

Asian Financial Crisis : Causes and Development

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Foreword

The HIEBS Studies are research publications of the Hong Kong Institute of Economics and Business Strategy. The series focuses on producing work that constitute the latest thinking on economic competitiveness and business strategy on issues of concern in Hong Kong, China and the Asia-Pacific region.

This book examines the causes and development of the Asian financial crisis, with special emphasis on its lessons for China and Hong Kong. Consideration is given to the broader issues exposed by the crisis that still need to be addressed. They include the need for better market regulation, greater transparency and improved corporate governance.

While China was largely shielded from the direct effects of the crisis by capital and exchange rate controls, it faces similar needs to reform its financial and state enterprise sectors. These needs have become even more urgent in view of its accession to the World Trade Organization.

The attack on Hong Kong's linked exchange rate regime has prompted the introduction of new measures to strengthen the operation of currency board system. Hong Kong had survived the crisis well, but has lagged other economies in recovering from the crisis. With domestic exports playing a diminished role, the benefits from the increase in global trade had been channeled into the provision of producer services in its re-export trade activities. Hong Kong has become a "metropolitan" economy to the PRC and the rest of Asia. To be able to provide added value and remain competitive in this new role, it will need to continuously upgrade itself as a knowledge-based producer service oriented economy.

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Y C Richard Wong
October 2000

Chapter 1. Introduction

For over three decades, most of Asia was a model of economic growth that developing countries strove to emulate. Its real per capita income rose by an average of 4% to 6% per annum. During this period, the overall life expectancy, education level, and living standards of Asian people vastly improved. In most countries within the continent, growth centred around the development of market economies and was made possible

by high savings levels, investments in human capital, and governments' encouragement of entrepreneurial activities. In almost all Asian countries, the export sector was the main growth engine, although the government's role in promoting specific industrial and export policies varied across the region.

Growth continued largely unabated during the early 1990s, during which time it was fuelled by significant inflows of capital, especially from Europe and Japan. However, hints of weaknesses began to emerge towards the mid-1990s. In many Asian countries, signs that the economies were exceeding their capacity, and thereby overheating, became evident; high levels of short-term foreign debts accumulated; corporations became highly leveraged; and export levels started to drop.

In 1997, what had started as a currency crisis in Thailand quickly developed into a financial and economic crisis and spread to other countries in the region. Currencies and asset prices in most countries dropped by as much as 30% to 40%, and even more in the harder-hit countries. Banks and corporations across the region encountered financial difficulties. Before the end of the year, Thailand, Indonesia, and Korea had to request the International Monetary Fund (IMF) for assistance. By 1998, all of the affected countries, including Singapore and Hong Kong, whose financial and corporate sectors were relatively sound, had entered a serious economic recession.

The effects of the crisis were felt far beyond Asia's perimeters. Within slightly more than a year, contagion had spread to other developing countries and global capital markets. The severity and contagion of what is now known as the Asia Crisis is unprecedented, and it took the international community entirely by surprise. As a result, important questions have been raised regarding the causes of the crisis, the role of the IMF, and the financial architecture of international capital markets. Although most of the affected economies significantly recovered during 1999, many of these questions remain to be addressed.

This study attempts to review the causes of the Asia Crisis, and to discuss its development. We concentrate on the more severely affected economies: Thailand, Indonesia, South Korea (hereafter referred to as Korea) and Malaysia. While Hong Kong SAR and more indirectly the PRC were also affected by the crisis, we focus mainly on the broad implications of the crisis for their future policies and development.

The United States, Europe, and Japan were all involved in the crisis to various extents and have significant roles to play in the region's recovery. As the world's largest export and capital market, the United States in particular exerts a predominant influence on the future of the region. Developments in the United States, however, are well documented and analysed. Developments in Europe, while important in themselves, do not have such a direct impact on Asia. This study focuses instead on Japan which has over the years built up innumerable ties with other Asian economies and exerts a direct influence on the region. We examine its role in the cause of the crisis, the economic and structural problems it currently faces, as well as their impact on the region's recovery.

This study is divided into several sections:

- Chapter 2 reviews the immediate causes of the crisis and traces its early developments: from isolated currency attacks to a currency, financial and eventual economic crisis for the entire region.
- Chapter 3 examines the management of the crisis in Thailand, Indonesia, Korea and Malaysia as well as evaluates the IMF's programmes and its overall role.
- Chapter 4 explores the underlying causes of the crisis, focusing on the role of monetary policy, fundamental weaknesses in the four economies, as well as inherent instabilities in international capital markets. It also briefly examines the role of Japan in the crisis.
- Chapter 5 reviews the steps the four countries have taken to attempt to recover from the crisis, the role of Japan in the region's recovery, and the efforts of the international community to address issues in the world capital markets raised by the crisis.
- Chapters 6 and 7 summarise the effects of the crisis on the People's Republic of China (PRC) and Hong Kong Special Administrative Region (SAR), respectively, and outline the preliminary implications of the crisis for future government policies and economic growth.

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Chapter 2. Immediate Causes of the Crisis, and Its Early Development¹

A. The Onset of the Crisis – Currency Attacks

Problems in Thailand

The Asian Crisis started with attacks on currencies in the region. The Thai baht was by all accounts the first to come under heavy selling pressure. Pressure on it is reported to have been exerted as early as July 1996, following the collapse of the Bangkok Bank of Commerce, and the Bank of Thailand's injection of liquidity to support the financial system. At this time, the IMF had already warned the Thai government about balance-of-payment problems and about the need to allow the baht – which was then pegged to a basket of currencies predominated by the U.S. dollar — greater flexibility. Thailand's foreign exchange reportedly stood at about US\$35 billion at the beginning of 1997.

More serious pressure on the baht was exerted in late 1996 and early 1997. During this time, increasing concerns about nonperforming assets in the financial sector, and poor fiscal and export data for fourth quarter 1996, were coming to the surface. A number of property developers were reportedly having difficulties servicing their loans. On 5 February 1997, the inability of Somprasong Land, a property developer, to meet its foreign-debt payment highlighted the plight of the sector. As finance companies were estimated to have extended 30% of their loans to the property sector, the vulnerability of the finance sector also became an issue of growing concern. Foreign banks that had significant dealings with the finance companies, as well as portfolio managers, began to retrench. At the same time, hedge funds were reported to be taking short positions on the baht.

The most severe attack on the baht occurred in May 1997. The capital markets started reporting increasing purchases of U.S. dollars by Thai banks, finance companies, and corporations, as well as accounts of capital flights. This was followed by more intensive speculative pressure on the baht, primarily on the parts of hedge funds and foreign banks. The Bank of Thailand initially intervened mainly via the forward market and was estimated to have sold US\$26 billion forward, based on an end June 1997 estimate. On 15 May, however, the Central Bank stopped intervening and started to let the interest rate rise, while instituting capital controls to defend the currency.

