم هذه الورقة باستعراض جذور هذه الأزمة، والعوامل التى أسهمت فى حدوثها، والسياسات الاقتصادية التى اتبعتها الدول الثلاث الرئيسية التى أضيرت من جراء الأزمة — كوريا وتايلاند وإندونيسيا — فى إطار البرامج التى يدعمها صندوق النقد الدولى. كما يقوم البحث بتقديم بعض التوقعات المبدئية لعواقب الأزمة واستعراض دور صندوق النقد الدولى، وهذا بالإضافة لبعض الأفكار الأولية عن 'المعجزة'.

I- Introduction

Since mid-1997, the East Asian economic crisis has shaken global financial markets which has required major and difficult adjustments in the economic policy of the affected Asian countries. As a result, economic activity has suffered tremendously in those countries. Changes of government have already taken place in some of those countries and painful reappraisals are occurring in all of them. The crisis presents a challenge to perceptions of the global economy and has led to calls for changing the way that international institutions, including the International Monetary Fund (IMF), do business.

This paper will review the background to the crisis; the factors that may have contributed to it; the economic policies implemented by the three main crisis countries — Korea, Thailand and Indonesia — in the context of IMF-supported economic programs. In addition, some tentative conjectures about the implications of the crisis and the role of the Fund are sketched, as well as some preliminary thoughts on the 'miracle'. Since the crisis is still unfolding, the following is only a preliminary attempt to draw lessons.

B. Background to the Crisis

Long-term Developments

Despite occasional difficulties over the recent decades, the newly industrialized economies of Asia — including Malaysia, Hong Kong SAR, Indonesia, Korea, Singapore and Thailand — experienced rapid economic growth, low inflation, and manageable balance-of-payments situations. In addition, output and living standards rose rapidly *(see table 1, p. 18)*. Fiscal policy was managed prudently, with governments deficits and debt kept low and surpluses achieved in some cases. At the same time, monetary policy was successfully aimed at achieving low inflation. In many of these economies, an exchange rate system involving a peg to the US dollar provided a simple way for managing monetary policy and ensured that inflation was kept broadly in line with the rate in the United States. Furthermore, savings and investment rates were high. In addition to large volumes of investment in physical capital, investment in human capital through spending on education and health care was high, supporting the development of a strong and skilled workforce. Except for

Hong Kong and Singapore, even though investment rates were still higher, current account deficits were incurred.

In the early 1980s, the value of the US dollar rose sharply, reaching a peak in March 1985. The Asian currencies with exchange rates pegged to the dollar also appreciated substantially. This led to an erosion of external competitiveness, contributing to rising current account deficits and external debt. In both Korea and Thailand, IMF-supported adjustment programs were required in that period.

In the early 1990s, the Asian economies boomed. High economic growth rates increased further, investment surged and asset prices rose rapidly. From 1990 to 1995, output rose at an average annual rate of 7.75 percent in Korea, 8 percent in Indonesia, almost 9 percent in Malaysia, and 9 percent in Thailand. The rise in investment could not be covered by domestic savings and current account deficits tended to widen. In both Malaysia and Thailand, the current account deficit averaged more than 6 percent of GDP from 1990 to 1995, while in Indonesia it reached 2.5 percent of GDP on average and in Korea 1.5 percent *(see table 1, p. 18)*.

At first, these deficits were easily financed. The US dollar was declining and the competitiveness of Asian currencies pegged to the dollar was boosted. Low rates of return in industrial countries and an increasing outward orientation by investors in these countries facilitated a rapid increase in private capital flows to developing countries; private capital flows increased from about $20 billion annually in the second half of the 1980s to $150 billion in 1995 and over $200 billion in 1996. Such flows to Asian developing economies increased from low levels in the 1980s to $90 billion in 1995 and over $100 billion in 1996 *(see figure 1, p. 20)*. At the same time, the spreads on international borrowing by emerging-market economies became very low *(see figure 2, p. 21)*.

Nevertheless, such rapid growth and boom conditions masked economic weaknesses. Large capital inflows posed challenges for economic management. Funds were pouring into banking systems that were poorly equipped to intermediate them. Bank supervision and regulation practices lagged behind international best practice. A part of the capital inflows was financing speculative investment in property and construction without adequate risk management and appraisal. As the boom moved towards its peak, the maturity structure of capital inflows began to shorten, thus heightening vulnerability. Moreover, within countries, lending was often

taking place to well-connected individuals without adequate assessment of economic returns. As long as the boom continued, these weaknesses remained hidden.

As of mid-1995, the external environment became less favorable. The yen began to decline in value while the dollar rose. This shift contributed to appreciations in Asian currencies pegged to the dollar and began to erode their external competitiveness. For example, the real effective value of the Thai baht (based on movements in consumer prices adjusted for exchange rate movements) increased by 17 percent between April 1995 and June 1997; the Korean won by 5 percent between early 1995 and August 1997, while the Indonesian rupiah rose in real effective terms by 17 percent between April 1995 and April 1997. Simultaneously, growth in world markets for Asian exports began to slow.

The Crisis

In the first half of 1997, the initial phase of the crisis focused on Thailand. The current account deficit was large; short-term external debt was high and export growth was slowing. Meanwhile, the Thai baht remained pegged to the dollar as the dollar rose. Moreover, the 'property bubble' was collapsing and capital inflows were slowing. The authorities were reluctant to devalue the Thai baht and hesitant to raise interest rates. Against this background, a series of speculative attacks against the baht took place, with the authorities spending large amounts of foreign reserves and engaging in massive intervention in the forward exchange market. In this phase, there was only limited concern about possible spillover effects on other countries.

Between May and July 1997, the Thai crisis intensified, which further prompted expanded intervention in the spot and forward markets. By mid-May, the authorities introduced exchange controls and allowed a rise in interest rates. Seeing the chance of a one-way bet, international investors began to take positions against the baht. Facing continued outflows and reserve losses, Thailand dropped its defense of the peg on July 2, thus allowing the currency to float. The currency quickly dropped by 10 percent and continued to weaken subsequently.

Once the baht fell, pressures emerged against other currencies in the region, and international investors began to reappraise their Asian positions. Concerns regarding other Asian currencies with sizable current account deficits and pegged exchange rates were also raised. In the Philippines, the authorities allowed the peso to float on July

11 after a brief defense. In Indonesia, the authorities widened the intervention band from 8 to 12 percentage points after the floating of the peso. With pressures spreading to Malaysia, the authorities allowed the exchange rate to decline rather than raising interest rates.

Over the following two months the situation further deteriorated. The announcement of the IMF-supported Thai economic program in August 1997 did not ameliorate the pressure for long. The news that the forward exchange commitments of the Thai authorities were in excess of $20 billion contributed to skepticism about official data and soon questions developed about the strength of Thai policy implementation. Concerns deepened about the impact of currency depreciation and high domestic interest rates on the highly leveraged corporate sectors and balance sheets of banks and other financial institutions. Moreover, in many cases the policy responses were evaluated by the markets as too little and too late. At the same time, international investors in these countries' assets were seeking to reduce their exposure. The interplay of these factors led to further loss of confidence and continued exchange rate declines. By mid-October 1997, the Indonesian and Thai currencies had dropped by more than 30 percent in value while those of Malaysia and the Philippines were down by 20 percent. Stock markets recorded heavy losses in local currency terms, and the drop in equity market values measured in dollars was even larger.

