THE CURRENCY CRISIS IN SOUTHEAST ASIA

MANUEL F. MONTES

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UPDATE
1 March 1998

The manuscript of the first version of this book went to press on 17 October 1997. That manuscript accurately reflected the fact that at that juncture, Indonesia had recently announced, on 8 October, that it was approaching the International Monetary Fund (IMF) for assistance, as a pre-emptive move. The subsequent extreme distress the Indonesian economy suffered from further currency attacks, even after the finalization of its IMF package, most sharply in January 1998, are not in the original analysis.

At that time, the analysis assumed that the panic in the Asian asset markets would subside, counting on the possibility that these asset markets would be efficient enough to interpret the devaluations as providing a hefty boost to the region's exports, providing a floor below which currencies could not fall any further. In the original analysis, the incidence of the panic and contagion was measured by the extent to which economies such as Malaysia and Singapore (which, based on their macroeconomic data and information about their financial system should not have been affected) had been drawn into the crisis.

The judgement that asset markets could not dominate the "real markets" in exports, imports, and production in setting currency exchange rates has proven to be mistaken. But it was a judgement commonly shared at that time. For example, subsequent to the Thai devaluation of 2 July 1997, the United States did not even participate in the US$17 billion

Thai rescue finalized on 5 August 1997. The problem was thought to involve mainly Japanese banks (though U.S. funds and financial institutions had some exposure to Thailand) and could be contained in Thailand. Indonesia and South Korea, both subsequently victims of the crisis, participated in the Thai rescue package, both pledging US$0.5 billion.

Now it appears that asset markets have taken charge in setting currency rates, leading to currency attacks on the Hong Kong dollar, the Korean won, the Japanese yen, and other currencies. This crisis will undoubtedly be the subject of numerous Ph.D. dissertations in the future; quantitatively identifying the relative roles of real developments as against financial factors and expectations will certainly be part of this effort.

This new section updates the analysis in the original volume. It also presents a set of policy suggestions which the course of the crisis has suggested to be appropriate and quite critical.

The basic interpretation of the nature of the crisis in the body of the book continues to apply. This analysis — which located the crisis in weaknesses in the financial systems that were then magnified by international contagion effects traceable to incomplete information — will be briefly rehearsed in this Update. If anything, written as it was in the context of what seemed then to be a subsiding crisis, the original analysis paid great attention to the problem of and strategies for resisting capital inflows, a discussion which has become more critical in the realization of the importance of preventing future crises of the type experienced by Asia.

The original analysis repeatedly warned that falling currency values and high interest rates have the effect of further weakening domestic financial systems which according to the analysis were the locus of the crisis in the first place. However, the original analysis failed to capture the quantitative extent of the unfolding crisis, being too optimistic that eventually the export competitiveness of Asian

TABLE U-1
Rates of Depreciation of Selected Asian Currencies

	Exchange Rate to U.S. Dollar (local currency unit/US$)		*Total Rate of Change in Dollar Value (percent)*
	1 Jul 1997	*24 Jan 1998*	
Indonesian rupiah	2,432.00	14,800.00	-83.6
Malaysian ringgit	2.52	4.58	-44.9
Philippine peso	26.37	43.50	-39.4
Singapore dollar	1.43	1.76	-18.8
Thai baht	24.53	54.00	-54.6
Korean won	888.00	1,744.00	-49.1

economies and their high savings rates would prevent the contagion effect from knocking currency values so low so that a second round of crisis — coming from the drastic and further weakening of domestic financial systems — would emerge. This development has occurred in the case of Indonesia and has the potential of appearing elsewhere as long as currency values are not stabilized.

The values of Asian currencies have fallen considerably since the initial failed attempts in July and August to stabilize them (see Table U-1); by end-January 1998, the baht had fallen by 55 per cent, the rupiah by 80 per cent, and the Korean won, whose currency came under attack in December 1997, by almost 50 per cent. As an attack on a set of currencies, the Asian crisis is the third such case in the 1990s: the first generalized currency attack in 1992–93 brought down Europe's Exchange Rate Mechanism (ERM), and forced the U.K. and Italy out of the system. In 1994–95, sparked by Mexican devaluation and economic crisis, the Latin American currencies, notably those of Argentina and Brazil, came under attack.

Twin Liberalizations and the Banking Crisis

The starting point made in the analysis in the body of this book is that the Thai crisis had precedents — in Chile (in 1981), three Scandanavian countries (Norway, Sweden, and Finland in the late 1980s and early 1990s), and Mexico (in 1994). We would now have to add Indonesia to this list. The attack on the Korean currency also arises from weakness in the banking system but there are specific features, to be elaborated below, in the Korean case different from those in the above list.

Such currency attacks follow on (or are justified by) an unhealthy domestic banking system, following an episode, of say 3 to 5 years, of vigorous external capital inflows. As explained in the main text, using illustrations especially from the Thai experience, failures in managing the process of the "twin liberalizations" — that of the domestic financial system and that of opening the capital account — precede the currency crises.

In the *first liberalization*, the expansion and the diversification of the financial system were transferred to the private sector (and to private sector creativity and agressiveness). This was very successful in all these cases before their crises. Indonesia began liberalizing its financial sector in June 1983, "by liberalizing interest rates and the complicated ceiling cum selective credit policy with subsidized interest rates" (Nasution 1997, p. 12) and accelerated after October 1988 with the removal of restrictions on the kinds of activities licensed banks could undertake. As in Thailand, a credit boom ensued in Indonesia, a significant proportion of which was channelled into property development. As pointed out in the main text, Indonesia's asset bubble was not as pronounced as that of Thailand's. However, the liberalization process provided banks and domestic corporations the possibility of borrowing from offshore sources at interest rates lower than available domestically. This provided the incentive for Indonesian corporations to accept significant

obligations denominated in U.S. dollars to finance their expansion, creating the conditions for a crisis should the Indonesian rupiah devalue precipitously.

The *second liberalization* — opening the capital account — provides domestic financial companies access to private funds abroad, and conversely provides foreign banks and investment funds access to financial assets that can be disposed of quickly (deposits, bonds, and equities) based on portfolio considerations of foreign investors. The main text of this book discusses the role that the offshore banking facilities of Thailand (the Bangkok International Banking Facility, BIBF) played in mediating the enormous inflow of funds in response to the opening of the capital account.

In the case of Indonesia, there have been minimal controls on capital account transactions since 1972. Early on, Indonesia recognized the physical and administrative futility of attempting to control asset flows between itself and Singapore. The implicit controls on capital account transactions were located in banking rules, so that the liberalization of these rules especially in 1988, opened up numerous possibilities for short-term flows into Indonesia. Ceilings on offshore borrowings of commerical banks were replaced by limits on net open positions. In November 1989, limits on incoming foreign investments were abolished (Nasution 1997, p.12).

There is a stark contrast between Indonesia and Thailand on the one hand and Singapore on the other with regard to the role of offshore funds in affecting domestic credit expansion. Singapore, which has long held ambitions to become an international financial centre and has been quite successful in this regard, began to develop offshore banking in 1972 through the institution of the Asian Currency Unit (ACU). These operations have created the Asian dollar market, the Asian counterpart of the Eurodollar market in London. With a daily turnover of over US$100 billion, Singapore is the fourth most active foreign exchange centre after London, New York, and Tokyo. ACUs can intermediate international funds but are subject to clear-cut regulations

separating their operations from those of domestic banks. In addition, Singapore monetary authorities have the means to monitor and the power to regulate the domestic purposes to which these offshore funds are applied. (See Montes and Tan [1998] for a review of Singapore's regulatory framework and how it applies to offshore banks in Singapore.)

In contrast to these two Southeast Asian cases, the weakness in the Korean banking system was not spawned directly from a dependence on short-term capital inflows as the basis for a credit boom. Korea had not opened its capital account to the same extent as Thailand, Indonesia and other emerging economies. There were restrictions on portfolio flows and investment inflows into equity markets (Park 1997). In view of its accession to membership in the Organization for Economic Cooperation and Development (OECD) these restrictions had been scheduled for a phaseout (Park 1997); in the aftermath of its falling victim to the 1997 financial crisis, these restrictions are being rapidly dismantled as part of its adjustment package. It remains to be seen if this sudden opening of the capital account will set the stage in a more distant future for a Thai-style currency attack in Korea.

Korea's being drawn into the crisis derives directly from the vulnerability of its banks, weakened by years of private overborrowing. In line with the country's development objective of moving the Korean economy up the technological ladder, the Korean financial system, drawing principally on domestic savings, provided considerable, perhaps much more than financially prudent, resources to high technology and advanced industrial ventures. When some of these ventures began to fall behind schedule or fail, they required further infusions of capital.

Just as gravity curves space, the structure of Korean lending is curved by Korea's business groupings, the *chaebols*. Banks tend to emanate from *chaebols* and certainly serve the financial requirements of their groupings. At the same time as Korean *chaebols* were investing in industrial development, they had been expanding their overseas operations and were raising

resources from international banks and investment funds eager to earn returns higher than they could have earned in the United States, Japan or Europe. A significant proportion of these foreign borrowings of *chaebols* were therefore offshore in a different sense: they were borrowed by their offshore operations from international banks operating under regulatory rules of the foreign country. The third element in this volatile mix is that these same international banks provided the Korean domestic *chaebol*-related banks the trade credits critical for Korea's import and export activities. When confidence in Korean corporate and banking system began to falter (as indicated by drastic losses in value in the Korean stock exchange), these international banks became obliged to terminate the renewal of short-term trade credits, and a Korean currency crisis had been set in train.

From Euphoria to Disaster Myopia

The unprecedented knockdown of currency, equity, and property values since July 1997 testifies to the enormous flight of assets denominated in Asian currency values to assets denominated in U.S. dollars that has been occurring in Asia. Economies with relatively healthy banking systems, such as Singapore and Taiwan, have seen significant losses in their stock exchanges and have also depreciated their currencies. Their own banking systems now have to expect servicing difficulties on the part of their clients in the economies whose currencies have devalued faster than theirs, and especially if the loans had been denominated in U.S. dollars, as they most often were.

It appears therefore that the Asian region has fallen into a classic financial crash, as analysed in Kindleberger (1978). A period of what Kindleberger calls "euphoria" precedes all financial crises; during this period, the credit boom is fed by intense investor interest and rising asset values which seems to confirm investor demand. The early 1990s, especially after 1994, might well have been Asia's "euphoria". When the

financial crisis occurs, Kindleberger describes how panic takes over and prices enter a downward spiral, confirming in the opposite direction, the panicky selloff. At that point, credit, is unavailable at any price. In the case of Indonesia in January 1998, trade credits completely disappeared.

Modern asset markets are particularly susceptible to boom-bust behaviour. Griffith-Jones (1997) explains that "herd behaviour" on the part of investment managers, as indicated by over-optimism during the time of euphoria being replaced by over-pessimism, can actually be supported by the incentive structure in which they operate. Fund managers receive bonuses based on the performance of their investments in comparison with other funds or some other "market" benchmark. If a fund manager misses out on an investment which proves to be profitable to most everyone else, then the incentive mechanism penalizes him. If he makes a wrong investment in which most everyone else makes the same mistake, it is less likely he will lose his bonus and he even might be rewarded if his fund has slightly better gains than the others. Thus, it becomes a virtue to follow the crowd all the time.

During the period of "euphoria" there are numerous incentive problems inherent in capital markets. With regard to developing economies, most institutions are on the "sale side" so that even when they were providing supposedly independent analyses, funds were also trying to sell their products, on commission. This creates an incentive to emphasize high yields and downplay the risks. During the period of crisis, many types of funds are susceptible to redemption by their investors. When uncertainty sets in, redemptions and likely future redemptions shrink the size of the fund and compel managers to cut back drastically that fraction of their (smaller) portfolio exposed to the distressed economy.

During the period of "euphoria", portfolio diversification, i.e., the fact that investors have only a small fraction of the fund in any one country, might actually serve as a disincentive to obtaining detailed information about their investments.

If detailed information gathering is costly, then there can be a trade-off between diversification and information: the more diversified a portfolio the less important it is to spend resources on gathering more information. Investment fund managers generally rely on monitoring a few key indices, which often do not discriminate finely between countries. Hence, during the inflow period (and the subsequent outflow period), increases (and decreases) in the proportion of the portfolio invested in a country depend very much on the proportion invested in the region. The lack of in-depth information abets "disaster myopia" (Guttentag and Herring 1984); investors have a hard time imagining a large calamity in the markets. More important, the lack of in-depth information encourages prickly behaviour on the part of investors, so that "small bad news" becomes the occasion for massive shifts in confidence, shifting the funds out being a substitute for the cost of obtaining more information (Shafer 1986). Thus when euphoria shifts to disaster, myopia continues to prevail.

Panic in Asian Asset Markets

For those inclined to understand things by studying cosmic patterns, the 1997 crisis has come right on time in an 11 or 12-year cycle (just like the cycle of the Chinese lunar calendar) of economic crises among the Asian economies, the two previous being around 1974 and around 1985. As in these two previous episodes, almost all economies have been affected. Moreover, in Table U-1, a healthy sprinkling of the number 4, an unlucky number in Asia, is ominously evident in the exchange rates at the end of January 1998.

The precipitous fall in confidence consitituting the Asian crisis can be traced through the sequence in crises that has appeared to come "just in time". When the Thai bailout package was announced on 5 August 1997, it was generally thought that while Indonesia might also require a reform programme the crisis could be contained. Unlike the Latin American countries and transitional economies (Russia and Eastern

European economies) where emerging country funds were also invested, Asian economies had high savings rates and unambiguously sound fiscal situations.