It is arguable, though impossible to test, that had the government devalued or floated the baht earlier instead of sharply drawing down its reserves in a prolonged defence of the peg, the crisis might have ended earlier or been less severe. In any case, speculation on the currency continued unabated. On 2 July, the baht was finally allowed to float, and domestic corporations that expected depreciation rushed to sell their local currency for U.S. dollars. This drove down the currency by 15% onshore and 20% offshore on the same day. Market sentiments were further exacerbated by reports on the Bank of Thailand's forward exchange position and by the perception,

¹ The contents and data in this chapter are based on IMF (1998c), BIS (1998), The World Bank (1998), and *Chronology of the Asian Currency Crisis and Its Global Contagion*.

though heavily exaggerated, that it had almost depleted the country of foreign-exchange reserves.

Contagion in the Region

The problems in Thailand and the rapid depreciation of the baht drew the attention of banks and investment funds to the conditions of other countries in the region. Soon afterwards, other currencies in the region also came under attack.

Malaysia

The ringgit came under strong pressure immediately after the baht's devaluation. The initial sources of the attack on the ringgit, however, were reportedly mainly foreign institutional investors selling off equity positions because of their concern about high equity prices and about possible interest-rate increases. (Back in March 1997, the government had announced ceilings on lending to the property sector and for stock purchases in an effort to reduce the overheating of the economy.) While Bank Negara Malaysia intervened heavily and effectively to defend the ringgit on the spot market, its sudden withdrawal from the market on 11 July caused the currency to depreciate by 6% over the following week. Although hedge funds had taken short positions prior to the depreciation, institutional investors, including domestic players, were reported to be major sources of speculation on the currency.

Indonesia

Although sentiments on the rupiah were initially bullish, Bank Indonesia widened its intervention band from 8% to 12% on 11 July 1997 as a preemptive move following the baht's depreciation. It was reported then that international banks, aware of the need for competitive devaluation among countries in the region and of the heavy foreign-debt exposures of domestic companies, saw the widening of the band as an opportunity to take positions against the rupiah. Domestic companies then reportedly also switched sides and began to hedge their own foreign-currency exposures. On 14 August, the central bank abandoned the rupiah trading band under heavy selling pressure, and the currency was allowed to float, depreciating by 4% initially.

Korea

By the time of the baht's depreciation, a number of bankruptcies and defaults had already occurred among large Korean business groups, mainly as a result of high leverage and overexpansion. However, attacks on the won were initially limited, as foreign investors could not readily access the currency.

Philippines

Domestic banks as well as international banks with operations onshore (and thus with access to pesos) were reportedly the primary sources of speculative pressure on the currency. On 11 July 1997, the Central Bank of the Philippines announced that it would allow the pesos to float within a wider range, thus abandoning the effective peg.

Table 2.1: Claims in Asian Countries

	Positions vis-à-vis	Con. cross-border claims in all currencies and local claims in non-local currencies						Memorandum items	
		Total	Distribution by maturity		Distribution by sector			Changes in:	
			Up to and including one year	Over one year	Banks	Public sector	Non-bank private sector	Consolidated claims	Cross-border liabilities
		in bn of US\$	in percentages of total consolidated claims						in billions of US\$
end-1996	Group	367.0	61.5	30.7	43.3	9.0	47.6	31.2	11.3
mid-1997	Total	391.2	62.3	29.8	44.1	7.5	48.3	33.8	5.9
end-1997		378.6	60.3	32.2	40.5	7.4	52.0	-7.8	18.8
mid-1998		319.6	53.0	39.0	37.0	9.0	53.9	-51.7	12.0
end-1998		299.4	52.5	38.7	34.7	9.8	55.4		
mid-1999		287.0	51.4	39.5	32.1	13.6	53.9		
end-1996	South	100.0	67.5	20.0	65.9	5.7	28.3	12.2	-1.8
mid-1997	Korea	104.2	68.0	19.7	65.3	4.2	30.4	5.7	6.8
end-1997		93.7	62.8	23.4	59.3	4.2	36.4	-10.2	5.9
mid-1998		71.6	45.4	39.4	56.6	6.8	36.6	-20.6	2.7
end-1998		65.6	45.3	38.2	57.0	8.3	34.4		
mid-1999		63.5	53.7	28.7	57.4	8.2	33.9		
end-1996	China	55.0	48.9	43.2	41.4	15.4	43.1	4.7	8.9
mid-1997		57.9	52.0	40.0	42.6	13.2	44.1	4.3	-1.6
end-1997		62.8	53.1	39.3	42.7	11.3	45.9	5.7	2.1
mid-1998		58.7	51.8	40.3	39.4	11.3	49.2	-3.3	1.4
end-1998		58.4	53.7	38.3	36.7	11.9	51.3		
mid-1999		51.8	46.8	44.7	35.3	16.2	48.3		
end-1996	Indonesia	55.5	61.7	34.1	21.2	12.5	66.2	6.3	2.7
mid-1997		58.7	59.0	35.0	21.1	11.1	67.7	4.8	-2.4
end-1997		58.0	60.5	36.2	19.8	11.8	68.4	-0.2	0.7
mid-1998		48.4	54.1	42.6	13.7	15.7	70.7	-7.8	0.6
end-1998		45.0	52.8	43.5	11.8	14.8	73.4		
mid-1999		43.8	49.6	46.6	10.1	21.0	68.8		
end-1996	Thailand	70.1	65.2	30.2	36.9	3.2	59.6	1.8	-3.0
mid-1997		69.4	65.7	30.4	37.6	2.8	59.5	1.5	-0.2
end-1997		58.5	65.8	30.7	29.9	3.1	66.9	-8.7	1.2
mid-1998		46.4	59.3	36.5	26.1	4.3	69.6	-10.9	2.5
end-1998		41.2	58.3	37.1	22.0	4.7	73.2		
mid-1999		34.7	54.9	39.4	19.4	6.2	74.4		
end-1996	Taiwan	22.4	84.4	13.8	57.8	2.1	40.0	0.0	-0.2
mid-1997		25.2	87.3	11.3	61.6	1.6	36.8	3.6	-1.3
end-1997		26.0	81.6	15.4	55.2	1.6	42.7	1.0	1.0
mid-1998		22.5	80.5	16.7	55.7	1.6	42.7	-2.6	-0.1
end-1998		21.0	78.8	14.2	56.5	1.9	41.6		
mid-1999		19.5	77.5	17.5	46.1	2.9	51.0		
end-1996	Malaysia	22.2	50.3	36.2	29.3	9.0	61.8	2.1	0.1
mid-1997		28.8	56.4	30.8	36.4	6.4	57.1	6.4	0.0
end-1997		27.3	52.7	37.8	35.3	6.4	58.2	-1.2	-3.5
mid-1998		22.8	48.2	41.9	30.8	6.6	62.5	-4.2	2.3
end-1998		20.9	44.7	44.0	27.7	8.8	63.4		
mid-1999		18.6	42.3	45.8	21.7	13.8	64.3		
end-1996	Other	41.8	51.1	42.5	31.3	17.5	50.8	4.1	4.6
mid-1997		47.0	51.2	41.9	33.0	13.7	53.2	7.5	4.6
end-1997		52.3	51.5	42.0	34.1	11.8	54.1	5.9	11.5
mid-1998		49.1	48.9	44.1	33.2	12.2	54.5	-2.3	2.6
end-1998		47.3	47.5	45.4	27.7	12.8	59.3		
mid-1999		55.1	46.1	46.9	23.8	19.7	54.7		

Source: *International Banking and Financial Market Developments-BIS Quarterly Review*, March 1999 and December 1999

B. Development into a Regional Currency and Financial Crisis

Within months, what had started as a series of speculative currency attacks and exchange-rate corrections quickly intensified into a regional currency and financial crisis, and even took on global dimensions.