From October through December 1997, the crisis intensified. Korea, the 11th largest economy in the world, with a GDP almost as large as that of Indonesia, Malaysia and Thailand combined, was engulfed in speculation. Contagion brought other economies into play. The authorities in the Taiwan Province of China allowed the exchange rate to depreciate in mid-October. Soon after that, pressures emerged against the currency board system in Hong Kong SAR. The Hong Kong authorities allowed interest rates to rise, but with the consequence of plummeting equity prices, which fell by 23 percent over a 3-day period in late October 1997.

Pressures emerged elsewhere, including Brazil, Estonia, Greece, Russia and the Ukraine, in all cases prompting hikes in interest rates. The Brazilian real came under attack, with a significant reserve loss in October. The authorities responded with a sharp hike in short-term interest rates, followed by a further increase in November and a major fiscal adjustment package. While the markets remained nervous, the pressure

subsided and reserves began to be recouped. The flight from emerging markets led to pressure against the Russian ruble. In response, the Russian authorities increased interest rates in November and December 1997.

Meanwhile, in Asia the situation was not improving. In Korea, information deficiencies came to the fore when it became known that usable foreign reserves were far below the published figure. In addition, concerns about possible default in the countdown to December 18 elections emerged. In Indonesia and Malaysia, the currencies were continuing to drop, despite the approval of an IMF-supported program in Indonesia in November and home-grown measures in Malaysia. Developments in Indonesia were clearly affected by erratic policy implementation and market doubts about commitment to implementing the program. In Thailand, after a period of political turbulence, the authorities started implementing strong policies. Nevertheless, the baht continued to decline as the portfolio adjustment by international investors continued.

At this writing, the peak of the crisis seems to have occurred in December 1997 and early January 1998. The announcement of an IMF program for Korea slowed the deterioration there, but initially did not stop it. Economic conditions in Indonesia continued to worsen and the currency to plummet. In Thailand, determined policy implementation was fighting a tide of skepticism from international investors. The currencies of the affected Asian economies continued to drop and renewed concerns mounted about default in Korea and a possible further intensification of contagion in other countries. By December 1997, the nominal effective exchange rate of the baht had dropped by about 40 percent from its June 1997 level, that of the rupiah by almost 50 percent, and the won dropped by almost 40 percent.

In the case of Korea, the turning point came at the beginning of the year when the incoming president took firm ownership of the reform program. The new steps taken included monetary tightening and market opening, rephasing of IMF disbursements, activating the second line of financing defense, and a successful effort to encourage improved rollover of Korean short-term debt by international banks. Slowly, Korean foreign reserves began to edge up and the currency to rise. In Thailand, a new government had come into office and courageous measures of financial sector reform followed; reserves were rising and, by the second half of January 1998, the currency slide was beginning to reverse. The Indonesian situation, however, remained more

difficult, with the currency stuck in the range of rupiah 9,000 to 10,000 per dollar. The political situation was unsettled and mixed signals concerning the Indonesian government's commitment to tight policies and structural reform emerged. Moreover, markets began to focus on the question of political succession.

At the time of this writing, the situation in the Asian economies has become differentiated, a differentiation that seems to be well understood by the markets. The phase of panic and contagion seems to have ended. In the absence of major new disturbances — which still cannot be ruled out — the global effects are being contained and most of the affected countries are implementing strong reforms. In Korea, reserves are rising, the currency has rebounded by more than 20 percent, stock prices are up, strong reforms are being implemented, an agreement for restructuring bank debt has been reached, and substantial current account surpluses are being accumulated. On the other side of the ledger, the latest production data indicate a sharp slowdown in activity. Similarly, in Thailand reserves are being rebuilt, the currency has risen by almost 20 percent, stock prices are rising and current account surpluses are being recorded — but indicators of economic activity are weak.

In sum, for both Korea and Thailand, there are two sides of the coin: first the nadir of financial and currency panic seems to have passed; second, the adverse effects on economic activity are still unfolding. Thus, even though the situation is still fragile and a great deal of hard work remains to be done, a corner seems to have been turned. By contrast, the situation in Indonesia remains difficult. Substantial price increases are taking place, large corporate and banking sector difficulties exist, and there are mixed signals about the framework for monetary and exchange rate policy in the context of debate about a possible currency board. Moreover, there is still skepticism about Indonesia's commitment to adjustment and reform measures.

C. Factors Behind the Crisis

The East Asian crisis left the whole world wondering why did it occur and what was behind this extraordinary sequence of events. A number of explanations emerged and there may be truth to several of them.

It seems clear that the crises were not entirely traditional balance of payments crises, triggered by loose fiscal and monetary policies, leading to large current account deficits — except to an extent in the case of Thailand. The data on central

government fiscal positions in Table 1 *(see p.18)* documents a record of fiscal prudence over time. Monetary policy had successfully achieved low inflation. There are some caveats to this judgment but the overall assessment would not be changed by them.

The weaknesses of the business sector represented an important factor that contributed to the crisis. Many businesses engaged in extensive unhedged foreign currency borrowing. Once the exchange rate pegs fell and currencies declined, businesses were exposed to rising losses. Moreover, accounting and reporting standards were lax and bankruptcy procedures were not well-established.

Another factor is that the problems in banking and financial systems were central. The pre-crisis period was one of financial excess, with large capital inflows intermediated through weak financial systems. Large amounts of loaned money went to well-connected individuals to support activities with low rates of return. Krugman sees the crisis as brought on by financial excess.[1] In his exposition, implicit or explicit government guarantees to financial institutions fueled a surge in lending, leading to inflation of asset prices. Once asset prices began to decline, the weaknesses of financial institutions became apparent. Stock prices declined, banks were under pressure and foreign investors began to withdraw their money. From this perspective, the crisis is seen as an international banking panic.

In addition, an inflexible approach to exchange rate policy and the reluctance to tighten monetary policy in the early stages were also important factors. One lesson to be learnt from this crisis is that exit from a pegged exchange rate regime is best undertaken early, whereas exit in the face of speculative pressure and loss of foreign reserves can become disorderly. For example, investors were presented with a one way bet in the case of Thailand, seeing that devaluation was inevitable.

The crisis may also have had some elements of a so-called ‘disorderly workout’. In this framework, a disorderly workout takes place when borrower difficulties prompt a race among creditors to get their money out of a company or a country. The massive efforts undertaken since December 1997 to coordinate improved rollover performance by international banks vis-à-vis Korea represent one way to address this problem.

International developments also clearly played a role. The dollar was rising and the competitiveness of Asian currencies linked to the dollar was deteriorating.