The US$17 billion Thai rescue package did not stem the flight of investment out of the region, as the stream of "small bad news" of corporate failures, exposure of banks and corporations beyond their domestic markets, and hesitation of public authorities in reversing policy stances, continued. The continued fall in the currency values and the high domestic interest rates markets put in place to prevent faster currency depreciation weakened the banking sectors in the region. Indonesia was particularly vulnerable; as the rupiah's international value continued to fall, Indonesian companies and the already vulnerable domestic banks, both of which had borrowed heavily in the international markets, needed to put up more rupiah to service their dollar-denominated debt.

But when Indonesia announced that it was approaching the International Monetary Fund on 8 October, it was generally regarded as a positive, pre-emptive move. On 17 October, Malaysia presented a belt-tightening budget, a self-imposed IMF programme as it were, to stem currency attacks. Austerity measures in the region meant that economic growth rates would be lower and corporate returns would decline in the near term. Lower-than-previously-projected economic growth rates also would mean that even good investment projects would be subject to lower returns and bank portfolios would be further weakened. The currency declines continued.

The Hong Kong stock market, the most regionally dependent and the most international in the area, came under fierce withdrawals on 20 to 23 October and again on 27 October; the withdrawals were thinly disguised attacks on the currency peg of the Hong Kong dollar to the U.S. dollar which had been fixed since 1983. Subsequent to the 27 October attack, Wall Street experienced its biggest one day loss ever. Thus, just at the time that the US$23 billion Indonesian package was announced on 31 October, the asset crisis had already

become much bigger than when Indonesia originally declared its intention.

Korea became a clear participant in the crisis one week after the Wall Street fall; on 6, 7 and 8 November there were heavy losses in Korean equities and the Korean Central Bank intervened heavily to prevent the won from sliding. News about weaknesses in the Korean banking system joined the stream of bad news.

In the first week of November, in the context of political controversies surrounding the Thai adjustment package, the government of Chavalit Yongchaiyudh was replaced by that of Chuan Leekpai. On 18 November, the Korean parliament failed to pass a financial reform bill and on 21 November Korea announced that it was seeking IMF assistance to respond to the crisis. For Korea, the recourse to the IMF was a politically unprecedented event and fraught with political recrimination.

The weakness in the Japanese banking system, originating from its own asset bubble in the 1980s, fed into the avalanche of non-renewal of short-term credits to Korea. Before the crisis, Japanese banks, mutual funds, and insurance companies were heavily invested in Thailand, Korea, and the rest of the region in order to earn higher returns beyond the almost zero interest rates prevailing in Japan. These institutions were still carrying uncollectible debts from the 1980s from Japan's own asset bubble and found themselves obliged to terminate short-term exposures to Korea when confidence in the Korean economy disappeared. On 24 November, the fourth largest Japanese brokerage, Yamaichi securities, became bankrupt. By the time the US$57 Korean IMF package was announced on 4 December, the crisis had been enlarged by actual and potential Japanese bankruptcies and the tumbling of the Japanese yen in sympathy with the Korean won. The IMF package did not stop the non-renewal of Korea's short-term credit lines and in the last week of December a potential default by Korea was only averted by forceful intervention of the U.S. Treasury,

strong-arming banks to continue to roll over Korea's immediate payment obligations.

Indonesia's IMF package also did not halt the non-renewal of short-term and trade credits, which reached critical levels in the first week of January 1998. Indonesia revised its budget programme twice in two weeks in January, announced an almost blanket government guarantee of deposits and external liabilities at the end of January as the rupiah exchange rate tumbled from the level of Rp8,000 to US$1 to Rp16,000. In its headlong search for means to stabilize its currency, the Indonesian Government in early February seriously considered replacing its central bank system with a currency board system, a move generally seen to be a last resort for troubled economies. At time of writing, the international financial institutions have expressed skepticism over the sustainability of installing a currency board system prior to addressing weaknesses in the banking system which had been worsened by the currency crisis and Indonesia's austerity programme.

In the course of the crisis, the ambiguities and perceived ambiguities in political prospects exerted hair-trigger impacts on asset markets in the region. In Indonesia, the crisis occurred in the period leading up to the presidential elections and intensified debates over the process of political succession. The steep currency depreciations and the reform programmes saw steep price increases of basic goods, panic buying, and the disappearance of supply of consumer goods in Korea, Indonesia, and to a more limited extent in Malaysia and Thailand. Governments in the region had to address the heightening of ethnic tensions (especially in the case of Indonesia) just as they either rode on or tried to dampen nationalistic fervour sparked by the crisis.

Global Lessons for Asset Crises

In Asia, it seems that currency crises occur in a cycle of 18–24 months, a pattern established in the 1990s. The world,

not just Asia, must learn to deal with these crises, both in the response mode and in the prevention mode.

The specific features of this type of crisis bear enumerating at this point. First of all, the forces that are driving changes in currency values do not arise out of flow deficits, but are driven largely by asset flows. Unsustainable current account deficits (perhaps driven by government deficits) were the conventional source of currency attacks. In the Asian case, as argued in the analysis in this book, there were no egregious flow deficits, especially in the public finance area. An argument is presented that even the elevated deficits exhibited by Thailand and Malaysia before the crisis might have been sustainable on the basis of long-term considerations. Second, there is a strong linkage in the asset prices across different economies, many of them quite different in terms of their real sectors. The key asset price is therefore currency exchange rates. In this kind of crisis, as was experienced, any possible change in one of the exchange rates, affects the exchange rates of the other economies, seen by asset markets to be linked. This happens even when the original currency attack is due to a political event specific to that country.

1. Response Mode

With regard to the response mode, the first step should be a recognition of the features of the crisis. In a generalized asset crisis, there is an overall loss of confidence in the soundness of domestic banking systems. Particularly in Asia where the real sector and the export sectors were quite robust before the crisis, the crisis can be seen as a genuinely "Keynesian-style" crisis in which developments in asset markets can seriously undermine the performance of output and employment and where adjustment in asset prices (such as the exchange rates of currencies) can be quite extreme and out-of-line with reasonable economic recovery.

Keynes used to characterize such conjunctures as one in

which people "want the moon", that is, wanting to hold on to financial assets and stop investing in production. Market-oriented economists used to deride Keynesian models as ones in which the tail (financial markets) wags the dog (real markets); here is a case in which the tail wags the dog but with an international dimension. It appears that currency values have been brought much lower than would be required to zero out current deficits. In this kind of crisis with an international dimension, as people seek to keep their assets in U.S. dollar denominated assets and their liabilities in the domestic currencies, domestic interest rates have to stay even higher — further weakening the banking sector, from whence the crisis originated.

1.1 Government Actions and Statements to Restore Confidence

As a general loss of confidence on the part of private actors whose actions are co-ordinated only by the panic to rush out of domestic assets as quickly as possible, the statements and actions by governments are critical in responding to the loss of confidence. Governments should enunciate their adjustment programmes clearly and be seen to fulfill their obligations under these programmes.

The role of government in asset crises is created by the features of these crises as explained above. The standard economist's way of justifying these role is that there are market imperfections in these asset markets, based on the presumption that markets in their natural state are perfect. This is an unfortunate formulation: as explained above these markets both in the upturn and the downturn have incentive features and informational peculiarities which can tend to make price changes self-reinforcing. The voice of governments and public authorities will necessarily be discounted in these markets; but sustaining public credibility is as important as public participation in the information process.

It is important to recognize that the experience of the crisis in Asia has also exposed the many indequacies in the information gathering and dissemination industry. Fund managers' and currency traders' days begin with a frantic reading of newspapers and wire service reports. There were countless and commonplace instances of errors in these reports (for example, reporting the total debt of a country to the amount by which its debt increased), of the understandable preference of the media given their space and time constraints for publishing or broadcasting the more sensational and simple-minded soundbites (some from other fund managers themselves, sometimes as anonymous "analysts") and of the ease with which rumours and opinions become news in the crisis landscape. It also became the province of analysts — perhaps more adequately trained in economics than in politics — to make pronouncements on what kind of political, constitutional, and cultural reforms would be appropriate for Thailand or Indonesia, or Asian governments in general. While the publication of these statements proved that business analysts enjoyed freedom of expression in Asia, they tended to emphasize the potential depth of the crisis, ignoring the fact that many of the problems Asia was experiencing in the management of investment had occurred even in industrial economies.

Government efforts to add to this information flow might prove futile, but it is the best that can be done in such a situation. While it is not possible to prevent the emergence of erroneous interpretations, it might at least be possible to prevent these beliefs from hardening.

When Indonesian President Soeharto announced a new budget programme on the evening of 6 January, news reports the following day were dominated by (1) interpretations that the budget represented a defiance of the IMF because its was judged not to be austere at all and (2) that the IMF was cutting off its programme with Indonesia. Both were subsequently proven to be false. It was probably an error to have made such an announcement with potentially strong effects

on the currency on a Tuesday night (the Mexicans made the same mistake in December 1994, announcing the widening of the band on a Tuesday), instead of making such an announcement late in the week so that market participants would have a weekend to mull over its implications. Still, the precipitous plunge of the rupiah began on that Wednesday as the belief hardened that Indonesia would be unable to work with the IMF. This belief eventually became self-fulfilling. Subsequently, by early February, the continuing plunge of the rupiah, despite the on-going IMF programme, made it difficult to operate under the IMF programme.

In the region, it was also a curious phenomenon to find private fund managers, based on their public statements, to be "more Catholic than the Pope" in measuring the magic of IMF programmes based on their "strictness" and their efficacy to depend on religious adherence to their regimen. IMF programmes are designed based on the best information at that point in time in public institutions by public bureaucrats; there is nothing necessarily magic about them or their contents. When they are not followed diligently, it is not necessarily because of the inborn inclination of public authorities to avoid pain (and seek pleasure). In the case of Indonesia, it appears that the massive withdrawal of deposits from the banks that continued to operate after the closure of the first sixteen banks forced the central bank to exceed liquidity ceilings almost from the start of the original programme. The withdrawal of deposits had not been expected, since it had been thought that closing the weak banks would increase confidence in the remaining banks.

1.2 Co-ordinated Currency Intervention

It also seems that exchange rates in emerging economies are more strongly linked than before and, unlike in the past, one does not need a formal exchange rate link (as was the case in the European ERM whose 1992 collapse triggered the first studies of these types of attacks). A devaluation in

one currency can trigger an attack on other related currencies. This means that single-country IMF programmes will be insufficient and will often be overtaken by external events in these kinds of asset crises. Co-ordinated exchange rate intervention or the intention to carry this out on the part of affected central banks appears to be an unavoidable add-on to single-country adjustment programmes.

1.3 A Well Understood Adjustment Package for Banking-Triggered Currency Crises

There should also be some attempt to standardize the elements of a response to this kind of banking-triggered currency crisis, so that when it is put in place, all parties, especially international fund managers can see a path to recovery. The standard IMF package is not oriented to the rehabilitation of the domestic banking system; it is oriented to domestic demand contraction in order to bring imports rapidly into balance with exports. This has proven wanting, not only because the strategy tends to weaken the banking system and reduce their future earnings stream.

The case of Indonesia, which sought IMF protection very early, is instructive. Indonesia had a not-unsound current account deficit of about 4 per cent, so that a required IMF demand contraction package would have been at most modest. The economy would already have been contracting anyway as the banking system buckled under the currency devaluation and investment dried up.

What was really at stake in Indonesia was the ability of domestic banks and corporations to service foreign debt, especially those such as trade credits that could be withdrawn immediately, at the more expensive (to Indonesian parties) exchange rates. The IMF package was meant to install confidence so that these short-term credits would be rolled over. Under current institutional arrangements, the IMF programme is supposed to make private lenders feel secure enough to maintain their credit lines to the country,

even if the programme itself contains only indirect provision for servicing debt falling due in the immediate future. Under current institutional arrangements, if the adjustment package had began instead by recognizing the immediate difficulties of servicing debt falling due immediately, this would be a short-step away from rescheduling debt, in which case all of private voluntary lending to Indonesia would then be tainted as not necessarily collectible. In the end, as the rupiah continued to fall, resort to this final step became unavoidable.

An alternative adjustment package in a banking-triggered currency crisis would immediately recognize this trade credits problem by providing resources *specifically* for this purpose based on best estimates of what would be required. A country's partner trading nations could be active in this regard. This explicit recognition provides an adjustment map not present in current programmes. These packages would also recognize more explicitly the need to halt further currency depreciation (which weakens banks) and be cautious about demand contraction and growth slow-down (which further weakens banks).

2. Prevention Mode

The increasing cost of the bailout package underlines the importance of prevention. The Mexican rescue package at US$48 billion was unprecedented for its size in 1995. In less than six months, the bailout packages of US$17 (Thailand), US$57 billion (Korea) and US$43 billion (Indonesia) have been committed.

2.1 Managing Financial Liberalization Processes More Prudently

At the level of the individual country, the better management of the process of liberalizing in financial and capital markets are old insights from the collapses in the Southern cone of Latin America and the Scandanavian countries but were still unlearned when it became Asia's turn. Stronger

supervision of banks and strengthening the capacity of public authorities to supervise banks as they diversify into new areas have been called for. Given that the ability to monitor bank operations especially as they relate to international transactions or to the creation of new financial instruments such as derivatives is more limited in developing countries, imposing higher capital adequacy and liquidity ratios should not necessarily be interpreted as attempts by public authorities to undermine the liberalization process; these regulations also force private lenders to internalize the risks of their actions. The same should apply to the imposition or re-imposition of bank reserve requirements; even though they increase financial repression, reserve requirements help authorities manage the liquidity creation of external capital inflows (Montes 1997).

Understanding the political economy of these liberalization processes is equally important as understanding their economics. It is effortless in hindsight to lay the blame for the failed liberalization programme on poor prudential supervision; the tensions inherent in the liberalization process makes this *post-hoc* advice seem naive. Blame for poor supervision has also recently been heaped on "Asian values". However, these kinds of problems have arisen in all the banking failures that have followed liberalization. To say, for example that these kinds of weaknesses are specifically Asian in character, is tantamount to blaming the savings-and-loan association disaster in the United States in the 1980s to a surfeit of Asian values in the United States.