Thailand

Thailand called in the IMF on 28 July 1997, and a rescue package of US\$16.7 billion (from both multilateral and bilateral sources) was arranged by August. However, the market continued to worry about political uncertainty in the country in the aftermath of the depreciation, as well as about the government's ability to carry out the policy actions that the IMF had prescribed, and about its commitment to doing so.

Meanwhile, problems within the financial sector became increasingly clear, as did the magnitude and structure of the country's foreign debts. As of mid-1997, the total foreign-currency debt owed to Bank for International Settlements (BIS) reporting banks was reported to be US\$69.4 billion, of which 65.7% would mature in one year or less. Banks accounted for 37.6% of the debt, and the nonbank private sector accounted for 59.5% (Table 2.1).

The depreciation of the baht, compounded by the short-term nature of the foreign debt, meant that many of the banks, finance companies and other private firms had difficulty meeting their foreign-currency debt payment obligations. Even as the government provided liquidity support to the banking system, depositor runs continued, and foreign banks were reluctant to roll over their short-term loans. The government had to announce guarantees for all depositors and persuade foreign banks to keep credit lines open to their branches in the country. In August, the central bank suspended forty-eight finance companies in addition to sixteen earlier and announced plans for a complete revamp of the financial sector as part of the IMF programme.

Political uncertainty and concerns about the depth of the problem in the financial sector prompted foreign capital to further retrench, putting even greater pressure on the currency and the stock market. By end 1997, the baht had dropped to approximately half of its June level. The stock market index fell by over 20%.

Indonesia

The magnitude of Thailand's foreign-debt problem focused the market's attention on similar problems in Indonesia. Foreign-currency debt owed to BIS reporting banks as of mid-1997 amounted to US\$58.7 billion (of which 59% were to mature in one year or less, and 67.7% of which were owed by the nonbank private sector) (Table 2.1). The country's total foreign debt (including loans and other capital-market instruments) was estimated by market sources to be US\$200 billion at end 1997, compared to the official figure of US\$117 billion. With the rupiah's depreciation, the sizeable foreign debt and the prevalence of short-term maturities raised questions about the private sector's repayment capability. The rupiah came under increasingly heavy pressure as

companies rushed to hedge their foreign currency exposures and foreign lenders and investors began to retrench.

The government requested the IMF's assistance in October 1997, and a US\$35 billion international financial-support package was arranged. However, the market continued to question the government's ability and will to implement the IMF programme. Meanwhile, political uncertainty also continued to dampen market sentiments. The closing of sixteen private banks in November led to a further loss of confidence among depositors and to a run on other banks, resulting in a financial crisis that extended across the country.

In January 1998, the government estimated that 228 companies had problems servicing their debts, and the market experienced an effective debt moratorium from the private corporate sector. Capital flights and the continuing retrenchment of foreign lenders and investors drove the exchange rate and the stock market index to new lows. By January 1998, the rupiah had lost more than 80% of its July 1997 value and the stock market index had dropped by more than 75%.

Malaysia

Malaysia's foreign-debt problem was small compared to Indonesia's and Thailand's. Malaysia's total foreign debt to BIS reporting banks in mid-1997 only amounted to US\$28.8 billion (Table 2.1).

Nevertheless, market sentiments deteriorated following a series of events that began with the prime minister pinning the blame for the currency crisis on international investors involved in a conspiracy, and threatening to ban foreign-currency trading. Then the UEM-Renong share-purchase scandal came to light, highlighting the long-suspected close ties between local business groups and political leaders. The government was also reluctant to discontinue large infrastructure projects despite signs of overheating in the economy. All these factors led to the emergence of questions about the government's willingness to deal with the crisis and to address weaknesses in the economic structure, and about its commitment to doing so.

Currency and the stock market remained under pressure. The government tried to arrest the trend by announcing austerity measures including reducing government expenditure by 18%, tightening bank credit, curbing the import of big-ticket items, and delaying several large construction projects. However, by January 1998, the ringgit had depreciated by over 45% and the stock market index had fallen by about 50%. By the beginning of 1998, major banks were reporting financial difficulties.

Taiwan

Despite strong economic indicators, exchange reserves of over US\$80 billion in 1997, and very little foreign debt, Taiwan's currency and stock markets were also adversely affected by contagion. Between August and October 1997, an estimated US\$7 billion in reserves were used to defend Taiwan's currency. On October 17, the government

decided to let the exchange rate float. The NT dollar had depreciated by 15% by end 1997. The stock market index fell by 30% during September to mid-October in response to concerns about currency depreciation, and it only partially recovered after the currency was floated .

Hong Kong

Despite the fact that it had exchange reserves of about US\$90 billion in 1997, and a well-regulated financial sector, Hong Kong's currency and stock markets have also been affected by the crisis since mid-1997. Interest rates rose in defence of the Hong Kong dollar (which is pegged to the U.S. dollar under a currency board). The PRC pledged its support by announcing its willingness to use its exchange reserves to help defend the Hong Kong dollar and by committing to not devalue the yuan.

With the floatation of the NT dollar, however, attacks on the Hong Kong dollar intensified. On 23 October 1997, overnight interest rate rose to 280%, and the three-month interbank rate reached 20%. The Hang Seng Index fell by 23% over four days. Contagion then spread to global markets. The Dow Jones Industrial Average lost 554 points on October 27, the biggest point drop in its history. Equity markets in Brazil, Argentina, and Mexico also saw their biggest single-day losses.

Subsequently, a series of events, mainly triggered by developments in the region, led to further attacks on the Hong Kong dollar and to sharp drops in stock prices. The events that took place were as follows:

- 1) Failure of the local investment bank Peregrine Investment Holdings led to an 8.7% drop in the stock market index on 12 January 1998.
- 2) The sharp fall of the Indonesian rupiah led to another round of attack on the Hong Kong dollar. The three-month interbank rate reached 17% on 23 January.
- 3) Concerns about the weakness of the yen and further downward pressure on currencies in the region again sparked attacks on the Hong Kong dollar and caused stock prices to drop. On 11 June, the three-month interbank rate reached 15%, and the overnight rate reached 10%.

While the currency link remained unchanged during the crisis, the stock market index at its lowest point fell by about 60% from its height.

Singapore

Despite having, like Hong Kong, substantial exchange reserves (US\$71.4 billion in 1997) and a well-regulated financial sector, Singapore's currency and stock market were also adversely affected. The Monetary Authority had been allowing the Singapore dollar to depreciate since July 1997. By January 1998, the currency had dropped by 20% and the stock market index had fallen by 30%.