Moreover, the current account deficit widened to 8 percent of GDP in Thailand in 1996, to
5 percent in Korea and to 3.25 percent in Indonesia. These deficits were financed to a substantial extent by short-term reversible capital inflows. In Thailand, private capital flows net of foreign direct investment (FDI) and portfolio flows amounted to 10 percent of GDP in 1995 and 4.5 percent in 1996 *(see table 2, p. 19)*; this category inter alia covers bank flows. In Korea, such inflows amounted to 2.5 percent of GDP in 1995 and 3 percent in 1996. In Indonesia, these inflows amounted to 3 percent of GDP in 1995 and 4.5 percent in 1996. Country authorities may not have appreciated how punishing market discipline could be and how quickly the tide could turn. The size of the swing in capital flows was remarkable. For Thailand, net private capital inflows amounted to 6.5 percent of GDP in 1996 and shifted to outflows of 8.5 percent of GDP in 1997 — a swing of 15 percent of GDP in a year. For Indonesia, net private capital inflows were 8 percent of GDP in 1996 and 1.5 percent in 1997 — a swing of 6.5 percent of GDP. In the new world of globalized capital inflows, policy weaknesses can be punished severely and quickly. Correspondingly, policy responses need to be strong, credible and swift.

Despite the crisis, the benefits of globalized international capital markets remain clear. Recipient countries gain from tapping the pool of global savings to finance investment and support growth of output and living standards. Investors benefit from a wider range of investment opportunities and higher returns. The rapid growth in Asian economies in recent decades underscores the long-run benefits to recipient countries of improved access to international capital markets. The magnitude and speed of movement of capital flows, however, have been among the complicating factors in recent months.

Perhaps one important point to note is that the crisis was not predicted by most market participants and analysts. Capital flows continued virtually unabated until the dawn of the crisis. Risk premia, or the spreads over US treasuries for the borrowings of these countries did not show much increase until the beginning of the crisis. Country credit ratings, which are supposed to alert creditors to increasing sovereign risk, also reacted to the crisis rather than predicted it. Traditional warning signals — such as current account deficits, overvalued exchange rates and export growth — gave

[1] Krugman (1998).

some reasons for concern but they were muted. Some observers have argued that the unanticipated nature of the crisis led to an overreaction when it began and that overreaction may have caused the crisis to deepen.

D. The IMF-supported Economic Programs

First, some basic principles needs to be underlined:

- A sound macroeconomic policy framework promotes growth by keeping inflation low, the budget deficit small, and the current account sustainable.
- Large current account deficits such as those of Thailand and Korea in 1996 should be a cause for concern. As the case of Indonesia illustrates, even a smaller current account deficit in the range of 2 to 3 percent of GDP can be problematic.
- Current account deficits financed by longer-term borrowing tend to be more sustainable; deficits financed by short-term capital flows can mean trouble.
- Large short-term foreign currency liabilities are problematic.

Reform Measures

While fiscal policy may not have been the proximate cause of the crisis, fiscal tightening has to be part of the solution. Measures to curb fiscal deficits have been implemented both to help ensure the necessary reduction in current account deficits and also to finance the costs of bank restructuring. The fiscal programs vary from country to country depending on their circumstances. In Thailand, the initial fiscal adjustment amounted to some 3.5 percent of GDP, in Korea to 1.5 percent of GDP and in Indonesia to 1 percent of GDP. As events have unfolded, the slowdown in economic activity is turning out to be larger than initially envisaged, whereas current account positions are improving more rapidly than expected. Slower activity has meant that fiscal revenue is tending to fall short of the target in some cases. Against this background — and with improvements in external positions — the IMF has not generally pressed for further fiscal tightening to offset revenue shortfalls. Rather there have been some adjustments in fiscal targets in response to events.

Monetary policy has been tightened with substantial increases in short-term interest rates. Some critics have argued that interest rates hikes have made matters worse, exacerbating the problems of the business and banking sectors. These adverse effects are there, but in an environment of currency crisis, capital outflows cannot be stopped

by lowering interest rates. The countries that have been most successful in squelching spillover effects from the Asian crisis — such as Brazil — have raised interest rates sharply and promptly as soon as pressures were detected.

Reforms of the banking and financial systems are also essential. Strong up-front action was needed to put financial systems on a sounder footing quickly. Insolvent institutions have been closed down, generally with some protection for depositors and creditors. Other financial institutions had to come up with restructuring plans and to comply, over time, with international best practice, in terms of accounting practices, disclosure rules and capital adequacy. At the same time, measures to improve financial sector supervision and regulation are underway. Some critics have argued that, by insisting on such steps at a time of fragility, the IMF may have exacerbated the problem. Nevertheless, the alternative of allowing insolvent institutions to continue to operate and to accumulate still larger losses would not have been a solution at all. With the benefit of hindsight, it would have been better for countries to address financial sector weaknesses when economic times were good. But this was not done and, as financial weaknesses intensified, the authorities were left with few attractive options.

The economic programs contain other important reform measures tailored to country-specific circumstances. These include measures to increase corporate transparency; improve the transparency of government accounts and official statistics; and to create a more level playing field for private activity by breaking domestic and import monopolies and opening goods and financial markets to foreign participants.[2]

These reform programs have been supported by extensive financing from the IMF, the World Bank, the Asian Development Bank and the rest of the international community. For Korea, the stand-by was approved on December 4, 1997, for a total of $21 billion. The total financing package from the multilateral agencies amounts to $35 billion, reflecting $10 billion of World Bank financing and $4 billion from the Asian Development Bank. With the second line of defense, $21 billion, the package reaches a total of $56 billion. Total IMF disbursements so far amount to $15 billion.

[2] Detailed information on the economic measures in Korea, Indonesia and Thailand can be found in the countries' letters of intent for IMF-supported programs, now available on the IMF website (www.imf.org).

Thailand's stand-by program for about $4 billion was approved on August 20, 1997. Purchases so far amount to $2.4 billion and a third purchase is expected soon, after IMF's Board consideration of a program review scheduled for March 4, 1998.

Indonesia's stand-by for some $10 billion was approved on November 5, 1997. Total multilateral financing was to amount to $23 billion. Including the second line of defense support, the total financing package reached $43 billion. The only purchase so far amounted to $3 billion.

Criticism of IMF-supported Measures

Criticism of IMF's efforts have come from all sides. Even though the fiscal programs varied from country to country depending on the perceived needs of the cost of restructuring and the need to control the current account, one criticism has been that the Fund is rigid in its approach to fiscal policy. Some observers have advocated more expansionary fiscal programs to offset the inevitable slowdown in economic growth. The balance here is a fine one. As already noted, at the outset of the crisis, countries needed to firm their fiscal positions in order to deal both with the future costs of financial restructuring and — depending on the balance of payments situation — the need to reduce the current account deficit. Beyond that, if the economic situation worsens, the IMF generally agrees with the country to let automatic stabilizers work and the deficit to widen somewhat. Nevertheless, the IMF cannot remain indifferent to the level of the fiscal deficit, particularly since a country in crisis typically has only limited access to borrowing and the alternative of printing money would potentially be disastrous in these circumstances. Thus, the Fund adopted a flexible approach in order to adjust fiscal targets as events unfolded.