To illustrate the political economy complications, we use an Asian example only because it is recent and, perhaps, a bit more pungent. With precedents stretching back to the previous century, Thailand had established a tradition in conservative macroeconomic management and the independence of the monetary authorities from political pressures. When financial liberalization accelerated, professionals from the public sector joined the growing banking sector at generous salaries. So, just at the moment that the Thai public

sector required more capacity to oversee a burgeoning and more sophisticated banking sector, it was losing personnel in the process. Well-known Thai technocrats also joined the boards of many of the prominent private finance companies. Moreover, as in Mexico before its 1994 crisis, the overall stance of the government was to encourage rapid diversification and growth in the financial sector. This made strict supervision unfashionable, if not awkward, even though there are reports of debates among Thai monetary authorities over how to respond to overaggressive lending (of some of their former colleagues) in the private sector. Information required by public authorities to monitor and supervise the private sector was thus becoming unreliable and politicized as the liberalization process proceeded and the ability to maintain the conservative macroeconomic stance and prudential regulations of financial institutions was being undermined.

2.2 Improving Information and Transparency

Many calls have also been made to increase the transparency and disclosure requirements in domestic Asian capital markets. As part of their liberalization process, Asian countries had been modernizing these disclosure requirements. During the period of "euphoria", these inadequacies did not prevent foreign investors from rushing in and particularly favouring investments in the companies of those known to be politically well-connected. (The same thing is happening in Russia and some other European transition economies, so this is not an Asian phenomenon.) As a means of appeasing the currency markets, the process of improving transparency is accelerating in Asia and will elicit much international support especially from the United States.

Bankruptcy procedures also have to be upgraded, if not put in place where these do not exist, as countries place greater reliance on credit and financial intermediation in their development effort. In the meantime, governments

in the industrial economies should mount information campaigns to inform their citizens and fund managers that they should understand the all-or-nothing risks they take when they invest in countries where these bankruptcy procedures are underdeveloped. Where they have the means to impose higher reserve requirements on these investments, they should do so. Authorities should also inform their public that both on the basis of political trends and on grounds of principle, it will be more difficult for public authorities, be they in developing or in industrial economies, to bail them out in the future should their investments fail.

2.3 Reducing International Moral Hazard Incentives

The Mexican, Thai, Korean, and Indonesian rescue packages have once again raised moral hazard issues, just as in the debt rescheduling packages in the 1980s. At issue is the extent to which the government will provide after-the-fact guarantees on or accept responsibility for servicing debt undertaken between private parties across international borders. Inserting public responsibility into these transactions encourages excessive private risk-taking in short-term lending. The debt negotiations in the Thai and Korean cases saw explicit attempts by public authorities to force private parties to accept losses on their exposures; but it is not clear if they succeeded. These efforts should be intensified in the future and co-ordinated among the concerned governments. Taxes on external borrowings and the proposal to create an international guarantee corporation (see below) can also force private parties to internalize some of the risks they are presently ignoring.

2.4 More Flexible Exchange Rate Regimes

More sophisticated management of exchange rates, permitting more exchange rate flexibility has become critical.

In the Asian case, a completely flexible exchange rate in the face of the fierce interest of foreign investors to purchase domestic financial assets in the period of "euphoria" would have required sharp appreciations in the Asian currencies but prevented the enormous injections of foreign funds in the domestic banking system which were poorly invested. Chile has enjoyed some success in unpredictably permitting sharp currency appreciations to ease pressure from incoming investments then depreciating gradually to protect the competitiveness of exports (Agosin and Ffrench-Davis 1995).

2.5 Insulating Domestic Financial Systems from Short-Term Capital Flows

Various means to insulate the development of the domestic banking system from dependence on short-term external funds seems to be called for (Kaminsky and Reinhart 1996); because of the large scope for regulatory evasion, a combination of capital controls, regulatory practice, and taxes appear to be promising (Griffith-Jones, Montes and Nasution 1997). Taxes on incoming short-term investments, such as that imposed by Chile, can also reduce over-reliance on short-term funds and force borrowers and lenders to internalize the cost of the increasing possibility of currency crises as the scale of short-term investment in an economy increases.

2.6 Taxing and Regulating Short-Term Capital Flows

In the international sphere, academic discussions on the "Tobin tax" which is like the Chilean tax on short-term investments but implemented on a world-wide basis to slow-down the flow of capital movements intensified after the 1992 ERM crisis. However, interest on the part of policy-makers over a proposed international regime that requires co-ordination among all the major countries has been tepid.

The 1997 Denver G7 summit did recognize the importance of searching for ways to monitor international capital flows.

George Soros, who clearly had the pivotal role to play in the 1992 ERM crisis and who had been accused of being instrumental in the Asian crisis, has himself warned that with the Asian crisis the "international financial system appears to be suffering a systemic breakdown" (Soros 1997) and suggested creating an international regime to counter the over-investment followed by over-withdrawal syndrome as seen in Asia. This would consist of an "International Credit Insurance Corporation" that would guarantee international loans for each country for a modest fee. The amount of loans the authority would guarantee for each country would be based on its judgement on the ability of countries to service the debt.

Proposals for taxes on short-term flows and Soros' proposal for an international regime would regulate international lending. Domestic financial institutions, especially in the industrial economies, are regulated in their local operations but are quite unregulated in their international lending activities. The imposition of taxes or fees for the guarantee of loans is a first step in regulating these activities.

2.7 Improving International Co-ordination and Mutual Surveillance

International regimes ready to implement the crisis response suggestions that I have proposed above also have to be created. In particular, these are the design of standard adjustment packages for economic crises emanating from banking crises and co-ordinated currency intervention. "Mutual surveillance" at the regional level among economies with linked exchange rates (which had been called for in the Manila Declaration of 18–19 November 1997) and increasing and regular consultation among central banks are a precondition for future co-operation in currency intervention.

2.8 Asia's Role

Asia is the latest victim of the kind of volatility, both in the inflow and the outflow phase, in short-term investment flows. Its experience and its situation makes it well-placed to participate actively in efforts to improve international capital arrangements. The aftermath of the crisis will see Asia's real economies damaged, but not devastated. As shown in the main text of this book, Asia's high savings rates and robust fiscal finances make it less dependent on short-term international investment funds both to close current deficits and to finance its development ambitions. Short-term international investments funds are more appropriately applied to closing the fiscal and trade deficits in the high wire developing and transition economies. Asia does not really need to compete internationally for these funds to close deficits; it can afford to accept these funds on its own terms. Asian economies basically require adequate hedging facilities to provide some predictability on the exchange rates for the goods that they trade internationally. Asia's own private financial and banking companies — beneficiaries of high domestic savings rates — are only beginning to internationalize and do not have vested interests in sustaining unstable international capital movement rules that could ultimately put Asia's own savings at risk. Asia therefore has adequate capability and a clear interest in reforming international financial arrangements.

Reform, of course, begins at home, with more prudent approaches to liberalization. Still, it remains to be seen whether the governments and the private sectors in Asia will seize the opportunity to decisively influence international reform efforts.

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INTRODUCTION

On 2 July 1997, Thai monetary authorities announced they were weakening the baht peg to the US dollar. This announcement was tantamount to a devaluation of the baht since the dollar had been steadily gaining in value against major currencies since mid-1996. Two months earlier, in May 1997, there had been a successful defence of the baht, supported by other central banks in the region. But with foreign exchange losses that have been estimated to be as high as US$15 billion (*Wall Street Journal*, 27 August 1997), an adjustment of the international value of the baht became unavoidable. On that day, the baht immediately lost about 16 per cent of its value, lost another 11 per cent in the next four weeks and a similar amount the following four weeks, losing a total of about a third of its 2 July value. The Bangkok stock market index lost 30 per cent of its value in the same period.

The Malaysian ringgit, the Philippine peso, the Indonesian rupiah came under a similar attack, as non-resident portfolios retreated from their investments in the region in a rout — or perhaps in recrimination — from economies that seemed to be like that of Thailand. Depending on the day one is doing the calculation, the peso and the ringgit have lost about 25 per cent of their end-of-June value. The rupiah has now lost about 40 per cent of its 2 July exchange value. Even the Singapore dollar has lost about 6 per cent of its starting value.

Touted since the mid-1980s as development paragons, the Southeast Asian economies were now being treated as extremely unreliable locations for investment, and questions about the sustainability of the high growth of economic development of these countries have surfaced. Have the rapid rates of growth in the late 1980s and early 1990s mortgaged the economic futures of the ASEAN countries? Has the "Asian miracle" ended in Southeast Asia? The answer to the last question would appear to be "No". This book argues this position by presenting an analysis of the apparent causes of the crisis and placing these causes in the context of the medium-term situation of the affected economies.

1
ONSET OF THE CRISIS
Background Factors

There are at least four competing explanations for the onset of the crisis:

1. With the entry of China, India, and other low cost producers into international export markets, the Southeast Asian economies had lost their competitive advantage, which could only be restored with drastic adjustments in their exchange rates.
2. With about a half-decade of significant current account deficits behind them, there was a common macroeconomic weakness in all the economies which only a drastic devaluation and public sector expenditure cutbacks could have resolved.
3. Despite the large current account deficits, the macro-economic situation of the countries, was basically sound. However, the locus of the crisis came from the banking sector because of undisciplined expansion and diversification in the domestic financial markets, financed by short-term private borrowing.
4. The economic situation in each of the countries is acutely different, in terms of either their international competitiveness, their macroeconomic situation, or the state of their financial sector. The shared currency crisis is only a reflection of the contagion effect.

These four possibilities are stated in stark, mutually exclusive, terms. A combination of these factors is undoubtedly

more accurate, though it is important to identify the key factors and prioritize these explanations in order to recognize how they are related to each other. It is also important to identify which of these explanations apply to which country and to what extent. The view that is developed in this book is that the third explanation applies particularly strongly to the Thai case, though it applies to a weaker extent to Indonesia, Malaysia, and the Philippines, in order of decreasing relevance. The macroeconomic weaknesses in these economies obtain less from the size of the current account deficits, but, as in a classic credit crisis, from an over-extended mismatch in the maturity and currency unit between sources and uses of credit. That the explanation does not apply in equal measure to the other economies identifies the extent to which the contagion effect has been operative.

Here, one would like to dispose of the first explanation. The year 1996 was one of economic slow-down for the Southeast Asian economies, primarily because of an export slump. There was a world-wide slump in the electronics industry which hurt Southeast Asian economies, but these are markets in which new entrants in international export markets — China and India — are not yet significant players. The growth rate of Singapore's exports which reached 25 and 22 per cent in 1994 and 1995, fell to 7 per cent in 1996. Malaysian exports grew by 23 and 26 per cent in 1994 and 1995, and grew only by 4 per cent in 1996. Thailand felt some competition for its labour-intensive exports and together with the electronics slump this translated into a zero export growth rate in 1996. In 1994 and 1995, Thai merchandise exports grew at rates of 22 and 25 per cent. Explaining the crisis in terms of loss of export competitiveness, therefore, places too great an emphasis on competing export products and misinterprets the time frame considerations of such an explanation.

Southeast Asia's export boom emerged from the boom in relocation of production facilities from Japan and the Asian

NIEs (newly industrializing economies, viz. Korea and Taiwan) from 1988. It caused elevated export and overall economic growth rates in the early 1990s, but had always been an impact that was expected to subside. The Philippines did not participate significantly in these relocations until after 1993 and was therefore behind in the phase, but has been affected by the crisis anyway. In the cases of Malaysia and Singapore, moving up the technological ladder, supported — among other policies — by a planned gentle appreciation of the currency, has been a key development policy.

In the period when heavy capital inflows threatened to cause currency appreciation, the macroeconomic stance of the Southeast Asian economies that relied more heavily on labour-intensive exports (Thailand, Philippines, Indonesia) had been to keep real exchange rates from appreciating to maintain export competitiveness. For the most part they have succeeded, even though this policy caused other policy contortions, such as widening interest rate differentials, that provided fuel to the subsequent economic crisis. In the medium term, it is important for these economies to upgrade their education and technology but the recent currency devaluations have ironically made them more competitive both in exporting labour-intensive products and attracting further production relocation of such goods from the industrial economies.

It is useful at this point to review the recent macroeconomic performance of the five Southeast Asian countries (Indonesia, Malaysia, Philippines, Singapore, and Thailand) involved in the currency crisis. Table 1 provides the basic data. The data suggests that where there are commonalities, these point in the direction of strong fundamentals on the part of the economies evolved. The differences on the other hand raise questions about how sensitive the currency knockdowns (and the associated disinvestment from these economies) are to economic fundamentals.