Korea

With a series of corporate failures starting in early 1997, Korea's financial sector came under heavy pressure. The pressure was greatest among merchant banks that heavily funded local corporations by borrowing foreign debt offshore. Total debt to BIS reporting banks as of mid-1997 reached US\$104.2 billion, of which 68% were one year and under and 65% were to banks (Table 2.1). As the banks' difficulties became known, the terms of their foreign borrowing deteriorated rapidly. In August 1997, the government had to restore confidence in the market by announcing a series of rescue measures including providing liquidity support, facilitating the disposal of nonperforming loans, and guaranteeing the foreign-debt liabilities of domestic financial institutions.

With the sharp drop in Hong Kong's stock market in October, and with reverberations in global capital markets, Korean banks' positions continued to deteriorate as a result of the drop in the prices of their emerging market investments, and of subsequent margin calls. The banks' rapidly worsening situation led to further retrenchment of international bank loans and to downward pressure on the Korean won. When the market reported that the Bank of Korea's "usable" reserve was only US\$6 billion, instead of the US\$31 billion reported at end October 1997, the won depreciated sharply despite government efforts to defend the currency.

As more corporate and bank failures occurred, including those of the larger Chaebols, the government had to take a majority stake in Korea First Bank and Seoul Bank. The government then negotiated a US\$57 billion international financial-support package with the IMF in December and supported domestic banks in their debt restructuring negotiations with international lenders. The depreciation of the won was only halted at year end after it was reported that disbursements of US\$10 billion in official assistance would be accelerated and that agreement on bank debt restructuring had been reached. The restructuring involved 33 Korean banks and 134 creditor banks covering a total of US\$21.8 billion in short-term loans. The won had dropped by 50% from end October to end December 1997. The stock market dropped by over 40% between mid-1997 and towards the end of 1997.

Philippines

The Philippines' currency and financial markets were much less affected than were those of the harder-hit countries in the region. Credit expansion and overheating of the economy were less prevalent, and the leverage levels of domestic enterprises were generally lower. In addition, the banking sector was better regulated. Nevertheless, by end 1997, the peso had depreciated by about 35% from July, and the stock market index had fallen by about 20%.

C. A Major Economic Setback

The Korean won rebounded at the end of December 1997, and the Thai baht, Malaysian ringgit, Singapore dollar, NT dollar, and Philippine peso all hit their lows in January 1998. The Indonesia rupiah remained volatile, reflecting increasing economic weakness and political uncertainty, and only hit its low in June 1998.

Although it seemed as if the currency crisis had been alleviated, problems in the financial sector accelerated, and overall economic growth slowed. Signs of severe retrenchment became increasingly apparent.

Many economies in the region were adversely affected by a combination of factors, which are listed below:

- 1) Domestic corporations' access to financing was severely reduced as a result of continuing problems in the financial sectors and of the withdrawal of international capital. (Thailand, Indonesia, Malaysia, Korea, and the Philippines had together recorded total net private capital outflow of US\$11 billion in 1997, as compared to total net capital inflow of US\$72.9 billion in 1996.)
- 2) High interest rates and austerity budgets set either by the IMF or by the governments themselves in order to defend their currencies severely affected economic performance.
- 3) A marked negative wealth effect brought about by sharp drops in stock and property prices significantly dampened aggregate demand.

Real GDP growth in the region slowed significantly in 1997 compared to 1996, particularly in the more severely affected countries. Thailand's GDP growth was negative 0.4%, compared to 5.2%. GDP growth slowed to only 4.7% in Indonesia, compared to 8%, and to 5.5% in Korea, compared to a previous 7.1%.

Note:

1. Chapter 2 uses the following sources extensively:
 - International Monetary Fund 1998c
 - World Bank 1998
 - Chronology of the Asian Currency Crisis and its Global Contagion

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Chapter 3. Crisis Management and the IMF

A. Governments' Responses and the IMF

Governments' responses to the crisis varied across the region. While some measures were effective, other actions likely exacerbated the situation. When the crisis worsened beyond their control, some countries requested the IMF's assistance. Thailand arranged a rescue package with the IMF in August 1997, Indonesia in October, and Korea in December. As a condition for extending financing, the IMF worked out individual programmes with each of the governments to manage the crisis and institute reforms. Malaysia, on the other hand, chose to handle the crisis on its own.

Malaysia

Even after the ringgit came under heavy attack, the Malaysia government avoided calling in the IMF and instead instituted its own austerity programme. Measures included the following (Chronology of the Asian Currency Crisis and its Global Contagion):

- 1) several multibillion dollar construction projects were delayed in September 1997;
- 2) a belt-tightening budget was announced in October; and
- 3) additional austerity measures were introduced in December, including reducing government expenditure by 18%, tightening bank credit and stock market fund raising, and curbing the import of big-ticket items.

In order to protect the financial sector and avoid systemic risk, the government also announced that banks would not bail out failing businesses, and it requested that the country's thirty-nine finance companies merge into five large companies.

These measures were well accepted by the markets. However, at the same time, the prime minister's widely reported confrontation with international investors and conflicts within the government caused concern among investors and increased the pressure on the market.

In September 1998, with the ringgit having fallen in value by nearly 40% since July 1997, the government fixed the exchange rate at ringgit 3.8 to 1 U.S. dollar and instituted exchange controls that included requiring central bank approval for currency conversions and stipulating that foreign investments in the stock market had to remain in the country for at least one year. The controls were subsequently lifted in February 1999 and were replaced by a set of exit taxes on capital withdrawals before September 1999.

B. IMF Programmes

Programmes adopted by the IMF in Thailand, Korea, and Indonesia were based on the assumption that a series of measures that had worked successfully elsewhere, most recently in Mexico between 1994 and 1995, would restore confidence in the market and attract private capital back to the countries. These measures broadly included the following:

- 1) Funding
 - commitment of official financing to provide reserves to the central bank
- 2) Structural reforms
 - restructuring of financial and corporate sectors to achieve greater market efficiency
- 3) Tight monetary policy
 - raising interest rates to defend and stabilize exchange rates
- 4) Tight fiscal policy
 - setting a surplus government budget to provide sufficient resources to cover anticipated carrying costs of financial restructuring and current account deficits

The initial programmes in each of the three countries provided for the following measures (International Monetary Fund 1998d):

Thailand

- Financial sector reform — closing nonviable financial institutions (fifty-six finance companies), intervening in weaker banks, and recapitalizing the banking system.
- Fiscal policy — government budget to achieve 1% GDP surplus in 1997/98 (increasing VAT tax rate from 7% to 10%).
- Monetary policy — raising interest rates to support the baht (overnight interest rates were often maintained at 17-27% over a one-year period).

Korea

- Financial sector reform — suspending operations of nine insolvent merchant banks, injected capital into two large commercial banks, required all commercial banks with inadequate capital to submit plans for recapitalization.