A second criticism has been that the Fund raised interest rates more than needed. By the time these countries approached the IMF, the value of their currencies was plummeting, and in the case of Thailand and Korea, reserves were perilously low. Thus, the first order of business was, and still is, to restore confidence in the currency. To reverse this process, countries have to make it more attractive to hold domestic currency, which means temporarily raising interest rates, even if this complicates the situation of weak banks and corporations. This is a key lesson from the 'tequila crisis' of 1994/95 in Latin America, as well as from the more recent experiences of Brazil, Hong Kong, and the Czech Republic, all of which have fended off attacks on their

currencies over the past few months with a timely and forceful tightening of interest rates along with other supporting policy measures. Once confidence is restored, interest rates should return to more normal levels. In addition, companies with substantial foreign currency debts are likely to suffer far more from a long, steep slide in the value of their domestic currency than from a temporary rise in domestic interest rates. Moreover, when interest rate action is delayed, confidence continues to erode. Thus, the increase in interest rates needed to stabilize the situation is likely to be far larger than if decisive action had been taken at the outset. Indeed, the reluctance to tighten interest rates in a determined way at the beginning has been one of the factors perpetuating the crisis. Higher interest rates should also encourage the corporate sector to restructure its financing away from debt and towards equity, which will be most welcome in some cases, such as Korea. It should also be noted that no currency crisis has ever been solved by keeping interest rates low. Events in the early part of the crisis suggest that hesitancy in raising short-term interest rates was part of the problem.

A third criticism has been that the IMF prematurely recommended that banks be closed down. It would be a mistake, however, to allow clearly bankrupt banks to remain open, as this would be a recipe for perpetuating the region's financial crisis, not resolving it. The best course is to recapitalize or close insolvent banks, protect small depositors, and require shareholders to take their losses. At the same time, banking regulation and supervision must be improved. Of course, the Fund takes individual country circumstances into account in deciding how quickly this can be accomplished.

Fourth, there is the moral hazard criticism. The argument is that IMF programs may encourage imprudent behavior by governments — because if events turn sour, an IMF program can help out — or by international investors, who may not sufficiently appraise investment risk, assuming that they will be made whole after IMF intervention. The first point is unlikely, this is because coming to the IMF is not an easy way out for countries. The second point is even more problematic because the decline in Asian equity markets' value has been massive — stockholders have not been bailed out. Moreover, by now, the general market perception is that investment in emerging market economies is not a risk-free proposition.

Fifth, the IMF has been criticized for being secretive. If ever true, this is no longer the case. IMF management and senior staff make many public appearances. Missions meet the private sector, the press, and trade unions. The Fund's many presentations on Asia are available on the IMF website. Countries are encouraged to make their letters of intent public, and these documents are also put on the Fund's website.

E. Some Conjectures

For the crisis-affected economies, the policy framework seems clear. Macroeconomic policy needs to be put on a sound footing with limited fiscal deficits, tight monetary policy and a pragmatic approach to exchange rate management. Attention has to be paid to current account deficits and their financing and to external debt, especially its short-term component. Banking and financial sectors need to be rehabilitated, with insolvent institutions closed and others restructured. Long-standing practices of connected lending need to end and financial decisions have to be taken on the basis of an assessment of economic return and risk. Financial supervision and regulation have to be brought to the level of international best practice over time. The transparency of corporate and government accounts has to be improved.

These events provide insight into the world of globalized capital flows. This new world has major benefits for recipient countries because it enables them to tap into global savings in order to finance investment, allowing output and living standards to rise more rapidly than otherwise. Furthermore, investors gain from increased investment opportunities and higher returns. The rapid growth of the Asian economies in the last three decades supports this assessment. But in a globalized world economy, market discipline against policy weaknesses can be large and swift.

Globalized capital flows may make crises less frequent by allowing countries access to private financing and cushion adjustments, while taking necessary policy measures. In the new world of globalized flows, however, crises may develop faster and be larger in magnitude when they do occur. Accelerating private sector response would not be an issue if the response of other players were similarly accelerated. But this may not automatically be the case. For example, while country authorities may have less time to prepare and implement difficult measures in response to emerging pressures, they inevitably take time to develop the necessary domestic consensus. In the same vein, other actors now have less time to prepare their own responses. The

IMF has had to streamline negotiations and procedures in order to respond in a timely fashion. The World Bank and the Asian Development Bank have also had to move fast.

Many observers have been surprised by the sheer size of currency movements in this crisis. The Dornbusch model indicates that exchange rates can overshoot their long-run equilibrium values, because of the asymmetry stemming from different speeds of adjustment between flexible asset prices and sticky goods prices.[3] If currency markets now adjust faster, while goods markets remain sticky, then this asymmetry may be larger and the extent of exchange rate overshooting could be greater.

This crisis underscores the need for sequencing reforms. There are dangers in liberalizing capital movements in an economy in which the macroeconomic framework and the financial sector are weak. There is thus a case for phasing liberalization, paying due regard to the country's macroeconomic and external situation, the development of its markets and institutions, and the impact of existing controls. Without coordination of capital account liberalization and financial sector reforms, there may be regulatory distortions and regulatory incentives for capital movements, unrelated to underlying economic conditions. Both factors could risk instability in capital movements.

F. The Role of the IMF

Clearly, diagnosis and early prevention of crises are preferable to a cure after a problem has broken out. To this end, efforts are underway to further strengthen IMF surveillance. Since the Mexican crisis in 1994/95, the IMF has placed increased emphasis on timely surveillance of market developments. But the international system cannot be built on the assumption that improved surveillance will prevent all future crises.

Much of the current work reflects efforts to bring to the international arena frameworks parallel to those which support efficient markets in individual countries. The data standards work is based on the premise that international capital markets function better if there was improved disclosure of economic information by countries. Information deficiencies in the Mexican crisis led the IMF to establish the

Special Data Dissemination Standard (SDDS) — a set of voluntary data standards to which countries can subscribe provided they meet certain good practice benchmarks.[4] Information deficiencies in the Asian crisis have brought renewed attention to these issues. Work is underway on expanding the SDDS to include detailed information on central bank reserve-related liabilities and forward positions together with appropriate banking sector data.

The financial sector is another area where work is underway to give global exposure to frameworks that have operated well at the national level. Working with the World Bank and others, the Fund has helped in developing and disseminating a set of 'best practices' in the banking area.[5]

Fostering an orderly approach to capital account liberalization is also a priority, which neither means a return to capital control nor a rush to liberalize without attention to sequencing. Through an orderly approach to liberalization, a larger number of countries can benefit from access to international markets. Work is underway on an amendment to the IMF Articles of Agreement to provide the Fund with jurisdiction over capital movements.[6]

Finally, as events in Asia have shown, the IMF's ability to provide financing in support of members' programs is crucial. With the programs in Asia, the IMF's usable reserves have declined by more than one-third to about $45 billion, leaving little room to maneuver. The international community has endorsed an increase in IMF quotas by 45 percent, or about $88 billion, which would yield $58 billion of usable resources. Simultaneously, steps have been taken to increase the special credit lines available to the IMF from its members. Quota payments are of course not a budgetary expenditure but a deposit on which interest is paid to members. This should be seen as a sound investment for member countries both in a narrow financial sense, because of the interest that is earned, and more broadly, as an important investment likely to reap significant returns in the form of global economic stability and prosperity.