Panel A indicates a three-tier development configuration among the Southeast Asian economies, with Singapore

TABLE 1

Key Macroeconomic Data of Currency Crisis Participants, 1991–96

Panel A: Per Capita Income and Recent GDP Growth Rates

	1995 Per Capita Income (US $)	*GDP Growth Rates (% per year)*					
		1991	*1992*	*1993*	*1994*	*1995*	*1996*
Indonesia	980	7.6	7.0	4.1	4.0	7.6	6.0
Malaysia	3,890	8.7	8.0	9.0	9.1	10.1	8.8
Philippines	1,050	-0.6	0.3	2.1	4.4	4.4	5.5
Singapore	26,730	7.3	6.2	10.4	10.5	8.8	7.0
Thailand	2,740	8.5	8.1	8.3	8.9	8.7	6.7

Panel B: Gross National Saving Rates (as % of GNP)

	1991	*1992*	*1993*	*1994*	*1995*	*1996*
Indonesia	30.4	32.3	32.8	31.9	31.4	33.7
Malaysia	29.9	34.1	35.3	35.5	36.4	38.8
Philippines	18.2	19.4	18.1	19.0	19.0	20.5
Singapore	45.8	46.5	45.9	49.2	49.9	49.7
Thailand	35.4	34.5	34.2	35.2	35.0	35.3

Panel C: Change in Consumer Prices (% per year)

	1991	*1992*	*1993*	*1994*	*1995*	*1996*
Indonesia	9.4	7.6	9.6	8.5	9.4	7.9
Malaysia	4.4	4.7	3.6	3.7	3.4	3.5
Philippines	18.7	8.9	7.6	9.0	8.1	8.4
Singapore	3.4	2.3	2.3	3.1	1.7	1.4
Thailand	5.7	4.1	3.4	5.1	5.8	5.9

Panel D: Current Account Balances (as % of GNP)

	1991	*1992*	*1993*	*1994*	*1995*	*1996*
Indonesia	-3.5	-2.1	-1.4	-1.6	-3.6	-4.1
Malaysia	-9.2	-3.9	-4.6	-6.0	-9.0	-6.3
Philippines	-2.2	-1.8	-5.5	-4.5	-3.3	-4.1
Singapore	11.1	11.1	7.3	15.9	17.6	15.3
Thailand	-7.8	-5.8	-5.2	-5.8	-8.3	-8.1

Panel E: Central Government Budget Surpluses (as % of GNP)

	1991	*1992*	*1993*	*1994*	*1995*	*1996*
Indonesia	-0.7	-0.4	-0.4	0.2	-0.2	
Malaysia	-2.0	-0.8	0.2	2.3	0.9	0.6
Philippines	-2.1	-1.2	-1.5	1.0	0.6	0.3
Singapore	4.7	5.4	4.6	3.4	7.4	5.4
Thailand	4.3	2.6	1.9	2.7	3.0	0.9

SOURCE: ADB (1997).

having a per capita income of a fully industrialized economy, Malaysia and Thailand making up the second tier, and the Philippines and Indonesia making up the third tier. Economic growth rates had been elevated in the 1990s for these economies as a result of export growth, except for the Philippines, whose growth recovery only began after 1994. The Philippines has been equally affected by the portfolio disinvestment during the crisis.

Panel B shows the elevated rates of national savings for the economies involved. For Malaysia and Singapore, government-operated mandatory savings programmes underlie the high rates. But even for Thailand and Indonesia, reported savings rates have been above 30 per cent of GNP in recent years. Panel C suggests that rates of inflation have been moderate, most particularly for Thailand, Malaysia and Singapore.

Panel D indicates that Singapore has been running positive and large current account surpluses, Indonesia and the Philippines current account deficits in the order of 4 per cent, while Thailand and Malaysia's current account deficits have been in the order of 6 to 8 per cent. (Key differences in the Thai and Malaysian balance of payments will be discussed later.) Panel E records the relatively healthy public finances of the economies involved. Both in terms of savings rates and public finances, it is probably no exaggeration to state that these economies are the healthiest economies into which the surges of "emerging country" portfolio investments have been inflicted.

2
THE THAI FINANCIAL CRISIS

The Thai baht crisis is the latest in a series of such crises in which a currency attack follows on (or is justified by) an unhealthy domestic banking system, following an episode, of say 3 to 5 years, of vigorous external capital inflows. The currency attack by itself further weakens the domestic banking system (by multiplying the number of unviable projects which had been based on the original exchange rate) and magnifies the financial crisis.

Understanding these crises is important because their social costs are not insignificant. These types of crises have always tended to be resolved by using taxpayer resources and through higher unemployment and lower growth so that the costs have been borne mostly by the those whose incomes are not based on asset holding. Table 2 suggests that these costs as a proportion of GDP have been as low as 8 per cent and as high as half of GDP. In the case of Thailand, estimates of the extent of non-performing loans have been as high as $40 billion, which is equivalent to about 15 per cent of Thai GDP.

Recently, there have been similar crises in Latvia and Estonia, and in the Czech Republic. Kaminsky and Reinhart (1996) examine 71 balance-of-payments crises and 25 banking crises during the period 1970–95. While there were only 3 banking crises associated with the 25 balance-of-payments crises during 1970–79, 22 banking crises coincided with 46 payments crises over 1980–95. In their view, financial

TABLE 2
Costs of Some Systemic Banking Crises with Heavy Capital Inflows

Country	*Scope of crisis*	*Cost of rescuing banks (% of GDP)*
Argentina 1980–82	16% of assets of commercial banks; 35% of total assets of finance companies	55.3
Chile 1981–83	45% of total assets	41.2
Israel 1977–83	Entire banking sector	30.0
Finland 1991–93	Savings banks affected	8.2
Mexico 1995–?	Commercial banks past due to gross loan ratio reaches 9.3% in February 1995	12–15

SOURCE: Taken from Reisen (1997), Table 7.

liberalization (which occurred mostly in the 1980s) appears to play a significant role in explaining the probability of a banking crisis preceded by a private lending boom. In turn, a banking crisis helps to predict a currency crisis.

Since the Mexico crisis of 1994, as a result of the rapid internationalization of investment funds (pension funds, mutual funds, country funds), this type of crisis has tended to have multi-country effects. The Thai crisis comes three years after the Mexican crisis, and shares many of the features of that crisis but differs in a few fundamental ways.

The Southeast Asian currency crisis follows in the wake of the twin liberalizations: the liberalization of the domestic financial system and the opening of the capital account. In the case of Thailand, these liberalization efforts began in 1990. Among the key elements of the Thai effort were: (1) three rounds of foreign exchange decontrol, (3) removal of all interest rate restrictions in June 1992, (3) encouragement of non-banking capital markets such as the bond, equity and derivative markets, and (4) the move to the capital adequacy standard as the principal means of bank supervision.

The foreign exchange decontrols effectively eased restrictions on outflows, since there were no controls on capital inflows. With the encouragement of non-banking sources of capital funding, Thai companies engaged in numerous bond and equity flotations, including a few internationally, and became less dependent on banks to raise their resources. Because of years of fiscal surpluses due to the historical conservatism of Thai fiscal finances, a market for local bonds had never developed. Beginning in August 1995, the Bank of Thailand began issuing one to 6-month bonds to help create an ongoing, liquid market for bonds; the rates on these bonds could also provide a benchmark for the domestic interest rates. The shift to the capital adequacy approach to bank supervision improved the independence of domestic banks to determine their lending activities, as long as they met the adequacy standard which was initially set at 7 per

cent (a bit lower than the 8 per cent suggested under the Bank for International Settlements guidelines).

For the purpose of understanding the role of the liberalization efforts on the subsequent crisis, it is useful to isolate the kind of behaviour these policies induced in the financial system. The key elements are as follows:

1. Financial liberalization permitted domestic financial units to offer any interest rate they deemed fit in order to obtain funds; this, in conjunction with the opening of the capital account, provided domestic financial intermediaries the means to be competitive in bidding for foreign funds.
2. Financial liberalization reduced the dependence of domestic financial units on lending to the government. This created a large new scope for the utilization of loanable funds but it also required banks and domestic financial companies to rapidly establish the capability to evaluate projects and judge credit-worthiness. This capacity had never been as important previously when the clients were the governments, state-related companies, and blue-chip private companies. A financial company could grow swiftly by undertaking more risk and lending aggressively.
3. Financial liberalization reduced the pervasiveness of credit ceilings and credit allocation rules. Public authorities had launched the liberalization programme with the objective of enlarging and diversifying financial intermediation in the economy (as measured by, say, the M3/GDP ratio). The removal of credit allocation rules stimulated bank and finance companies to seek out projects to finance. Consumer lending (Mexico before 1994), and property development (Thailand before 1997) provided the most rapidly developing segments of the market.
4. Financial liberalization inaugurated an arena of intense competition in the domestic financial system in which the eventual financial dominance depended on the outcome of a "race to the swift" in expanding their lending

portfolios, generating off-balance sheet transactions (less subject to prudential supervision), the creation of quasi-banking operations.

The other liberalization effort consisted of opening the capital account. Because most developing countries (not Korea) have historically taken the stance of encouraging the inflow of foreign investment, these economies are effectively open on incoming capital. This implies that opening the capital account effectively consisted of

1. providing guarantees to non-residents that they can withdraw their investment from a country effortlessly, and
2. given that a significant proportion of non-residents could actually be nationals of the country (significant for places such as Mexico and Hong Kong, for example) effectively easing outward foreign investment restrictions on and limitations on foreign asset holdings of nationals.

Historically, developing countries, including those in Southeast Asia, have taken the stance of encouraging or even subsidizing inflows. If opening the capital account effectively meant as has been defined above, an immediate dilemma is created since subsidizing inflows while removing controls on capital inflows effectively subsidizes net outflows, a self-defeating stance for a capital-needy economy to take. It is important to dismantle these subsidies in opening the capital account (Williamson 1993), but because many of these implicit subsidies were provided through a myriad of investment incentives programmes it is difficult to completely remove them.

Moreover, the nature of the process discouraged a fundamental change in stance against encouraging inflows. First of all, the liberalizing country was still capital short and the inflows provided additional financing. But most important of all, the availability of external funds in the process of liberalization also meant that the question of distribution between gainers and losers in the liberalization

process could be avoided. New entrants could compete with old established banking institutions based on their wits and tolerance for risk (as long as government regulators did not get in the way).

Given that international interest rates are on the whole lower than domestic interest rates in developing countries, opening the capital account provided the domestic financial system access to lower cost funds, with which to fuel intermediation growth and domestic rivalry between financial groups. It permitted the rapid flourishing of offshore banking operations[1] as the convenient conduit for private domestic borrowing from private external sources. Opening the capital account in the manner I have defined it also provides foreign fund managers access to domestic stock and bond markets. In this way, an economy's short-term and liquid liabilities are generalized way beyond the trade credits (deposits) that used to comprise short maturity exposures in times past; if these liabilities have to be called in a crisis, the country would have to call on its international reserves. Before the Mexican crisis in 1995, it was estimated that these short-term foreign currency denominated liabilities exceeded its reserves by five times (Calvo and Mendoza 1996).

Based on the statistics normally used to analyse the success of liberalization programmes, the Thai financial and capital account liberalization process proceeded extremely well. For the mainline deposit money banks, lending to the government declined from 2.6 per cent of GDP in 1990 to 0.6 per cent in 1995, while lending to government enterprises declined, from 5.1 per cent to 2.6 per cent of GDP. However, lending to the private sector increased dramatically from 64.3 per cent of GDP in 1990 to 99.8 per cent by 1995. The affliction of financial repression had seemed to have been banished from the Thai economy at minimal political cost. It also appears that the process of financial intermediation had taken off. For the whole financial industry, lending to the private sector dramatically increased

from 71.9 per cent of GDP in 1990 to 142 per cent in 1995, a signal success.

Underneath the lending boom were dramatic increases in property lending, nourished by rising property prices and prices on the stock exchange. Property companies would be able to borrow money from the banks to start up their projects. These projects would either be sold to prospective buyers or the project would be floated in an initial public offering (IPO). Rising asset prices permitted banks and original investors to recover their exposure quickly, often with handsome capital gains.

To a quantitatively smaller extent, property lending booms occurred in Singapore, Malaysia, Indonesia and the Philippines, all of which had been deregulating their financial markets at different speeds and from different starting points. With its already highly developed financial and real property markets, the boom was particularly strong in Singapore. In 1996, Singapore imposed heavy charges on property resales within 3 years of purchase.

Later in the same year, Indonesia and the Philippines imposed limits on bank exposure to property lending. This latter approach collides with the objective of financial liberalization to remove all credit allocation restrictions in order to permit the private sector to determine which projects should be pursued. In the case of Malaysia, informal estimates suggest that about one-fourth of the financial system's outstanding loans are in real estate. However, the asset price boom has not been as steep as in Thailand. Moreover, Malaysia, as the Philippines and of course Singapore, has exercised a rather effective and active prudential supervision over the financial system. The capital adequacy ratio of Malaysia's banks stood at over 10 per cent before the crisis, more than the 8 per cent Bank for International Settlements benchmark. In the case of the Philippines and Malaysia, the expansion in the size of the financial system before the currency has been distinctly modest when compared with Thailand. The Philippines had already

experienced two such booms, one in the late 1960s and another after the mid-1970s. Remaining banking participants tend to be more conservative and entry to the financial system remains tightly controlled. The same is the case for Malaysia.

Over-expansion in the property sector and supervisory weaknesses can be a problem for Indonesia, which had started its deregulation process in 1988 and had already experienced some bank failures before the currency crisis. For Indonesia, in particular, it is important to address the problem of non-performing loans since recent estimates of this figure of about 9 per cent of portfolios approach the 10 per cent that is presumed to prevail in Thailand (these numbers are rough estimates). In April 1997, Indonesia had already raised bank reserve requirements, another measure that would have to be interpreted as in conflict with the financial liberalization effort. The Indonesian central bank has now asked the existing banks to increase their capital adequacy ratios to 9 per cent immediately, leading banks to call in loans immediately due. In early October 1997, Indonesia approached the International Monetary Fund for a programme, originally estimated at US$12 billion but eventually reaching US$23 billion as the currency attacks persisted, to backstop this effort.

KPA Konsorsium Pembaruan Agraria

3
THE CRISIS DEEPENS
The Lawson Doctrine and Other Theories

As in other episodes, the Thai financial meltdown came from a credit boom that had been permitted to get out of hand. The hesitation of Thai authorities to prick the boom can be traced to two attitudes which proved to be self-defeating: the belief that it would be inappropriate for public authorities to worry about current account deficits which are purely private-sector driven, and the stance that imposing a heavier regulatory hand within a programme of financial development would unnecessarily stifle the financial sector development programme.