- Corporate sector reform — dismantling ties among government, banks, and businesses; phasing out cross guarantees within conglomerates.
- Fiscal policy — achieving a balanced budget through widening the base for corporate, income, and VAT taxes.
- Monetary policy — monetary tightening (overnight interest rates reached 11-27% over a seven-month period) and abolishing the daily exchange-rate band.
- Liberalization of trade and capital accounts.

Indonesia

- Financial sector reform — closing nonviable institutions (sixteen small banks) and merging state banks.
- Structural reforms — liberalizing foreign trade and investment, dismantling domestic monopolies, and expanding privatization programme.
- Fiscal policy — maintaining government budget surplus of 1% of GDP during 1997/98 and 1998/99 (by rescheduling major state-enterprise projects, discontinuing government subsidies, and adjusting administered prices, e.g., electricity and diesel prices).
- Monetary policy — maintaining tight monetary policy to stabilize the rupiah (overnight interest rates rose above 20% starting July 1997, and reached a peak of 90% in August 1998).

Programme Outcome

Despite the IMF's pledge of over US\$110 billion in total funding to Thailand, Korea, and Indonesia, foreign capital continued to withdraw from these countries. Net capital outflow started in mid-1997, accelerated during 1998, and continued even during 1999, albeit at a slower rate.

According to the IMF (International Monetary Fund 1999c), private capital recorded a total net inflow of US\$62.93 billion for the Asia-5 countries (Thailand, Korea, Indonesia, Malaysia, and the Philippines) in 1996, but reversed into a total net outflow of US\$22.13 billion in 1997, US\$29.61 billion in 1998, and US\$18.11 billion in 1999. The magnitude of the outflow was most evident in the commercial-bank sector.

Exchange rates also continued to depreciate sharply, even after the programmes had been implemented. For Thailand, the baht did not start to stabilize until first quarter 1998 — about half a year after the start of the IMF programme — and then it remained at only about 60% of its pre-crisis level. The Korean won also started to stabilize during the first quarter of 1998 — more than three months after the IMF first became involved — and also settled at only about 60% of its previous level. The Indonesian rupiah was much more volatile and did not start to stabilize until third

quarter 1998 — approximately a year after the IMF programme began — and it remained at only about 20% of its previous level.

Equity prices likewise continued to fall sharply despite IMF involvement. By end 1997, equity prices had fallen by about 70% in Thailand, by almost 80% in Indonesia, and by about 60% in Korea.

The massive capital outflows from the banking sector, rapid currency depreciations, and sharp drops in asset prices cumulated in severe economic contractions for all three countries. GDP growth in 1998 was -10% for Thailand, -5.8% for Korea, and -13.7% for Indonesia.

As the IMF itself pointed out in its preliminary assessment report, “the programme projections badly misgauged the severity of the downturn”. The report continued:

The depreciations had strong expenditure-reducing effects via their impact on the balance sheets of financial institutions and corporations. Further balance sheet effects came from sharp drops in asset prices and the disclosure of existing problems in portfolio quality. The resulting wealth effects and disruptions to financing, along with adverse effects on confidence, were reflected in a collapse of domestic investment and a severe decline in consumption associated with the sharp economic downturn (International Monetary Fund 1999a, 119).

Programme Modifications

As it became increasingly apparent that economic conditions were deteriorating in all three countries, the IMF had to revise its projections and repeatedly modify its programmes (International Monetary Fund 1998d). It agreed to adjust Indonesia’s 1998/99 budget from a surplus of 1% of the GDP to a deficit of 1% of the GDP in January 1998, and to an even more pronounced deficit of 8.5% of the GDP in June, as the severity of the downturn became clear. It also agreed to let Thailand revise its 1997/98 budget from a surplus of 1% of the GDP to a deficit of 2% of the GDP in February 1998, and again to a deficit of 3% of the GDP in May. Korea’s balanced-budget plan for 1998 was revised to a deficit of 1% of the GDP in February 1998, to a deficit of 2% of the GDP in May, and eventually to a deficit of 5% of the GDP in July, as the economy rapidly lost ground.

In Indonesia, where economic contraction was most severe, the IMF had to delay its plan to eliminate subsidies, and instead provided in June 1998 for increasing the government’s social expenditure to a level equivalent to 7.5% of the GDP, allowing for the provision of subsidies for food, fuel, medical supplies, and other goods.

In the area of financial-sector reform, the IMF had taken the position that closing nonviable financial institutions early in the programme would induce greater confidence in the banking sector. In all countries, the closing of financial institutions led to depositor runs on the banking system, and even the healthier banks were jeopardized. In Thailand and Korea, the crisis to the banking system was subsequently

alleviated by the extension of government guarantees to depositors. However, for Indonesia, the programme had to be revised.

In line with the IMF's advice, the Indonesian government closed sixteen small banks in November 1997 but extended only partial guarantees to depositors (covering only up to the rupiah equivalent of about US\$5,000). This led to widespread depositor runs on the banking system as larger depositors became alarmed and transferred their funds to either state or foreign banks, or overseas. Many banks soon faced growing liquidity shortages. This situation was only rectified in January 1998 when the government, under an agreement with the IMF, provided full guarantees on all bank liabilities for two years. It was also reported that the IMF subsequently dropped its demand for further bank closures in Indonesia (Radelet and Sachs 1998).

Review of IMF Programmes

Many reviews, including the IMF's own preliminary assessment in January 1999, have criticized various aspects of the programmes implemented in Asia by the IMF since the onset of the crisis. One underlying criticism of the programmes was their adherence to what the fund regarded as tested measures based on its experience elsewhere (primarily in Latin America), and the fund's consequent failure to take into account the Asian economies' specific conditions at the time of the crisis. Some criticisms of the IMF's major policies are summarized below.

- 1) Unlike countries with which the IMF had previous experience, in which the crisis primarily resulted from the monetization of fiscal imbalances, government budgets in all three of the Asian countries were in good shape until the crisis, and were not its cause. Thailand had a budget surplus of 1.9% of GDP in 1996, Korea of 0.3%, and Indonesia of 1.2%.

Ignoring this fact, the IMF programmes initially prescribed additional tight fiscal policies. This imposed more hardships on the three economies, adding to those they had already weathered as a result of massive capital outflows, and thus contributed further to their downturn. Eventually, the programmes' fiscal targets had to be revised – and on an increasingly expansionary basis (as noted above) – in order to ameliorate the growing economic contraction in the three countries.

- 2) Raising interest rates to defend exchange rates during the crisis imposed heavy pressure on businesses, particularly since companies in the three countries were generally highly leveraged. This resulted in additional financial difficulties for companies that were already suffering from currency depreciations, and thus contributed to the overall contraction in economic activities.

The IMF's preliminary assessment report reviewed various studies of whether higher interest rates were useful for supporting exchange rates or whether they rather had the opposite effect. The report found the studies inconclusive (International Monetary Fund 1999a, 74-75). Nevertheless, the question remains as to whether tight monetary policy necessarily has a direct positive effect on exchange rates, and as to whether the policy should be pursued regardless of its adverse effects on the economy. As it turned out, the currencies of all three

countries continued to depreciate for extended periods of time (as noted above), even after monetary policies were tightened.