[3] Dornbusch (1976).
[4] By February 1998, 43 countries — virtually all industrial countries and most emerging market economies — were subscribers to the SDDS. Information about subscribing countries' statistical systems is provided on the Dissemination Standards Bulletin Board (www.dsbb.imf.org).
[5] Folkerts-Landau and Carl Lindgren (1997), including the Core Principles of the Basle Committee as an annex to the paper.
[6] Fischer (1997).

G. The 'Miracle'

The question to be raised thus is: 'miracle or mirage?' Over the past decade or so, the perceived economic success of the East Asian countries was one of the reasons behind the dramatic change of the economic policy environment in developing countries. It is precisely this success that has been called into question by the current financial crisis in the region, which has been described in the press as an economic 'meltdown'.

The countries under consideration have experienced at least a decade and a half of rapid economic growth — rapid compared to other countries during the same period, as well as relative to what observers had predicted. Moreover, this growth has been achieved with a more egalitarian distribution of income and wealth than typically observed in other developing countries. Thus, it is a 'miracle' both in terms of the rate of growth and the pattern of income and wealth distribution.

While the growth strategy differed from country to country, several common features can be observed. First, throughout the period of strong growth performance, the countries maintained prudent fiscal policies and monetary policies aimed at low inflation rates providing a conducive framework for private savings and investment which remained high. Second, while the degree of openness varied from one country to the other — with Singapore and Hong Kong SAR being the most open economies to both trade and investment, and Korea and Malaysia maintaining barriers to foreign direct investment, including in the banking sector — in general, all of those economies were clearly more open than those of other developing countries. Specific export promotion policies such as export processing zones, tax breaks, and direct export subsidies were administered by an efficient and well-trained civil service but without endangering macroeconomic stability and introducing significant price distortions. Finally, these countries consistently allocated a relatively high share of education expenditure to basic education followed by secondary education compared to other developing countries of the same income level.

But, with the current crisis two questions are to be raised:

1. Was the 'model' fatally flawed?
2. What will happen to the 'miracle' after the crisis? Will economic growth resume, or does the crisis signify the end of the 'miracle'?

The crisis has occurred owing to a sharp reversal of capital inflows arising from a perception of increased risks of overheating and concerns for financial market weaknesses. Liberalization with insufficient regulation meant that banks did not have the appropriate incentives, and the high growth environment meant that many of the risks were not easy for the regulatory apparatus to fully comprehend. The high growth environment also made foreign funds available at increasing rates.

In many of these countries, capital was allocated through close consultation among banks, governments and firms. The term used in the press to refer to this is 'cronyism'. If productivity growth was low due to 'cronyism', then revamping the way in which capital is allocated in the region may actually increase long-run growth. If it helped allocate capital efficiently, perhaps even inducing additional saving (retained earnings of family-owned firms represent a significant contribution to Asian saving rates), the attack on 'cronyism' may have adverse long-run effects on the 'miracle'.

This is not a crisis that would arise as a gradual result of foreseeable structural factors such as the slowdown in accumulation. It is a crisis resulting from an unexpected shock. It was not bound to happen, since it resulted from key policy mistakes such as not managing the exchange rate flexibly, failing to restrain the financial system, and allowing excessive short-term capital inflows. Indeed, it can even be argued that the key policy mistakes ran directly counter to the East Asian model, including maintaining a competitive exchange rate, a fairly tightly regulated financial system, and in most countries, strong restrictions on capital movements.

What does the crisis portend for future growth in the region? From past experience, we have seen that countries with similar experience such as Chile in 1982 and Mexico in 1994 resumed growth almost immediately once the appropriate policies had been put in place.

Table 1: Selected Asian Countries - Economic Indicators

	1975-82	1983-89	1990-95	1996	1997
			(Annual percentage change)		
Output Growth					
Thailand	7.0	8.0	9.0	6.4	0.6
Indonesia	6.2	5.5	8.0	8.0	5.0
Malaysia	7.0	5.3	8.8	8.6	7.0
Philippines	5.6	1.0	2.3	5.7	4.3
Korea	7.0	9.6	7.8	7.1	6.0
Inflation					
Thailand	8.9	3.0	5.0	5.9	6.0
Indonesia	14.9	8.1	8.7	7.9	8.3
Malaysia	5.3	2.0	3.5	3.5	3.7
Philippines	10.9	14.4	10.8	8.4	5.2
Korea	17.4	3.8	6.6	4.9	4.3
			(In percent of GDP)		
Central Government Balance					
Thailand	-3.5	-1.2	3.0	1.5	-0.4
Indonesia	0.6	-1.2	—	1.2	0.9
Malaysia	-5.7	-5.5	-0.3	1.1	1.6
Philippines	-2.0	-2.8	-1.9	-0.4	-0.9
Korea	-2.7	-0.3	-0.3	0.3	-0.2
Domestic Savings					
Thailand	19.6	25.4	34.4	33.1	31.8
Indonesia	19.3	23.2	28.9	28.8	27.3
Malaysia	21.6	29.4	31.3	36.7	37.0
Philippines	19.9	18.1	18.6	19.7	21.0
Korea	25.7	32.7	35.3	33.3	32.9
Current Account Balance					
Thailand	-5.6	-3.2	-6.7	-7.9	-3.9
Indonesia	-1.2	-3.5	-2.5	-3.3	-2.9
Malaysia	-2.0	-0.7	-6.2	-4.9	-5.8
Philippines	-6.5	-0.3	-4.1	-4.7	-4.5
Korea	-4.6	2.5	-1.4	-4.9	-2.9

Sources: IMF *World Economic Outlook* (December 1997)