In the case of the first, the Thai stance has precedents, notably in what one might call the "Lawson doctrine" named for UK Chancellor of the Exchequer Nigel Lawson who proclaimed in September 1988 (before the UK's output crisis of 1989) that "we are prisoners of the past, when UK current account deficits were almost invariably associated with large budget deficits, poor economic performance, low reserves and exiguous net overseas assets. The present position could not be more different ..." In more formal economic terms, Corden (1994), quoted by Begg and Griffith-Jones (1997), expresses the "what-me-worry" attitude towards privately[2] determined current account deficits:

> The current account is the net result of savings and investment, private and public. Decentralized optimal decisions on private saving and investment will lead to a net balance — the current account — which will also be

> optimal. There is no reason to presume that governments or outside observers know better how much private agents should invest and save than these agents themselves, unless there are government-imposed distortions. It follows that an increase in a current account deficit that results from a shift in private sector behaviour should not be a matter of concern at all. On the other hand, the public budget balance is a matter of public policy concern and the focus should be on this.

In fact, the same kind of formulation might have explained the central bank stance in Mexico before its 1994 crisis as Reisen (1997, p. 1) relates:

> In January 1994, the Governor of the Banco de Mexico told *The Economist* that the current account deficit was not a problem because it was associated with the inflow of foreign funds, rather than expansionary fiscal or monetary policy. A year later, foreign and domestic investors forced Mexico to reduce the deficit on her current account from almost 8 per cent of GDP in 1994 to about zero.

Just as in the 1981 Chilean crisis, insufficient attention was paid to the mounting dire consequences of the lending boom by all parties (domestic public authorities, international financial institution staff and international investors). In the end, as in other episodes, public funds and taxpayer resources would be called upon to resolve the crisis.

In the Thai case (as in the Mexico case before that), when capital surges into Thailand began, the current account deficit was decidedly due to the excess of private investment spending over private savings. The public sector savings rate has been consistently positive during this period, and *quite high for a developing country*. Chart 1 shows the current account (which is the sum, *ex post*, of the public and private savings-investment deficit) and the public and private savings deficit.

In fact, the volume of capital inflows into Thailand and other Southeast Asian countries has been enormous (and

CHART 1

Thailand: Current Account, Public and Private S-I Deficits

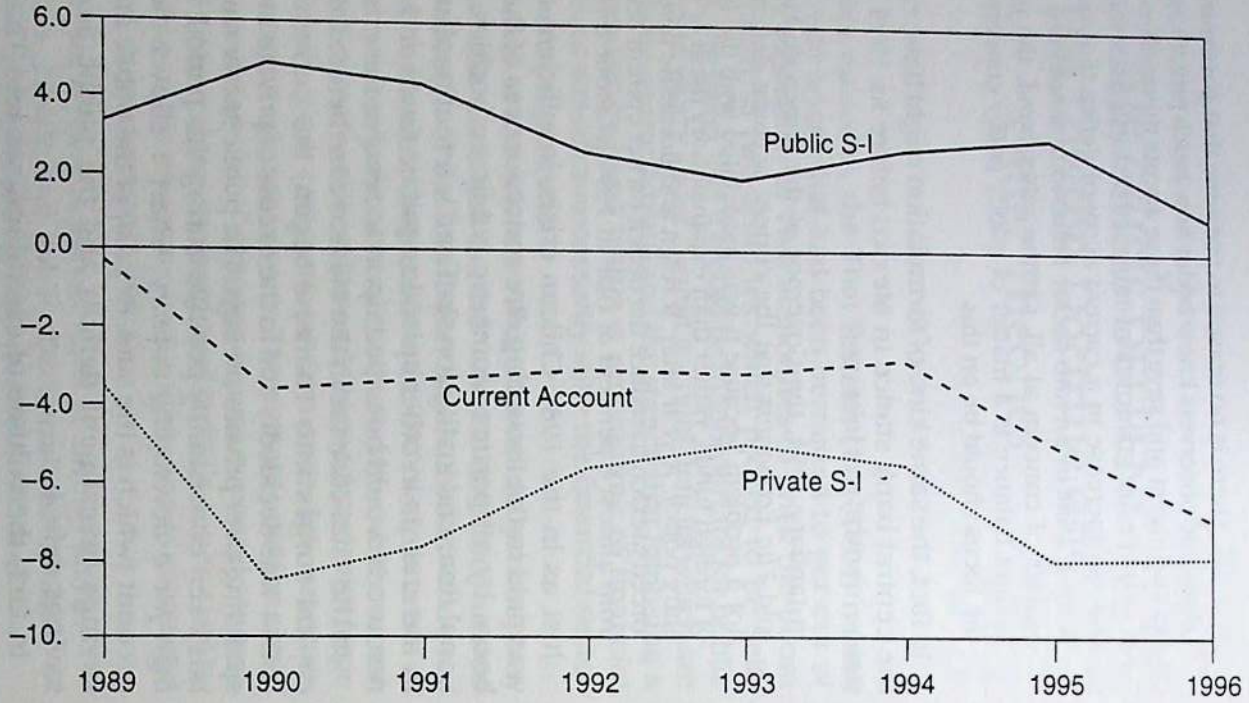


TABLE 3
Key Macroeconomic Variables, Thailand 1989–96
(In percentages)

	1989	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*
Growth Rate of Real Gross Domestic Product	12.2	11.6	8.5	8.1	8.3	8.9	8.7	6.7
In Percent of GDP								
Consumption Expenditure	65.0	65.8	64.8	64.8	64.4	64.0	63.3	63.7
Private	55.5	56.4	55.5	54.9	54.5	54.2	53.8	54.1
Government	9.5	9.4	9.2	9.9	9.9	9.8	9.5	9.6
Gross Fixed Capital Formation	34.6	40.3	41.6	39.4	39.4	39.9	41.8	40.8
Private Business	29.6	34.2	34.4	31.2	31.6	31.2	32.6	31.1
Public Sector	5.0	6.1	7.2	8.1	7.9	8.7	9.2	9.7
Change in Stocks	0.4	1.0	1.1	0.6	0.5	0.5	0.5	0.2
Exports of Goods and Services	34.9	34.1	35.3	36.5	37.7	38.7	41.7	38.6

Balance of Payments								
Current Account	-3.5	-8.5	-7.7	-5.7	-5.1	-5.6	-8.0	-7.9
Capital & Financial Acc	7.8	11.3	11.5	8.5	8.4	8.4	13.0	10.5
Net Direct Foreign Investment (DFI)	2.5	2.8	1.9	1.8	1.3	0.6	0.7	0.8
Portfolio Investment	2.1	0.0	0.0	0.8	4.3	1.7	2.4	1.9
Other Investment	3.3	8.6	9.6	5.9	2.8	6.1	9.9	7.9
Error and Omissions	1.2	1.6	0.4	-0.1	-0.2	0.1	-0.7	-1.4
Overall Balance	5.5	4.4	4.2	2.7	3.1	2.9	4.3	1.2
Implicit total net capital Inflow	9.0	13.0	11.9	8.4	8.2	8.5	12.3	9.1
Net capital inflow excluding DFI	6.5	10.1	10.0	6.6	6.9	7.9	11.6	8.3
Investment and Savings								
Gross Domestic Investment	35.1	41.3	42.7	40.0	39.9	40.4	42.3	41.0
Gross National Savings	34.1	33.2	34.0	33.9	34.2	34.8	34.8	34.1
Gross Domestic Savings	30.6	24.7	25.7	28.2	29.2	29.2	26.8	26.1
Foreign Savings	3.5	8.5	8.3	5.6	5.0	5.6	8.0	7.9

SOURCE: Basic data is from the CEIC Data Base.

this relates to the subsequent discussion between so-called "fundamentals" and "superficials"). In the case of Thailand, Table 3 estimates this to have been consistently over 8 per cent of GDP since 1993, peaking at 12.3 per cent in 1995, just before the Asian export slump of 1996. There is a sharp fall off in net capital inflows in 1992, when a coup occurred in Thailand. Table 3 also suggests that the net capital inflow into Thailand depended quite heavily on portfolio and equity flows, as opposed to direct foreign investment. In 1995, for example, out of the 12.3 per cent of net capital inflow, 11.6 per cent was not directly related to direct foreign investment.[3] In the Thai case, the item "other investment" which would be a mix of trade credits, deposits, and other inflows under offshore operations was especially large, especially in the period of the financial liberalization programme.

With regard to macroeconomic management, between 1990 and 1995, one might almost describe the Thai public authorities effort as one of a gallant rearguard action in the face of enormous offers of portfolio financing seeking to participate in Thailand's development prospects. One might have thought that with such a volume of inflow, the real exchange rate would have appreciated significantly, further weakening the export sector. Thailand has managed to maintain a baht real exchange rate remarkably close to its 1990 level (Bond 1997, p. 8). Thai inflation rates have also been low during the period. While central bank operations everywhere can only be observed indirectly, this achievement entailed enormous leaning against wind. First, as already shown above, the public sector generated surpluses to offset the demand effects of the capital inflow. Second, there would have been substantial sterilization operations at significant costs in terms of quasi-public deficits. Thailand engaged in periodic and significant sterilization operations in defence of its real exchange rate, that is, against its appreciation. Suggestions that the baht should have been depreciated

earlier would have required accepting higher public deficits from an even greater measure of sterilization.

Sterilization, of course, exerts upward pressure on domestic interest rates, widening the differential between domestic and foreign interest rates and provoking further inflows. As a result of the exchange peg and the sterilization operations, Thai differentials increased, especially when international interest rates began to fall after 1992. Bond (1997) estimates that the increased differentials explains 26.5 per cent of the Thai reserve accumulation over the period 1988–95.

Public authorities in the region might have chosen, instead, to permit their currencies to appreciate during the capital surge period of the 1990s. One way to have done this is to inaugurate fully flexible exchange rates. Appreciation would have kept interest rates constant and confined interest differentials to narrow ranges and would have limited, if not completely eliminated, the fund injections into the domestic banking which fuelled the lending booms. There would have been no need to sterilize and accumulate reserves. However, the passions and pressures in export-oriented Southeast Asia are quite different from those in other climes, where currency appreciations and lower-cost imports tend to be appreciated by the public and the business sector. Even in the Philippines, the straggler in the region into the export-oriented game, the export sectors screamed when the peso tended to appreciate as a result of "hot money" inflows. Some currency appreciation would have been justified to the extent that the flows are judged to be permanent; some currency appreciation reduces the opportunity costs inherent in higher domestic interest rates and in reserve accumulation. In the region, Singapore and Malaysia had been undertaking controlled appreciation — but have not escaped the rigours of the currency market during the crisis. Fully market-determined exchange rates in the era of capital inflows would have been equivalent to abandoning the region's export-oriented development model.

It is important at this point to highlight the different macroeconomic impact of direct foreign investment (DFI) in plant and equipment from that of incoming investment to purchase domestic financial assets. DFI flows, since these involve the import of equipment and new imports of intermediate inputs, have a limited impact on reserves, money supply, or domestic interest rates. (Flows associated with privatization programmes might be counted as DFI and because these involve the purchase of domestic financial assets have a macroeconomic impact. These flows might have been significant for Latin America, but not in Southeast Asia.) In the medium term, and with the proper trade regime, DFI flows increase the production of exports and other tradables. Morever, these types of investment are less easily withdrawn from an economy as a result of changes in rates of return on assets.

It is useful to contrast the Thai case with that of Malaysia. Malaysia (which has been the most prominent currency attack target) had managed to keep the interest differential low, supporting the contention that when the baht crisis began, Malaysia did not have a significant amount of short-term flows left in its system. Malaysia's case is particularly interesting in that it had been particularly successful in resisting the entry of short-term capital before the crisis. Table 4 shows that in 1993, capital inflows peaked into Malaysia at a fantastic 22.5 per cent of GDP, of which 14 per cent of GDP can be estimated as short-term, another fantastic amount. These flows had subsided in 1994–96, when short-term flows actually turned negative. The emotional response of Malaysian leaders to its becoming enmeshed into the recent short-term frenzy is quite understandable in the light of these numbers.

Korea (which has not undertaken the twin liberalizations to the same extent [Griffith-Jones, Montes and Nasution 1997]), Indonesia and the Philippines actually had higher interest rate differentials than Thailand. In the case of Thailand, the differential increased in 1995, when the largest

inflow (and presumably sterilization activity) occurred. It fell in the middle of 1996, then it started to go up, preparatory to the baht crisis.

Where the Thai authorities appear to have failed is in protecting the long-term viability of their banking system, through their established charge of prudential regulation. In hindsight, given the unprecedented scale of capital inflows, prudential regulation would have necessitated abandoning the objective of rapidly increasing the size of financial intermediation, if such intermediation principally entailed unsustainable portfolio build-up in property development. This is where the slow-down might have been engineered; it would have been too destabilizing and fiscally costly to engineer it through a devaluation. In the end, of course, the Thais had to begin the adjustment with an attempt to engineer a controlled devaluation which eventually was overtaken by market forces, in much the same way as Mexico's announcement of widening its exchange rate band in December 1994 led to the tequila crisis.

By 1996, after the first cases of financial failures emerged, Thai authorities faced the dilemma that macroeconomic policies directed at lowering the interest differential and devaluing the currency, would have increased the number of financial failures. In any case, even a controlled devaluation would still have been too blunt an instrument for forcing the banking sector to implement a pause in its growth and to begin recognizing the increasing proportion of their portfolio as uncollectible.