- 3) IMF programmes implemented to effect financial-sector reforms were based on the assumption that the restructuring of the sector, including the closure of nonviable financial institutions, would restore market confidence such that depositors would maintain their deposits and creditors would continue to roll over their loans as they fell due.

The assumption turned out to be incorrect. Once the reforms were put into place, panic spread across the banking systems of all three countries. Even relatively strong private banks came under intense pressure as foreign creditors stopped rolling over their short-term loans and depositors transferred their funds to state and foreign banks. By early 1998, the banking systems in the three countries had ground to a near halt. Foreign banks that had lent extensively to domestic financial institutions withdrew their credit and even stopped accepting letters of credit opened by domestic banks. Domestic companies, including many exporters, had difficulty finding banks to service their needs. Banks were either charging high interest rates or did not have the funds to make new loans (Radelet and Sachs 1998, 35). This further contributed to the overall economic downturn.

It has been argued that while financial sector weaknesses existed in all three countries, and reforms were required, the IMF failed to devote sufficient attention to the method and timing of the reforms so as not to jeopardize the financial system and create a creditor panic (Radelet and Sachs 1998, 33).

Lack of Private Sector Involvement

Unlike that of Latin America countries, with which the IMF had previous experience, foreign capital in the three Asian countries was primarily invested in the private sector (mainly in the financial sector in Thailand and Korea and in the corporate sector in Indonesia). In addition, as will be discussed below, foreign capital (in particular, bank debt) had in the years leading up to the crisis been an important source of finance for the three countries. Once this capital withdrew, the domestic economies would be severely affected.

The IMF programmes typically provided available lines of credit to governments to be used as reserves as required. The funds were to be disbursed to the government in stages and each time only after the IMF and the individual government had agreed on specific terms and conditions. The funds were therefore not readily and directly available to the private sector as a source of support in the face of a creditor run. The IMF operated on the assumption that once the lines of credit were available and the programmes were in place, foreign creditors would be willing to roll over their loans and thus create a “virtuous circle” under which exchange rates would stabilize.

As it turned out, the assumption was wrong. Since foreign creditors mainly lent to the private sector, which had no direct access to IMF funds, they had to base their credit decisions on the overall economic environment as well as on their debtors’ individual

viability under the situation. Considering the severe downturn of the economy (in which exchange rates were rapidly deteriorating, interest rates were high, and bank closures and corporate bankruptcies had become commonplace) and the increasing lack of liquidity in the market, it was not unthinkable that foreign creditors would withdraw their capital. As a result, instead of the “virtuous circle” that the IMF had expected to create, what transpired was a vicious circle of massive capital withdrawal, further currency depreciation, and even greater economic contraction.

Moreover, an important part of the IMF programmes’ focus was on raising confidence by instituting structural reforms in the financial and corporate sectors. These reforms would often involve amassing substantial amounts of funds, as well as making fundamental changes to the countries’ regulatory and legal systems, both of which would take considerable time. The reforms failed to address the short-term concerns of foreign creditors regarding the immediate viability of the borrowers or those of investors regarding the value of the securities they held, and they were therefore ultimately ineffective in stopping the tide of capital withdrawal.

The IMF itself acknowledged in its preliminary assessment report that:

In each of the programs (but particularly in Indonesia and Korea) very large official financing packages, together with sound economic policies, were intended to restore confidence and limit private capital outflows. However, the programs were not initially successful in restoring confidence, and private capital outflows far exceeded program projections.... An obvious question is whether more direct action should have been taken at an earlier stage to limit these outflows by attempting a rescheduling of private external debt (International Monetary Fund 1999a, 34-36).

It has become increasingly clear to the international community that since one of the immediate causes of the crisis was a withdrawal of private capital, the IMF programmes were by themselves insufficient. In spite of the IMF’s intervention, massive capital withdrawals continued to take place. Once a system crisis of this nature was underway, what was needed was an arrangement to “bail-in” private capital, in conjunction with official programmes, to stem the capital outflow and to work towards an across-the-board restructuring of private sector debts.

In the case of Korea, when its banking sector faced mounting difficulties in rolling over short-term foreign debt, the U.S. government (led by the Federal Reserve Board and the U.S. Treasury) exerted pressure on foreign commercial banks to reschedule their debts. In addition, the IMF also agreed to accelerate the disbursement of its loan package as part of the arrangement (Radelet and Sachs 1998, 30). The restructuring of US\$21 billion worth of short-term bank debt was agreed upon in January 1998, and this formal arrangement to halt capital withdrawal seemed to have restored confidence and to have helped the won and the stock market recover. The currencies and stock markets of other countries in the region, with the exception of those of Indonesia, also seemed to have stabilized during first quarter 1998 as a result.

No similar effort to organize an across-the-board restructuring of private-sector debt occurred in either Thailand or Indonesia. The Thai government guaranteed all

liabilities owed by Thai commercial banks in January 1998, including liabilities to foreign creditors. However, repayment of corporate debt generally fell into partial suspension, and attempts at negotiating rescheduling remained piecemeal and often inconclusive. In January 1998, the Indonesia government also provided guarantees on all commercial bank liabilities, both to foreign and domestic depositors and to creditors. However, the bulk of the country's foreign debt was in the private nonbank sector rather than in financial institutions, and it was more difficult for the government to co-ordinate any debt restructuring. Debt payments were largely suspended, and attempts at debt-restructuring negotiations took place mainly on a case-by-case basis.

In light of the example of Korea, it has been suggested that, in the case of a massive capital withdrawal by private-sector creditors, there is a need for a general moratorium on debt servicing, and for a mechanism to bring international creditors and domestic debtors together for collective negotiation and debt restructuring (Radelet and Sachs 1998, 42).

The IMF itself acknowledged that there was no “straightforward mechanism” to “assure the concerted involvement of the private sector” when it worked on its programmes for Asia (International Monetary Fund 1999a, 34), and suggested that this was an issue to be addressed in discussions about a new international financial architecture.

Chapter 4. Underlying Causes of the Crisis

A. Introduction

The Asia Crisis's distinctive feature was its rapid development from initial speculative currency attacks into full-scale financial and economic crisis, and the subsequent widespread contagion across the region. The vulnerability of the Asian economies was largely unexpected in view of their solid growth record during the past decade, particularly in the cases of Thailand, Korea, Indonesia, and Malaysia.