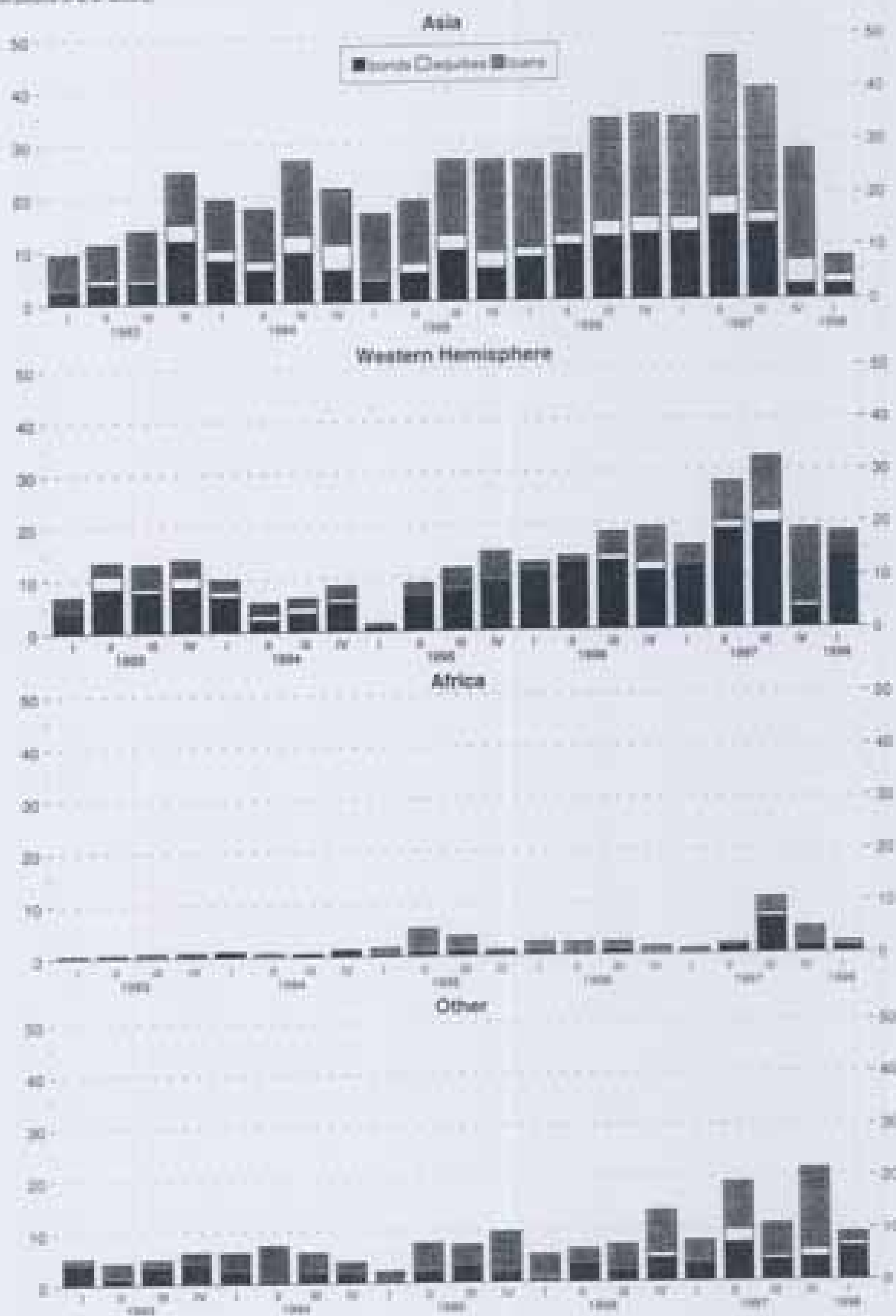
Table 2. Asian Economies: Private Capital Flows 1/

	Net private capital flows	Direct investment	Portfolio flows	Of which: equity	other	Other net private flows
Indonesia						
1995	6.2	2.3	0.7	...	...	3.1
1996	8.1	2.8	0.8	...	...	4.6
1997	1.4	1.4	-1.0	...	...	1.0
Korea						
1995	4.4	-0.4	1.9	(1.1)	(0.8)	2.5
1996	5.3	-0.4	2.3	(1.3)	(1.1)	3.0
1997	3.1	-0.2	-0.3	...	...	3.5
Philippines						
1995	4.6	1.8	0.3	(6.1)	(-5.7)	2.4
1996	9.7	1.6	-0.2	(2.5)	(-2.7)	8.3
1997	0.9	1.4	-5.6	(-0.4)	(-5.2)	5.0
Thailand						
1995	12.4	0.7	1.9	(4.2)	(-2.3)	9.8
1996	6.5	0.9	0.9	(4.0)	(-3.1)	4.6
1997	-8.4	1.5	1.8	(1.9)	(-0.1)	-11.6

1/ Data are from IMF World Economic Outlook database. The figures for 1997 are preliminary and in cases may be partially estimated.

Figure 1. Public and Private Financing for Emerging Markets: 1993Q1 to 1998Q1

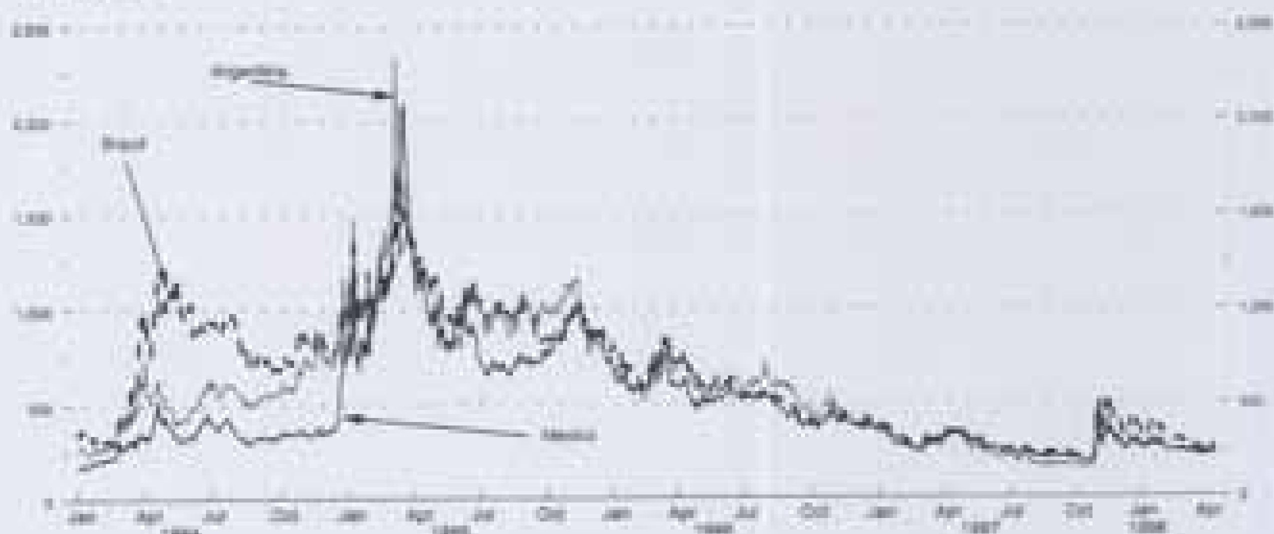
(In billions of U.S. dollars)