Private Behaviour and the Three Guarantees

The theory is that the private sector (domestic and international) will internalize the costs of its own behaviour. This would mean that, for example, private lenders to Thai finance companies would carefully consider the rising risk of increasing exposure. They would be cognizant of the susceptibility of property markets to speculative bubbles. As the

TABLE 4
Key Macroeconomic Variables, Malaysia 1989–96
(In percentages)

	1989	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*
Growth Rate of Gross Domestic Product	9.2	9.7	8.7	8.0	9.0	9.1	10.1	8.8
In percent of GDP								
Gross National Savings	29.0	29.1	28.4	31.3	33.0	34.0	34.7	36.0
Consumption Expenditure	65.2	66.6	66.5	63.5	62.3	61.2	60.5	58.1
Private	50.8	52.6	52.6	50.5	49.2	48.6	47.9	46.9
Public	14.4	14.0	13.9	13.0	13.1	12.6	12.6	11.2
Gross Capital Formation	29.3	32.4	36.4	36.0	38.3	40.1	43.0	41.8
Private	18.5	20.9	25.9	24.8	26.7	27.2	30.5	29.2
Public	10.8	11.5	10.5	11.2	11.7	13.0	12.6	12.6

Balance of Payments								
Current Account	-0.7	-2.1	-8.8	-3.8	-4.8	-6.3	-8.5	-5.2
Official Long Term Capital	-2.4	-2.5	-0.5	-1.9	0.6	0.3	2.7	0.3
Private Long Term Capital	4.4	5.5	8.3	8.9	7.8	6.0	4.7	4.5
Long Term Capital, Net	2.0	3.0	7.8	7.0	8.4	6.2	7.4	4.8
Basic Balance	2.7	0.9	-1.0	3.2	3.6	-0.1	-1.1	-0.4
Private Capital: Net	1.5	1.2	3.9	8.0	8.4	-4.5	1.1	4.5
Private Capital: Commercial Banks	1.1	2.0	2.7	6.2	6.6	-7.0	0.1	3.4
Private Capital: Others Private	0.4	-0.8	1.2	1.8	1.8	2.5	1.0	1.1
Errors and Omissions	-1.0	2.6	-0.3	0.1	5.7	0.2	-2.0	-1.6
Overall Balance	3.2	4.6	2.6	11.3	17.7	-4.3	-2.0	2.5
Implicit capital inflows	3.9	6.8	11.4	15.1	22.5	2.0	6.5	7.7
Short-term capital inflows	1.9	3.8	3.6	8.1	14.1	-4.2	-0.9	2.9

SOURCE: Basic data is from the CEIC Data Base.

current and previous crises have demonstrated, this conjecture can be quite presumptuous, for a variety of reasons.

In every economy, public authorities stand behind the *viability of their domestic financial system*. This is the first guarantee. This cannot be interpreted as a market distortion; it is a feature of a capitalist economy, in which markets for financial assets are an indispensable feature. These markets, however, cannot be liberalized in the same manner as one would a goods market. Financial assets constitute an uncertain contract for delivery of resources at a future date and entail substantial problems of asymmetric information, moral hazard and contractual enforcement (Stiglitz 1994).[4] This creates at least an implicit, if not explicit, guarantee that monetary authorities stand behind the foreign liabilities of, as a minimum, the explicitly supervised part of their financial system. To the extent that domestic financial liberalization has expanded the sources and destinations of financial lending to non-supervised financial activities, the guarantee to the supervised activities is implicitly extended to the non-supervised portion. In line with its free-market philosophy, the Chilean Government that led the economy into financial crisis in 1981 had explicitly announced that no foreign borrowing would be guaranteed by the state. During the crisis, foreign lenders forced the government to absorb these liabilities. This issue has been one of the most problematical points in the current Thai rescue package.

Even inside industrial economies, domestic financial systems are notoriously susceptible to exuberance and overoptimism. One proposition is that, for developing economies, where supposedly competent financial sector staff is scarce, bringing in foreign funds, by bringing foreign expertise, would improve the efficiency of domestic markets. Unfortunately, incentives in the international markets could actually intensify emerging economy exuberance (and in a downturn, exacerbate pessimism), notwithstanding the higher educational levels of staff working in international funds.

First, there is by-now the well discussed institutional feature of herd behaviour.

Second, these staff have tended to over-estimate the permanent income increases which are insinuated by major liberalization efforts (McKinnon and Pill 1995). In fact, governments that have paid an enormous price getting their trade regimes liberalized often find themselves punished, as happened to New Zealand in the mid-1980s, with excessive capital inflows, strengthening their exchange rate, and knocking the ground off efforts to expand and diversify their export sectors.

Third, private actors tend to neglect the Harberger 1985 externality, even while their practices create it. The price of international financing to a developing country increases as its external indebtedness increases and private lenders and borrowers do not internalize this rising cost, which can rachet up drastically when international confidence in a country is lost. In fact, Harberger 1985 proposed a tax on foreign borrowing as a device to force private actors to internalize this cost. With financial liberalization and capital account opening, international borrowing activity is privatized and decentralized, making it difficult to install a monitoring system (unless certain capital account controls are kept), let alone impose a Harberger tax.

The price of international financing for projects does not depend on the viability of the particular project; in practice, international financing tends to bundle a country's projects into one, and as the recent crisis suggests, the Southeast Asian projects were in one Southeast Asian bundle. This also implies that the size of the Thai international liabilities exerts a Harberger externality on the price at which the other Southeast Asian economies can now obtain international financing.

Dooley (1996*b*) identifies two other guarantees that help explain the private basis of the banking-cum-exchange crisis:

1. commitment to an open capital account, and
2. the adoption of a fixed exchange rate (or limited flexibility).

In combination, these two guarantees are effectively subsidies to short-term external financing. They have a minor effect on foreign direct investment, but they represent significant support for non-resident equity investments and offshore banking facilities. With these two guarantees, plus the standard guarantee on domestic financial institutions, international investors do not have much incentive to monitor the use of their lent resources and have enormous incentive to lend some more. Dooley (1996*b*, p. 200) suggests a provocative parallel of external financing to the 1980s savings-and-loans crisis in the United States: "... depositors did not care if the savings and loan bought a junk bond (international reserves), a shopping centre (domestic investment), or a new car for the bank president (imports of consumer goods)".

The Thai case included a particularly beguiling form of currency risk guarantee. Since the Thai baht continued to be heavily pegged to the U.S. dollar in 1996, when the dollar was appreciating, yen investors into baht were already being conferred at the minimum unrealized exchange gains.

4
FUNDAMENTALS AND SENTIMENTALS

Because it is in fashion, one might analyse the current crisis in terms of "fundamentals" and non-fundamentals. There are limits to this approach, the main one being that international private asset managers have a different definition of what constitutes fundamentals and what does not. There are thus substantial issues of definition. Private asset managers appear to associate "fundamentals" with factors that support the one-year to year-and-a-half stability of key asset prices, especially exchange rates. Economists and public officials would probably think of "medium-term" in terms of 3 years and look on fundamentals more in terms of the impact of asset prices on real economic variables, such as output growth, exports, and employment.

I suggest these differences help to make sense of the different readings of the day-to-day volatile fluctuations of asset markets, which for economy of language one might call "superficials" or perhaps "sentimentals". Superficials has a lot to do with "sentiment" or "market perception". The private sentimental response to the 3 September Malaysian policy to prop up its stock exchange (withdrawn the following day) and the equally sentimental response to Indonesia's policy to remove foreign restrictions in the stock market the following day had little to do with changed fundamentals. Indonesia has had an open capital account since 1968, but this has never been the object of macroeconomic attention since the available Indonesian debt and equity instruments

had never been of the international investment grade quality, something that is true for the most part today. Economists and politicians are notoriously undertrained in social psychology. On the other hand, as the early repayment of the Mexican 1995 bailout suggests (while its real economy has not recovered fully), international market players are notoriously susceptible to self-fulfilling behaviour in time-spans of 3 to 4 months, setting prices critical to economies that have little to do with "fundamentals".

In a quiet economic/political situation, the two definitions of fundamentals should coincide: "the fundamental things apply as time goes by". More important is the possible effect of sentimentals, when these change drastically enough, on fundamentals.

What are the key fundamentals in regard to the Southeast Asian currency crisis? Here is a short list:

1. Viability of the Domestic Financial Systems

If private agents in the capital importing countries such as Thailand behaved based on the economic models of intertemporal optimization (Glick and Rogoff 1995 and Razin 1995), the Thai private sector should have actually increased its savings rate as a means of smoothing consumption while international interest rates were temporarily lower and the current account deficit should have declined in the same period. If this had been the case, one would have expected instead of a weakening of the domestic banking system, a strengthening of these systems during periods of portfolio inflows. Unfortunately, it appears as if the private sector cannot be trusted to behave in ways economists think it should behave.

International lending in favour of the Southeast Asian economies in the early 1990s has seen the financing of investment booms, especially in the property sector, and to a smaller extent than Latin America, a spending boom (Griffith-Jones, Montes, and Nasution 1997). Some of the

increase in spending might have been justified under the economists' conception of a rise in "permanent income" in the Southeast Asian economies. It is arguable whether international investors had this factor in mind when increasing their exposure to these economies; it is likely that the three guarantees explained in the previous section weighed more heavily on their mind.

One fundamental to be faced in the current crisis is the resolution of bad debts in the banking systems. In this regard, Thailand's problem is particularly acute. The resolution of these problems is critical for investment to re-start. Their resolution raises complex political problems of assigning the burden of the write-off, something that even Japan has not fully resolved when dealing with its own property bubble. Putting the burden on taxpayers (including those from the source countries through an IMF package) would be the fastest way to resolve the issue. Like the Mexican bailout and the earlier bailout in connection with the international debt crisis of the 1980s, this approach raises issues of moral hazard and does not help in preventing another similar crisis.

Just as in the period of capital inflow, the "sentimentals" have an enormous capacity for unfavourably influencing the fundamentals in regard to the health of the domestic financial system. If the value of Southeast Asian currencies are knocked down too far as a result of the intense sentimental activity, there will be an increase in the proportion of projects in the portfolios of the domestic banking system that would be unviable at the new exchange rate. This has the potential of provoking a secondary round of domestic banking crisis.

2. Responsiveness of Exports and Domestic Output to Nominal Devaluations

In 1996, key Asian economies suffered an export slow-down. The recovery of the Thai economy and the continued health of the other Southeast Asian economies depend on the impact of the recent currency changes on their real sectors.

This impact hinges on two factors: (1) the ability of the nominal currency changes to bring about real devaluations and (2) the responsiveness of the tradables and export sectors to a real devaluation.

Latin-American economies have historically been unable to engineer real devaluations since in their highly urbanized societies real wages have tended to adjust rapidly to the internal inflation provoked by nominal devaluations. The societies of Thailand, Indonesia, Malaysia, and the Philippines, with a large weight of the economy in the rural areas have managed in the past to carry out real devaluations from nominal changes in currency value. (Trends in inflation rates bear watching in the next few months. Indications are that inflation continues to be moderate in all the Southeast Asian countries, indicating that indeed they are managing to undertake real devaluations.)

With regard to the second factor, the Southeast Asian economies have robust export sectors that are not hobbled by rigidities in the supply side in responding to real devaluations. Thailand is doubly blessed in having an export-oriented agricultural sector, so that devaluations can actually improve rural incomes, alleviating the normal adverse distributional implications of a fall in the average real wage fall necessary to a real devaluation.

In fact, the actual impact on the real sector of the recent asset price crises in Southeast Asia raises questions about the "social" or "real" role of currency, equity, and portfolio markets in the development process. (See Fitzgerald [1997] for a discussion of the different channels by which these asset markets might affect real economic performance.) Consider this question: if prices in the Southeast Asian asset market were to bounce back from their overshot levels in the next three months, would it have a significant impact on real economic performance? There would be some easing of credit constraints, but not by much since interest rates have already been at historical highs for long stretches even before the crisis because of the sterilization activities in each

of the countries. Savings rates are still at historically high levels in all of the Southeast Asian economies (except the Philippines), and the fiscal revenue performance quite healthy; these factors, more than price knockdowns in the asset markets, provide the domestic resources to complete current investment projects. Even without waiting upon a recovery of these asset markets, Malaysia, quite uncontroversially, projects a reduction of one percentage point in its economic growth rate for the whole of 1997.

Even in the industrial economies, stock markets have primarily been venues for the risk-sharing among asset owners and much less institutions in which to raise financing — a respectable casino institution, as it were (Stiglitz 1994). In recent years, the Southeast Asian economies have been Latinized to the extent that their liberalization approaches, such as the establishment of the BIBF, have created asset markets whose influence on the exchange rate, arguably the most important single price in an open economy, far exceeds its social contribution to real investment. These asset markets have of course provided another arena for Asian banks and financial institutions to play in (and perhaps to learn Western methods of risk-sharing), and created new-found excitement in the area of initial public offering (IPO) activities. However, Asian investment can rely heavily on real factors — foreign direct investment in plants and equipment (not privatization, which has been important in Latin America and in the European transition economies), tedious bank lending operations, and even government-led investment. All of these argue that the Southeast Asian real sectors, except for weaknesses in the financial system, are relatively immune from the recent asset market frenzy.

On the demand side, it appears that the knockdowns of the Southeast Asian currencies are occurring when the world economy is not in a recession and not about to enter into a slow-down. The expected reduction in growth rates in the Southeast Asian economies will weaken their ability to export to each other; however, the increased trade dependence

within Southeast Asia is an extremely recent phenomenon (Menon, Montes, and Tan 1997). The Western economies and China are expected to remain robust markets, even while Japan is not expected to grow as strongly as expected.

Where the sentimentals can adversely affect the output and export response is: (1) if the high level of uncertainty over future currency values disrupts trade credits to the region and (2) the changes in currency values spawn political consequences. The first is not likely. In the case of the second, even the most egregious governments and political systems do stake a significant part of their reputation on a stable currency. Drastic changes in government can lead to further policy uncertainty, if not policy reversals which could undermine the output response.

3. Sustainability of Current Account Deficits

Current account deficits measure the extent of total external financing being provided to an economy. In the 1990s, equity and portfolio investments began to overtake direct investment, loans, and trade credits as the means for providing such external financing. *Ex post,* a large current account deficit signifies both a high rate of external borrowing and a strong willingness on the part of non-residents to lend to the country. Given that private actors have not proven trustworthy in terms of generating current account deficits which are consistent through time (based, say, on intertemporal maximization of the models in the manner of Glick and Rogoff [1995] and Razin [1995]), how should public authorities judge when the deficits are "excessive" and therefore put a brake on external borrowing by residents?