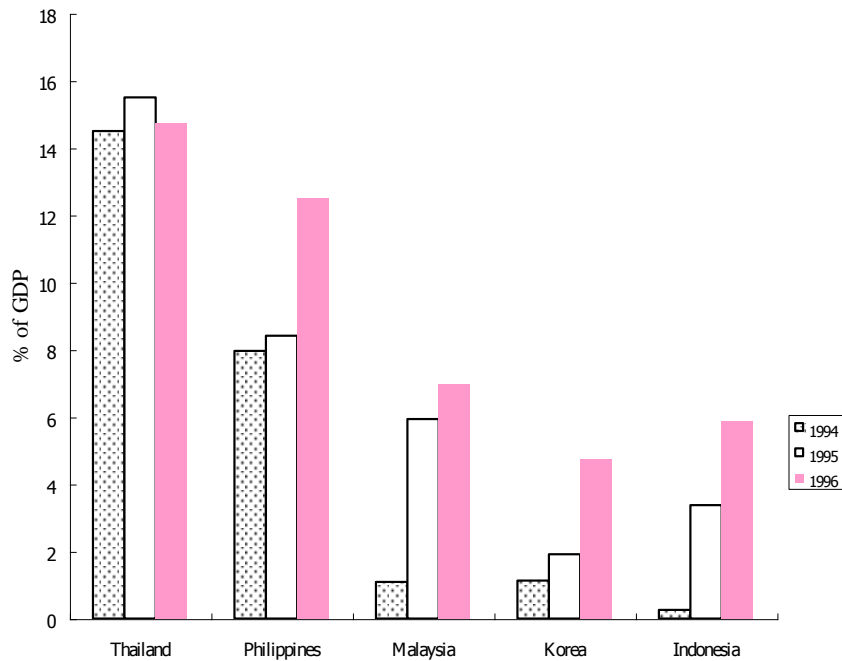
In analysing the crisis in retrospect, various explanations have emerged, citing both cyclical and structural causes. One major cause of the crisis lies in the monetary policies pursued by many Asian countries to support their managed, or pegged, exchange rates during the period before the crisis. As a result of these policies, increases in international capital flows into these countries translated into excessive monetary growth in their domestic markets, and led to overheating. This situation was further exacerbated by adverse developments in the global economy, as well as by Japan's extended recession. Once problems started to appear in these countries' financial and corporate sectors and the crisis was triggered, the intrinsic instability in international capital markets led to massive capital outflows and contagion, resulting in severe economic downturns across the region.

B. International Capital Flow and Excessive Monetary Growth

The fast growth of the Asian economies during the period 1990-97 coincided with the rapid expansion of global capital markets and the increasing flow of capital to the "emerging markets". The World Bank study on East Asia (1998, 4) reported that during the same period, the volume of private capital flows to developing countries rose from US\$42 billion in 1990 to US\$256 billion in 1997, growing by nearly 30% annually. This contrasted sharply with the growth in world trade, which reached only about 5% per annum during this time.

Commercial bank debts and portfolio investments generally set the pace of growth in private capital flows to the "emerging markets". Increasing liquidity and the overall slower growth environment in developed countries during this period prompted financial institutions and investors to seek higher returns overseas. Asia, with its rapid growth, relatively sound macroeconomic management, and stable currencies, attracted the bulk of the capital. Between 1994 and 1996 in particular, net private capital inflow into Asian countries expanded rapidly as a share of the GDP. In 1996, the share reached about 5% in Korea, about 6% in Indonesia, and over 7% in Malaysia. Thailand's share, on the other hand, had already reached over 14% in 1994 (World Bank 1998, 6, Figure 1.3) (Figure 4.1).

Figure 4.1: Net Private Capital Flows to East Asia, 1994-6



Source: Adapted from *World Bank Global Development Finance*, The World Bank, 1998

IMF sources revealed that net private capital inflow for the Asia-5 countries rose from US\$24.9 billion in 1990 to US\$35.1 billion in 1994, and then rapidly expanded to US\$62.9 billion in 1995 and US\$72.9 billion in 1996 (International Monetary Fund 1998c, 13) (Table 4.1).

Table 4.1: Private Capital Flows to Asia, 1990-97 (US\$, billion)

	1990	1991	1992	1993	1994	1995	1996	1997
Asia								
Total net private capital inflows ¹	19.1	35.8	21.7	57.6	66.2	95.8	110.4	13.9
Net foreign direct investment	8.9	14.5	16.5	35.9	46.8	49.5	57.0	57.8
Net portfolio investment	-1.4	1.8	9.3	21.6	9.5	10.5	13.4	-8.6
Other	11.6	19.5	-4.1	0.1	9.9	35.8	39.9	-35.4
Net external borrowing from official creditors	5.6	11.0	10.3	8.7	5.9	4.5	8.8	28.6
Affected countries' net private capital inflows ²	24.9	29.0	30.3	32.6	35.1	62.9	72.9	-11.0
Net foreign direct investment	6.2	7.2	8.6	8.6	7.4	9.5	12.0	9.6
Net portfolio investment	1.3	3.3	6.3	17.9	10.6	14.4	20.3	11.8
Other	17.4	18.5	15.4	6.1	17.1	39.0	40.6	-32.3
Affected countries' net external borrowing from official creditors	0.3	4.4	2.0	0.8	0.7	1.0	4.6	25.6

Sources: IMF, *International Financial Statistics* and *World Economic Outlook* database.

¹Net foreign direct investment plus net portfolio investment plus net other investment.

²Indonesia, Korea, Malaysia, the Philippines, and Thailand.

Faced with such large capital inflows, countries which had maintained managed, or pegged, exchange rates, such as Indonesia, Thailand and Malaysia, largely opted to absorb the inflow by creating domestic liquidity rather than let their exchange rates appreciate. As a result, these countries experienced excessive monetary growth, with money and credit growth rates at times reaching in excess of 30% per annum (Greenwood 1999).

C. Weaknesses in the Economies

The cyclical problem of massive capital inflow and excessive monetary growth in the region was exacerbated by a number of largely structural weaknesses within the domestic economies, which rendered the countries susceptible to crisis.

1) Moral Hazard, and Reliance on Short-Term Foreign Debt

Bank debt accounted for the major portion of the capital flows to Asia, and a substantial part of the debt was short term in nature. The effective peg of most Asian currencies to the U.S. dollar over an extended period created a problem of moral hazard and prompted short-term and often unhedged borrowings among domestic institutions. This was further encouraged by the interest rate differentials existing in many Asian countries in favor of borrowing in US dollars (Greenwood 1999). The World Bank (1998, 6) estimated that East Asia generally absorbed nearly 60% of all short-term capital flows to developing countries. In terms of bank borrowings, BIS reported that as of mid-1997, short-term (up to and including one year) borrowings accounted for 65.7% of Thailand's total foreign bank debt of US\$69.4 billion, 59% of Indonesia's US\$58.7 billion, 68% of Korea's US\$104.2 billion, and 56.4% of Malaysia's US\$28.8 billion (Bank for International Settlements 1999, 5) (Table 2.1).