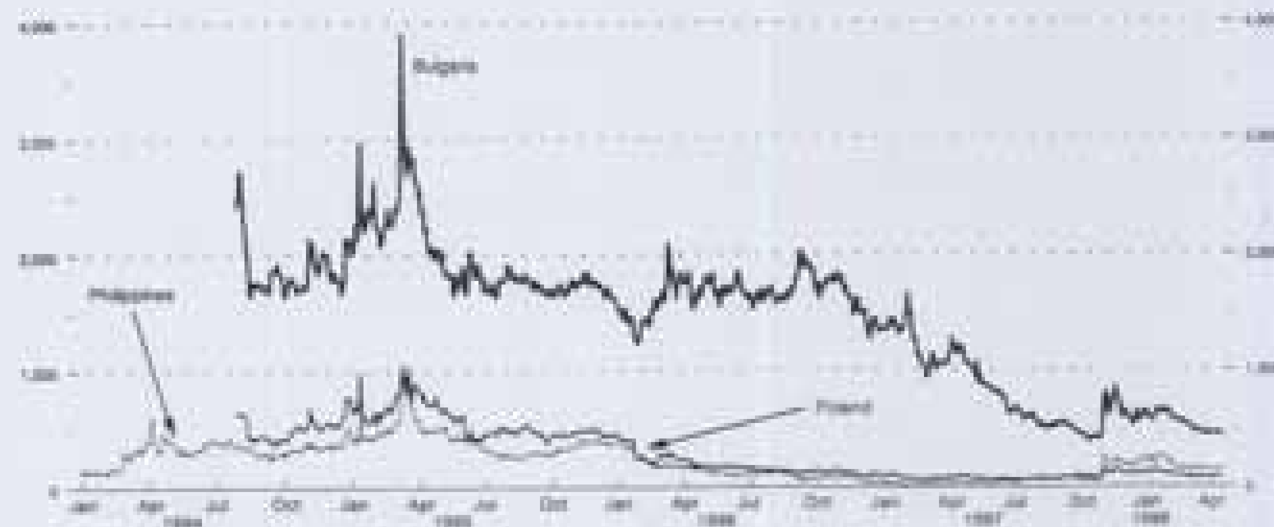


Source: Developing Country Bonds, Equities and Loans (DCBEL) database.

Figure 2. Stripped Yield Spreads for Seleted Brady Bonds, January 1994 to February 1998

(In basis points)





Source: Reuters, Salomon Brothers, and IMF estimates.