Reisen (1997) suggests that offers of financing by non-residents should be resisted when these cause unsustainable currency appreciation, excessive risk-taking in the banking system, and a sharp drop in private savings. All of these bring to the fore a few sore points in terms of the fundamentals-sentimentals dichotomy. The strength of the Southeast Asian

currencies in the last three years, while for the most part gallantly resisted by public authorities, have undermined the region's international competitiveness and now necessitate the search from sentimentals to fundamentals for the "proper" exchange level between these currencies and the international economy and the proper relationship in exchange level among the Southeast Asian currencies themselves.

Table 5 compares the impact of the capital inflow surges on investment and productivity between four Latin American and four Southeast Asian economies. Investment ratios have risen strongly in the Southeast Asian economies, in contrast with the Latin American economies. However, except for Argentina and Peru, the period of massive capital inflows has seen the (measured) efficiency of investment fall in all the countries. Malaysia and Thailand exhibit the sharpest deteriorations in current account balances. Nevertheless, in a piece drafted in May 1997, based on long-term considerations of productivity growth, accumulated debt levels, levels of foreign direct investment, trends in the terms of trade, and robustness of government financing, Reisen (1997, p. 12) makes the judgement that Malaysian and Thai current account deficits "appear to be sustainable". Table 5 in fact indicates that before the Thai crisis, Malaysian gross savings had been steadily increasing from 29.1 to 34.7; once again, this level is quite high and attests to the relatively strong Malaysian fundamentals before the crisis. This is a trend that could be reversed if the current currency crisis imposes a reduction in Malaysia's economic growth rate.

Table 6, based on calculations from the time capital inflows commenced up to 1995, show the impact of capital inflows on foreign reserves, savings, and consumption. In Thailand, private consumption actually declines, the savings rate increases by 6.4 percentage points of GDP (in sharp contrast to Mexico where it decreases by 6.0 percentage points of GDP), and foreign reserves have increased.

Southeast Asian fundamentals are not as robust as their

TABLE 5

Capital Inflows and Investment, Growth and Productivity[a]

	First year of inflow	Investment Ratio		Real GDP Growth Rate		Efficiency[b]	
		before inflow	thereafter	before inflow	thereafter	before inflow	thereafter
Argentina	1991	16.9	18.3	-1.4	7.5	-9.0	41.0
Chile	1990	20.9	23.3	8.0	7.0	37.8	30.6
Mexico	1989	18.8	19.7	1.7	3.0	8.8	15.6
Peru	1992	17.8	20.4	-2.7	4.8	-14.8	28.4
Indonesia	1990	32.7	34.1	6.0	7.0	18.3	20.6
Malaysia	1989	23.6	35.1	7.2	8.7	30.2	23.5
Philippines	1992	19.6	23.2	3.8	4.2	20.1	16.2
Thailand	1988	27.6	39.8	9.6	9.0	34.7	23.6

[a] Data are annual averages for the first period from 1987 to the year that preceded the first year of inflow and for the second period from the year after the inflow started to 1995 (investment, efficiency) or to 1996 (growth). For Argentina and Mexico, the second period stops in 1994.

[b] Efficiency is defined as the inverse of the investment rate to the real GDP growth rate.

SOURCE: Reisen (1997, p. 4).

TABLE 6
Current Account Balances and International Reserves

	Change[a]				*Memo*		
	Foreign reserves	*Current account*	*Saving*	*Private consumption*	*First year of inflow*	*Year when current account deficit peaked*	*Peak current account deficit*
Argentina	1.4	-1.9	-0.5	4.5	1991	1994	3.5
Chile	5.7	1.2	3.7	1.2	1990	1996	3.3
Mexico	-0.7	-6.9	-6.0	3.1	1989	1994	7.8
Peru	5.9	0.1	2.8	0.7	1992	1995	7.2
Indonesia	-0.2	-0.5	0.9	-0.3	1990	1996	3.7
Malaysia	8.8	-11.8	-0.7	3.4	1989	1995	8.1
Philippines	3.4	-1.6	1.9	3.8	1992	1994	4.5
Thailand	8.2	-5.8	6.4	-4.9	1988	1995	8.2

[a] Changes are calculated as the annual average changes between the first period from 1987 to the year that preceded the first year of inflow and the second period from the year after the inflow started to 1995 (for Argentina and Mexico, 1994). Saving rates were derived as residual.

SOURCE: Reisen (1997, p. 6).

previously exaggerated reputation made them out to be, but they are clearly as strong as any other economies in the region and stronger than those of Latin America and in other regions which have been the subject of more recent international portfolio interest. The weakening of these currencies should put the current account balances on a firmer footing and in a fundamentals-driven world should establish a floor on how low their currencies should go. In light of the real exchange rate trends, one would venture to state that the values of these currencies have been driven too low — if the objective is the recovery of sustainable current account deficits. In fact, before the crisis, the unchallenged consensus was that the Malaysian ringgit was undervalued and needed to appreciate faster.

In a market-sentiment driven world, on the other hand, just as currencies can be made "too strong" when offers of financing are strong, they can be made "too weak" in episodes of capital withdrawal. "Too weak" in the case of the Southeast Asian economies has positive implications for current account recovery but can have serious consequences for the health of the domestic financial system as explained above.

4. High Savings Rates and Robust Public Finances

In the 1990s, Singapore's gross national savings rate has hovered at 49 per cent of GDP, Thailand's and Malaysia's from 35 to 38 per cent, Indonesia's at over 30 per cent (Table 1). The Philippines at 20 per cent of GDP had lower savings rates, but even these levels would be considered respectable among developing economies.

In the years before the crisis, Southeast Asian economies' public finances were extremely healthy. Troubled Thailand ran eight consecutive years of government surpluses, in the order of 2 to 3 per cent of GDP, except in 1996, during the export slump, when the government budget surplus fell to

1 per cent of GDP (Table 1). Since the 1970s, Indonesia's budgetary system has ensured a balanced budget, with explicit co-ordination with external donors in identifying financing for government investment projects. The Philippines had been strengthening its fiscal sector, basically having balanced budgets in the last 3 years.

What the robustness of savings rates and fiscal finances means at the current juncture is that, barring further gratuitous depredations from the private currency markets, these economies have more-than-normal domestic resources to address weaknesses in their financial systems. The question therefore is not one of insufficient resources but whether each of the affected economies can launch programmes, even if only to lighten the haze in international perceptions, to repair weaknesses in their banking systems. Such programmes are difficult because they mean a more rapid recognition of potential banking losses, which involves questions of judgement, valuation, and public authorities' supervisory capacity and access to information from the private sector.

One tragedy of the situation is that Thailand must now show an even more healthy fiscal standing, in spite of its quite sound fiscal situation before the crisis and the still unmet demands for public financing in infrastructure and education. Another tragedy is that in order to maintain confidence in the currency markets, Southeast Asian governments are delaying or cutting back on their investment projects, with an implicit objective of attaining current account deficits in the order of 3 per cent of GDP. Because of the region's established export industries, the higher-than-world-average growth of its productivity and its relative success in attracting more stable inflows of foreign direct investment, current account deficits higher than 3 per cent, a developing country benchmark, can be sustainable in the region (Reisen [1997]). It appears, however, that currency markets, whose players seem to be just as laggard in doing their homework during the currency crisis as before it, will

not permit high current account deficits at this juncture. Each of the Southeast Asian economies experienced significant economic crises in the 1980s. During these episodes, each demonstrated a capacity to carry out these kinds of drastic expenditure cut-backs and, unlike many other developing or transitional countries into which emerging funds have been rushing, can point to this track record.

5
INTERVENTION, POLICY, CO-ORDINATION?

In addressing the question of policy response, this section first discusses whether, in the context of the twin liberalizations and external arbitrage markets on exchange rates, policy matters in attempting to manage short-term capital flows. Adapted from Montes (1997*b*) based on a rather involved review and evaluation of the literature and the evidence, issues regarding policy response are as follows:

1. There exists a more limited but still significant scope for monetary independence in the countries of the type found in Southeast Asia, because the types of financial assets traded domestically are not complete substitutes for external assets. Public authorities would do well not to let the ideology of liberalization obstruct the specific objectives of these efforts — the sound development of the financial system and the increase in the productivity of investment. Chilean authorities, with the (mis)fortune of having experienced the same type of crisis in 1981 and in contrast with the stance taken in Mexico and Argentina, have indeed taken the position that public authorities have a longer-term perspective than the market and are justified to intervene in exchange rate setting and in slowing down speculative activity (Agosin and Ffrench-Davis 1995).

Public monetary and fiscal authorities would do well to take a skeptical view of economists' market fatalist instincts because, as proven once again in the Thai case and other earlier episodes, public authorities do have significant

contingent liabilities when financial systems fail. The size of the scope for monetary independence depends on the soundness of macroeconomic management and the willingness of authorities to take discretionary actions. "Moral suasion" used to be one of the listed instruments of monetary policy. Unfortunately, in an episode when authorities seek the private-sector driven development of the financial system, it becomes an awkward instrument.

Stricter supervision of the banking system when its sources of finance have expanded as a result of opening the capital account is not only an exercise in standard prudence but is also one more means of leaning against overheating of the economy (Montes 1996). In this way, the burden of leaning against overheating is not placed solely on the shoulders of public authorities. In actual practice, this requires considerable sophistication since it is also important not to constrain financial development that is supposed to be the rationale for financial liberalization. Imposing limits on consumer and property lending immediately contradicts the intentions of removing credit ceilings as part of the financial liberalization process.

Every economy has its own capacity and characteristics for monitoring, regulation, and supervision. Regulatory procedures should not be dismantled just because they are regulatory or financially repressing in the interest of completing the twin liberalizations: the U.S. financial system has prospered under decades of Regulation Q restrictions. In many cases, some previously dismantled policies and regulations have to be reinstated. In 1996 Indonesia began using reserve requirements as an instrument of policy, after these had been dramatically lowered in order to minimize financial repression. Financial repression is often the consequence of retaining tools with which to supervise the domestic financial system; the costs of financial repression which has often been estimated at around 2 per cent of GDP pale in comparison to the cost of rescuing banking systems in the order of 8 per cent of GDP as shown in Table 2,

estimates which actually ignore costs from the loss of investment confidence, unemployment and other social costs imposed by the adjustment from systemwide banking failures. Moreover, reinstating restrictions after these have been dismantled, as Malaysia learned in early August in trying to reinstate some Regulation Q-type ceilings can be destabilizing.

2. It is clear that during periods of currency attack, capital controls and other efforts to prop up a currency are ineffective and actually subsidize further speculative actions. Krugman's 1979 model identifies the key features: countries have finite reserves and when the reserves run out, speculators' bets are rewarded with significant gains. Raising domestic interest rates can hurt both the financial domestic system and the tradables sector, undermining external performance. Investing additional resources to prop up the currency only provides additional subsidy for speculative activity. For these episodes, international co-operation and co-ordination have been the best response.

3. During periods of external speculation in favour of the developing economy, authorities have significant capacity to intervene to prevent unsustainable currency appreciation, the weakening of their domestic banking system, or the decline in the domestic savings rate.

Does Public Policy Matter against Short-Term Capital Movements?

The issue of the capacity of public policy can be broken down into two related items: (1) the possibilities of monetary independence and the (2) the efficacy of controls on capital flows.

Persisting public responsibilites with regard to the level of economic activity (and some of its key components, such as export growth and diversification) and with regard to setting the level of the money supply (given its lagged impact on the general price level) motivates the quest for monetary

independence. Can domestic authorities in net-capital importing countries set, say through sterilization operations, the domestic interest rate, the money supply, and the exchange rate independently to achieve these targets? The Mundell-Fleming model, with a few assets, says it is not possible (Frankel 1994).

With a rich enough menu of financial assets,[5] combined with a public policy stance of exchange rate flexibility, monetary independence on the part of net capital-importing countries is not necessarily elusive. First of all, developing country bonds are not complete substitutes for international bonds in terms of their inherent characteristics; secondly, if either international investors are risk averse instead of risk-neutral (Kenen 1993) or if there is strong home-country bias on the part of foreign investors (as appears to be the case), developing country governments can use the country premia to provide some scope for targetting the exchange rate. The question of monetary independence hinges less on its existence and more on its use. While complete independence does not exist (and never did), even after financial liberalization, there would appear to be enough independence for countries to enhance or damage their macroeconomic stability.

If the existence of these premia interact with a policy stance which subsidizes the risk to foreign investors (as had appeared to be the case in Mexico in the period immediately leading up the the 1994 crisis [Griffith-Jones 1997]), the stage would be set for an episode of more-than-sustainable external financing. Because of the possible existence of multiple equilibria, even consistent programmes can be undone by volatile capital reallocation; but this is another argument for efforts to safeguard some scope for monetary policy. The presence of panicky international investors was a complementary explanation for the Mexican crisis (Gil-Diaz and Carstens 1996). Heterogeneous expectations between Mexico's own nationals and international

investors, mainly from the United States, may also have played a role in maintaining the premia.

While measures to discourage excessive capital flows are tools for defending monetary policy, it is not clear if these controls are themselves sustainable or if the costs they impose outweigh benefits they might generate. This is argued by Dooley (1996*a*) in a survey on the literature on capital controls, a literature that nonethless provides evidence that "both developed and developing countries have succeeded in driving wedges between domestic and international interest rates" (Dooley 1996*a*, p. 680), measured as covered interest differentials being sustained over significant periods of time. However, it appears that a good proportion of the wedges have been used to generate government revenue and reduce domestic debt servicing costs — which then provides the temptation in favour of inconsistent macroeconomic stances.