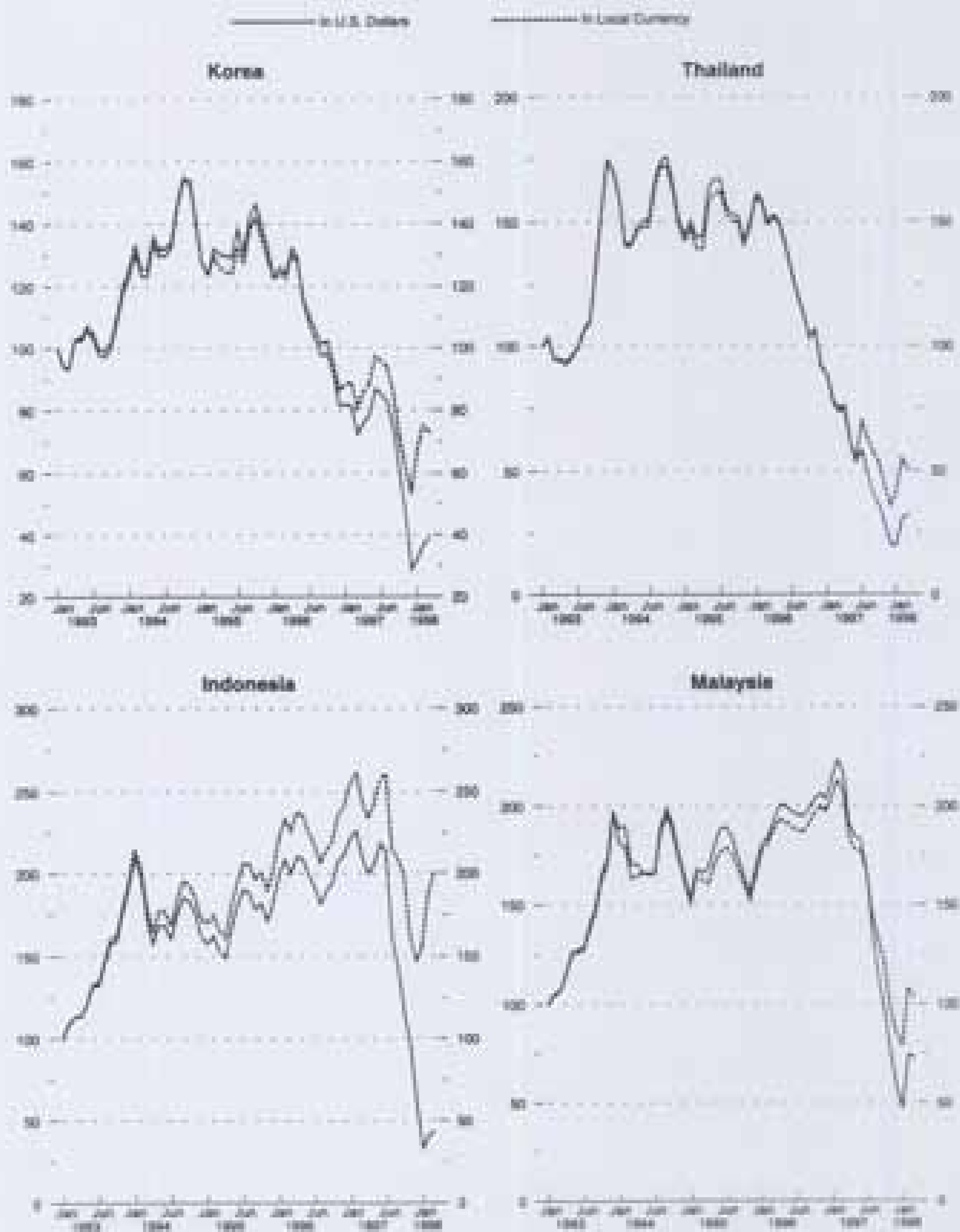


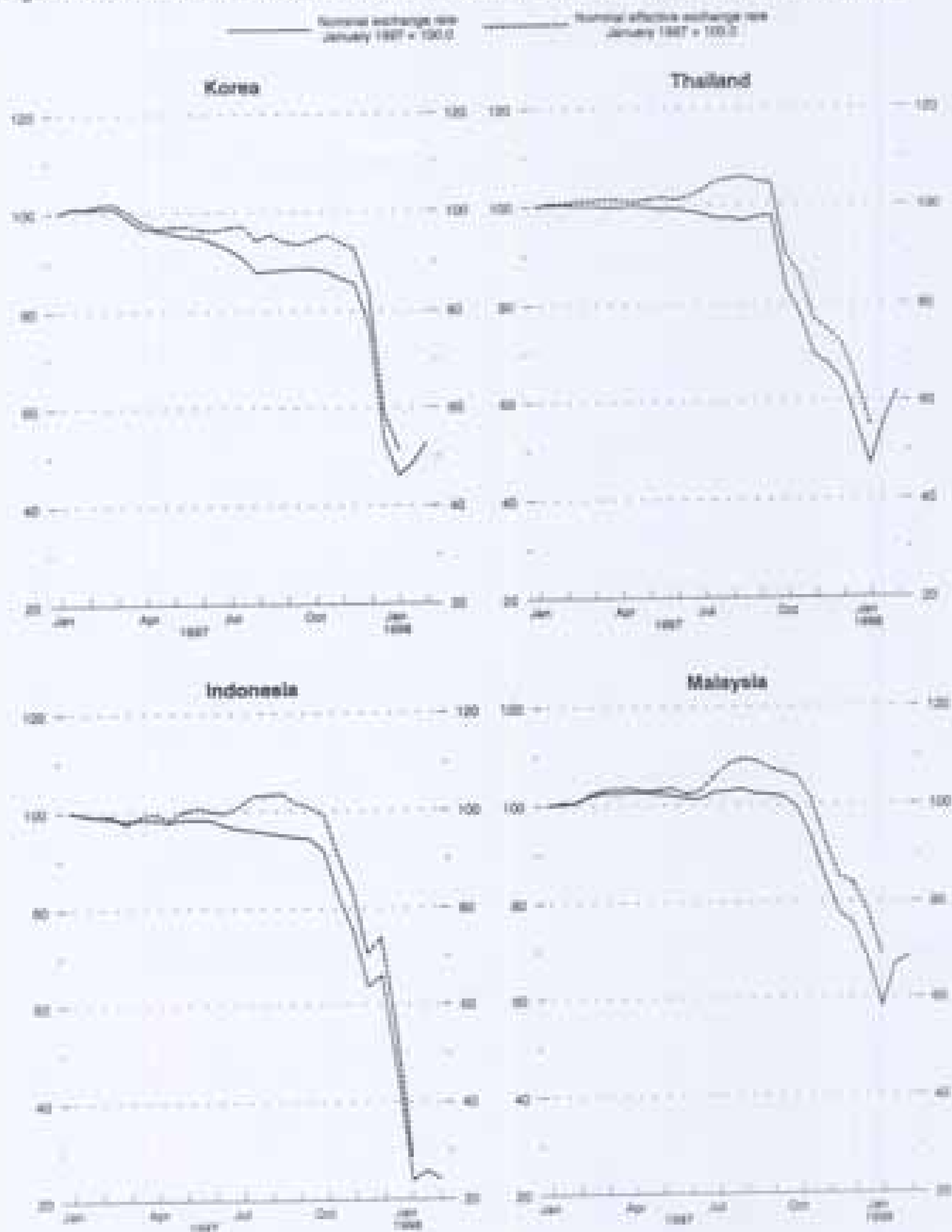
Figure 3. Selected Asian Economies: Monthly Share Price Indicies
(January 1993 = 100)

Source: International Finance Corporation (IFC), Emerging Markets database and the WEFA Group (DERFR) database.

Figure 3 (continued). Selected Asian Economies: Monthly Share Price Indicies
(January 1993 = 100)

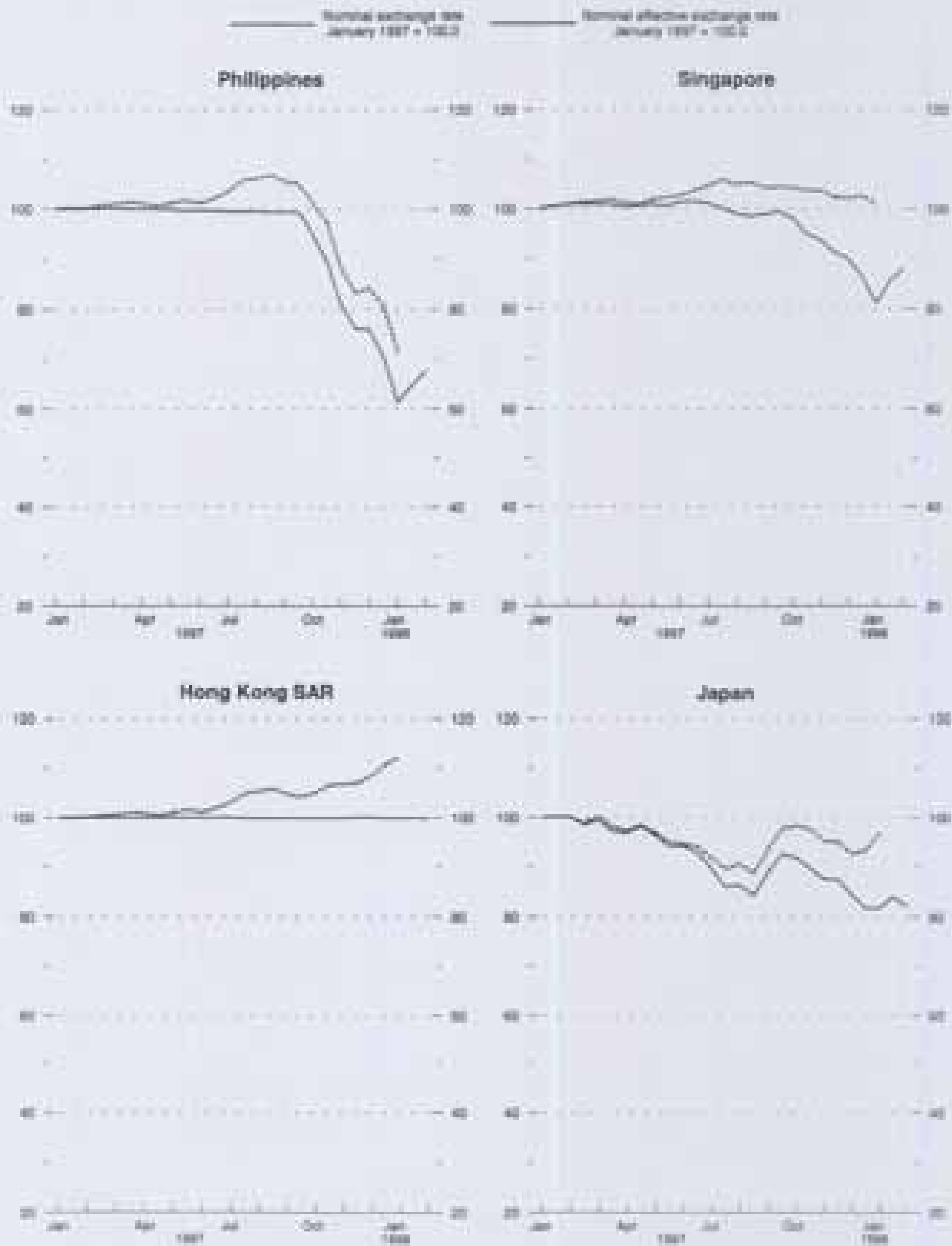
Source: International Finance Corporation (IFC), Emerging Markets database and the WEFA Group (DEPFIN) database.

Figure 4. Selected Asian Economies: Nominal Exchange and Nominal Effective Exchange Rates



Source: IMF Information Notice System (INS) database and the WEFA Group FOREX database.

Figure 4 (continued). Selected Asian Economies: Nominal Exchange and Nominal Effective Exchange Rates



Source: IMF Information Notice System (INS) database and the WEFA Group FOREX database.

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