Much of the work that Dooley surveys is motivated by the need to understand speculative attacks against a currency regime or in the context of a policy regime devoted to either maintaining a strong currency, assisting governments to finance their deficit from domestic and international sources, preventing capital flight or all of the above. The literature therefore speaks to a time when private offers of financing to developing countries were quite moderate and needed to be enticed. This literature tends to treat capital inflows and outflows symmetrically; it is important to raise the issue of whether such a symmetrical treatment is justified.

Speculative attacks against a currency regime are directed at a finite level of reserves and highly conditioned on the (perceived) existence of policy inconsistencies. While countries can borrow reserves, it is at the cost of weakening indicators of solvency. The policy choice set in the case of threatened financial outflow tends to be more politically difficult — domestic demand contraction (including investment spending of the private sector) and exchange depreciation.

On the other side, the failure of controls against incoming capital can cause unexpected money supply increases, unexpected increases in the domestic interest rate as a consequence of greater-than-expected sterilization, or currency appreciation. Except for the potential increase in the interest differential from sterilization, the other two consequences tend to undermine external demand for domestic financial assets; moreover, any degree of effectiveness of controls against inflows reduces the costs of sterilization of inflows. Specific controls against capital inflows are eventually subject to evasion. The manner in which these are implemented determines their effectiveness, as the experiences of Chile (Agosin and Ffrench-Davis 1997), Korea (Park 1997), and Malaysia (Aziz 1997) suggest. If it is the case that capital inflow episodes follow upon structural reforms and include an element of portfolio adjustment on the part of external investors, then the length of the episode is finite and it is more likely that such controls can be effective.

Williamson (1993) also argues for the differentiating between controls against outflows and inflows but suggests even more exacting criteria for the right time to remove controls on inflows, a set of preconditions which few countries have probably qualified for. These are: (1) that nontraditional export industries are firmly established, (2) that fiscal discipline is achieved, and (3) that the liberalization of the import regime and the domestic financial system (including adequate prudential supervision) is essentially completed. Williamson argues for a sensible gradual liberalization, starting with liberalizing outward direct investment as suggested by Fischer and Reisen (1993).

Policy Implications

One might suggest the following list of policy implications from the previous discussion:

1. Weakening the guarantees on the open capital account and a stable exchange rate (by either floating or having a

wide band) can reduce international investor confidence but is critical in making sure that private actors internalize the risks of their activities in holding portfolio positions in emerging markets.

The first implication of this is that exchange rates have to be more flexible. In the case of Chile, because the volume of inflows has been significant over long periods of time, authorities have had to resort to discrete nominal appreciations, followed by a series of depreciations to return the currency to a value that authorities consider to be consistent with the development objective of expanding and diversifying exports (Agosin and Ffrench-Davis 1995). The Thai case, while quite successful in real exchange rate terms, underscores the perils of pegging too closely to a currency that is appreciating.

2. Developments in the weeks following the Thai devaluation confirm the proposition that controls are ineffective in episodes of capital outflows and that investing more resources to defend the currency only subsidizes speculative activity further. Moreover, the recent difficulties of the ringgit, which have been interpreted as market reactions to Malaysia's recent policy responses, have appeared to have affected the other Southeast Asian currencies.

These events suggest the indispensability of closer consultation among ASEAN countries. As explained above, one of the institutional realities of the new international financial markets is that these markets tend to lump projects in one country into one, and, with a little bit of adjustment, countries in one region into one. Prior private notice of intended drastic policy changes among central banks in the region seems to be critical. Increased frequency of meetings among central bank and treasury officials will establish the confidence to underpin these prior notice arrangements.

In April 1996, Japan's Ministry of Finance and the Bank of Japan signed a set of bilateral securities-repurchase agreements with six other Asia-Pacific countries and Hong Kong. Under the agreements, central banks needing U.S. dollars

will be able to borrow from the Bank of Japan in order to defend their currencies. The agreement indicates the inadequacy of current arrangements, as they exist under the Bank for International Settlements and the IMF (Montes 1997*a*).

Moreover, it is particularly important to avoid the exigency of competitive devaluations against each other among the ASEAN countries, for both game-theoretic reasons (the number of rounds of devaluations could be quite high) and the fact that the recent experience proves the power of international markets to force a certain relationship between the ASEAN currencies.

In May 1997, some co-ordinated actions in the currency markets appeared to have succeeded in defending the baht. However, as we have indicated above, while the Thai macroeconomic situation was not, by itself, inordinately unsound, the financial system required radical policy attention. No amount of co-ordinated action could have avoided the drastic Thai adjustment in 1997 since it was rooted in a weakened banking system. However, these financial system difficulties could have been faced earlier and these would have been a totally domestic problem. This brings up many sticky points of international co-operation, about the division of labour between external co-operation and purely national responsibilities as discussed in Montes (1997*a*).

Countries should have the primary responsibility of prudent development of their financial system; other countries in the region should have the ability to comment — in private — on unhealthy trends in the financial sector they perceive in other countries. Standard IMF surveillance procedures would have been and should continue to be the first approach. But as the 1980s debt crisis indicated and has been proven again in this episode, Bretton Woods staff are often overwhelmed by their own liberalization ideology and often raise the alarm bells too late. Individual countries and countries that might be affected by policy failures in individual countries have to accept more responsibility. Efforts to increase information-sharing among prudential and

regulatory authorities in the region, particularly in order to minimize regulatory evasion need to be supported. These efforts at prudential and regulatory co-operation should involve the source countries — Japan, and the United States in particular.

Countries like the Philippines should be encouraged to build up their international reserve balances at levels that would be comparable at least to government short-term liabilities. The increase in such reserves improves individual countries' ability to withstand speculative attacks and reduces the risk to the system as a whole. Beyond the April 1996 agreement, Asian countries might consider standing ready to match a certain proportion of a country's reserves should it come under speculative attack, as an initial position (Montes 1997*a*).

3. The approach to domestic financial liberalization is critical both to the effectiveness of short-term macroeconomic policy and the sustainable use of incoming capital funds. As suggested above, the crisis in the Thai financial system and weaknesses in the financial system in the other South-east Asian economies are the only real and fundamental feature in the current crisis. These kinds of weaknesses are endemic, even in industrial economies. In Southeast Asia, the enormous availability of short-term foreign funds, as a result of the "three guarantees", quantitatively exacerbated these weaknesses and created a large asset price bubble in Thailand; their presence in the current crisis has the potential of exaggerating the kind of adjustment that would be required.

In the longer term, there are justifications for seeking to isolate the domestic banking system from short-term volatility through regulatory measures and capital controls (Kaminsky and Reinhart 1996). There is also a greater need to strengthen bank regulation and to devote increased attention to consumer and property lending during episodes of capital inflows. More sophisticated understanding on the part of the international private asset managers is called for

in this regard; because of more limited policy handles in developing countries, stopping consumer and property lending often requires blunt and abrupt policy actions on the part of authorities. These actions are appropriate in the period of inflows but can be counter-productive in an episode of capital withdrawal.

Prudence suggests that in developing countries the presumption should be in the direction of stricter regulation (especially with regard to the introduction of new financial instruments). When public authorities' capacity for financial regulation does not match that in industrial economies, there is strong justification for raising capital adequacy requirements beyond the 8 per cent level under the Basle rules (which had originally been suggested for financial institutions in advanced industrial economies). In developing countries, authorities are particularly hobbled by their weaker capacity to monitor international transactions and by inexperience in evaluating new financial instruments. (Even large multinationals have borne large losses in taking positions in derivatives.) Monetary and fiscal authorities have to increase their human resource capability in monitoring the activities of financial companies and in prudential supervision.

With regard to the monitoring and supervision of domestic financial systems, while these are primarily the responsibility of domestic authorities, there is an enormous scope for international co-operation to reduce the mischief of "policy arbitrage". Policy arbitrage occurs when countries are forced by competitive pressure to reduce their regulation operations because of the existence of competing and less regulated economies nearby. Lower capital adequacy requirements in some countries, for example, create pressures for other countries to reduce theirs in order to attract financial companies.

6
CONTAGION AND BANKING REFORMS

The interpretation of the crisis developed in this book suggests a significant role for contagion in the Southeast Asian currency crisis, but in a specific way. The Thai financial crisis quickly spread a haze of uncertainty over the sustainability of (1) macroeconomic performance and (2) the health of domestic financial systems. International investors might take a little more time to distinguish between the first and the second factors, but, based on the situation before the crisis, only the domestic financial systems should have been at stake and even here there are significant quantitative differences between the Thai and Indonesian cases compared with the other three countries whose currencies came under attack.

International funds that had previously expressed frustration over the heavier regulation and stodgy attitude towards entry and flotation of new instruments in the other economies have also retreated from these economies, which are left relatively healthy precisely because they had depended less on — or succeeded less in obtaining — such financing. Using the language of "punishment" and "discipline" for explaining the impact of these markets on real economies rings hollow: even in the recovery phase, as pointed out above, the contribution of a recovery of prices in these asset markets on real recovery in the case of Southeast Asia will be limited. The restoration of liquidity in the Thai economy

has less to do with the recovery of these asset prices and more to do with the workouts of non-performing loans.

It is more fruitful to locate the source of the contagion in incomplete information than in the ardour of speculation, as public authorities, who daily find themselves tilting on the other side of currency markets, are roused to do. The data on Southeast Asian fundamentals — current account deficits, savings rates, public sector deficits — are readily available and support the contention that there should have been no generalized currency crisis.

What is less readily available is information about the health of domestic financial systems. Even in industrial economies, however, publicly available quantitative data for evaluating the health of financial intermediaries are scarce. The supervisory reputation on the part of the authorities generally substitutes for such information, much of the basis of which is not only confidential but subject to a wide latitude of judgement. The Southeast Asian economies had been undertaking efforts to raise to Western standards the quality of accounting information and modernizing bankruptcy procedures. The crisis has overtaken these efforts. In the future, after the crisis is past, there is some value for the larger financial institutions in the region to seek to be rated by international commercial rating agencies; even here, if the variance in the rating is narrow, the value of the information can be limited.

For all the economies, however, projecting the image of a solid supervisory reputation and forthrightness in reducing current account deficits have become indispensable. Why take the effort to build the image at all if the fundamentals are basically sound and risk another round of unsustainable currency appreciation as a result of the reflow of external voluntary financing? The answer is that there is a real threat that further currency declines will themselves cause domestic banking difficulties so that the currency markets end up manufacturing a second round of crisis.

Weaker currencies mean that more domestic income has

to be devoted to service the same amount of external debt; this, by itself, weakens banking portfolios. Recent calls to set up a $100 billion Asian fund to respond to such crises became a prominent non-agenda item in the annual joint meeting of the World Bank and the International Monetary Fund in Hong Kong in September 1997. These calls have to be understood in the context of heading off a second round of domestic banking crises, such as can be sparked precisely by an over-adjustment of currency values.

However, the modalities of such a currency stabilization fund for the original crisis would have been questionable since in that case resources would have been squandered to sustain an unsound financial system in Thailand; for that case, only a direct reform programme would have justified the use of such a fund. In fact, Thailand itself drew down its own reserves and borrowed heavily in a futile attempt to initially defend the baht.

Learning the lessons regarding the role of public authorities during the process of private-sector driven and foreign-fund financed financial development seems to be an even slower process. The string of failures and taxpayer charges remains unbroken since the Southern Cone financial misadventures in Latin America at the start of the 1980s. Before the Mexico crisis in 1994, three Scandanavian countries (Norway, Sweden, and Finland) experienced the same capital inflow surges, property lending boom, and crash in the late-1980s and early 1990s in the wake of their own "twin liberalizations". With larger private international funds and increased ease of movement, the pace is quicker than in the earlier periods and the Southeast Asian cases indicate that even sounder medium-term fundamentals do not provide immunity.

Some of the underlying resources come from retirement savings in industrial economies. There would be enormous benefit all around if the international private sector itself learned some lessons from this string of crises. For example, would it not be prudent for them to hedge at least their

currency risk of their investments; would it also not be sensible for these funds to set some reserves against against credit losses? The incentive is quite limited, since so far, in the nature of all rescue packages, international creditors have been the first to be saved. It remains for recipient countries to attempt to regulate the manner in which these private offers of financing from abroad are absorbed into their economies.

Update: For further discussion, see pages xv–xxxvii of this Updated Edition.

KPA

Notes

1. In the case of Thailand, the introduction of the Bangkok International Banking Facilities (BIBF) in March 1993 was a key strategy for internationalizing the financial market. The Thai effort sought closer integration with international financial markets and to provide the other countries in mainland Southeast Asia a market with which to raise their capital requirements. Under a BIBF licence, a company not only received tax and regulatory incentives competitive with other offshore centres, but it was also allowed to operate practically all the standard international banking activities. In particular, the offshore facility permitted onshore lending, as a means to introduce new foreign financial institutions to the domestic financial market. In fact, BIBF licensees were permitted to open two branches outside of Bangkok. By March 1995, BIBF accumulated inflow into the Thai economy stood at US$12.5 billion; the corresponding amount of funds that came into the facility and lent out of Thailand was US$0.6 billion (Nijathaworn 1995). The BIBF evolved into a vigorous source of short-term funds for Thai banking operations.
2. In fact, under Ricardian equivalence even publicly dominated current account deficits is not a policy problem because households are expected to automatically increase their savings in response to public deficits in anticipation of higher tax liabilities in the future.
3. There are some problems of definition as to what would constitute direct foreign investment and which flows would not. These problems are acute when equity inflows are associated with

privatization programmes in the domestic economy. These were not significant for Thailand in the period under consideration.

4. The classic treatment of this problem was made in the early 1980s, in response to the Southern Cone financial crises; see Diaz-Alejandro (1985).
5. Indeed, public authorities have a role to play in creating some of these assets (Reisen 1993), providing external investors the kind of assets they need while creating the means to sterilize at least part of the inflows. In 1994, Malaysia created such a foreign exchange stabilization asset.

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