**Table 4.2: Distribution of International Bank Lending by
by Nationality of Reporting Banks**

Position vis-à-vis		Total claims in billions of US\$	European Banks	North American Banks	Japanese Banks	Other Banks
end-1996	Developing Countries	708.2	50.2	17.6	19.8	12.4
mid-1997		746.9	52.1	16.1	19.4	12.4
end-1997		770.6	56.0	15.8	17.6	10.6
mid-1998		736.1	57.9	15.9	16.1	10.1
end-1998		705.9	55.1	15.7	15.1	14.1
mid-1999		696.7	55.0	16.4	13.3	15.4
end-1996	Asia	367.0	42.2	11.0	32.3	14.5
mid-1997		391.2	44.0	10.1	31.7	14.3
end-1997		378.7	47.5	9.8	30.3	12.5
mid-1998		324.8	49.6	9.0	30.3	11.1
end-1998		297.9	47.3	8.7	28.8	15.2
mid-1999		287.0	48.1	9.8	26.1	16.0
end-1996	Latin America	242.4	54.2	31.2	6.4	8.3
mid-1997		252.3	58.6	27.6	5.8	8.0
end-1997		281.4	61.7	26.1	5.2	7.0
mid-1998		295.7	62.0	25.7	5.0	7.3
end-1998		288.5	58.4	25.6	5.0	11.0
mid-1999		283.4	58.2	26.0	4.2	11.7
end-1996	Middle East	48.6	66.0	8.9	5.8	19.3
mid-1997		50.9	64.0	10.0	5.8	20.2
end-1997		52.4	62.1	10.9	6.5	20.5
mid-1998		57.3	62.4	10.4	5.3	21.9
end-1998		63.1	58.6	10.2	6.2	25.0
mid-1999		67.5	56.7	9.5	6.1	27.8
end-1996	Africa	50.2	74.5	8.6	6.9	10.0
mid-1997		52.5	70.0	11.9	6.5	11.6
end-1997		58.1	78.3	9.9	4.8	7.1
mid-1998		58.3	79.5	9.7	4.0	6.7
end-1998		56.4	76.0	8.1	3.3	12.5
mid-1999		58.8	71.6	9.9	2.8	15.7
end-1996	Eastern Europe	103.0	79.5	9.3	3.9	7.3
mid-1997		116.5	79.3	10.1	3.4	7.3
end-1997		123.0	80.4	8.9	3.4	7.3
mid-1998		133.4	80.3	9.7	3.1	6.9
end-1998		121.6	81.7	5.6	3.2	9.5
mid-1999		112.9	79.5	5.7	2.5	12.3

Source: *International Banking and Financial Market Developments--BIS Quarterly Review*,
June, 1998, November, 1998, June, 1999.

The high weighting of short-term foreign bank debt within the capital inflow rendered the economies vulnerable to any sudden reversal. One indication of this vulnerability was the ratio of short-term foreign debt to foreign-currency reserves. By mid-1997, this ratio had reached 1.5 in Thailand, 1.7 in Indonesia, and 2.1 in Korea. These ratios were much higher than those of most developing countries during the same year. Malaysia, which had substantially less foreign debt, had a ratio of 0.6 (Radelet and Sachs 1998, 9, Table 3) (Table 4.3).

Table 4.3. Short Term Debt and Reserves, 1994 and 1997 (US\$, millions)

Country	June 1994			June 1997		
	Short-Term Debt	Reserves	Short-Term Debt/Reserves	Short-Term Debt	Reserves	Short-Term Debt/Reserves
Argentina	17,557	13,247	1.325	23,891	19,740	1.210
Brazil	28,976	41,292	0.702	44,223	55,849	0.792
Chile	5,447	10,766	0.506	7,615	17,017	0.447
Colombia	3,976	7,718	0.515	6,698	9,940	0.674
India	5,062	16,725	0.303	7,745	25,702	0.301
Indonesia	18,822	10,915	1.724	34,661	20,336	1.704
Jordan	647	1,291	0.501	582	1,624	0.358
Korea	35,204	21,685	1.623	70,612	34,070	2.073
Malaysia	8,203	32,608	0.252	16,268	26,588	0.612
Mexico	28,404	16,509	1.721	28,226	23,775	1.187
Pakistan	1,708	2,307	0.740	3,047	1,249	2.440
Peru	2,157	5,611	0.384	5,368	10,665	0.503
Philippines	2,646	6,527	0.405	8,293	9,781	0.848
South Africa	7,108	1,755	4.050	13,247	4,241	3.124
Sri Lanka	511	1,983	0.258	414	1,770	0.234
Taiwan	17,023	90,143	0.189	21,966	90,025	0.244
Thailand	27,151	27,375	0.992	45,567	31,361	1.453
Turkey	8,821	4,279	2.061	13,067	16,055	0.814
Venezuela	4,382	5,422	0.808	3,629	13,215	0.275
Zimbabwe	704	534	1.319	731	447	1.635

Sources: Steven Radelet and Jeffrey Sachs, *The East Asian Financial Crisis: Diagnosis, Remedies, Prospects*, Harvard Institute for International Development, April 20, 1998, table 3.

2) Financial-Sector Liberalization, and Inadequate Regulation

A large portion of the capital inflow from international markets was intermediated through domestic banking systems, particularly in Thailand and Korea, where financial institutions had borrowed heavily in foreign currencies.

Asian countries had generally implemented financial reforms in order to cope with the requirements of rapid economic growth. However, significant weaknesses continued to plague the regulatory and supervisory areas. The World Bank report cited specific areas that generally did not meet international standards. These included: low capital-adequacy ratios, weak legal lending limits on single borrowers or borrowing groups, loose asset classification systems and provisioning rules for possible losses, and inadequate disclosure requirements. Financial institution governance was weak, often leading to heavy direct or indirect influences by government policies. In addition, the institutional development of the financial sector was general lagging. Much of the credit was either evaluated on a collateral rather than a cash-flow basis, or provided on the basis of the borrowers' relationships to governments or bank owners (World Bank 1998, 34-35).

Against this background of weak regulatory and supervisory frameworks and loose market discipline, some of the countries' attempts at liberalizing their financial sector actually left the sector exposed to the instabilities of the international financial markets and rendered it even more vulnerable.

Financial liberalization occurred in many Asian countries during the 1990s. In Indonesia, a series of financial deregulations led to a tremendous expansion of the banking sector, with the number of private banks (including foreign and joint-venture banks) soaring from only 74 in 1988 to 206 six years later. Thailand introduced the Bangkok International Banking Facility (BIBF), and in 1993 permission was given to 46 domestic and foreign commercial banks to operate international banking business. The banks were allowed to borrow and lend in foreign currencies, both on- and offshore. Owing to its special incentives, the BIBF provided an important channel by which the domestic financial sector could raise short-term foreign-currency-denominated funds. In Korea, similar reforms in the mid-1990s increased the access of domestic banks to short-term international loans. (Radelet and Sachs 1998, 12-13; World Bank 1998, 35) Table 4.4 summarizes the structure of the financial sector in the Asia-5 countries immediately before the Asia Crisis.

Table 4.4. Structure of the Banking System Before the Crisis
(number of financial institutions)

	Private domestic commercial banks	State banks	Merchant banks	Finance or security co.	Foreign financial institutions	Total
Indonesia	144	34 ^a	0	0	44	222
Korea	26	8	30	53	52	169
Malaysia	23	1	12	40	14	90
Philippines	40	2	0	0	14	56 ^b
Thailand	15	5	0	108	14	142

- a. Includes 27 regional government banks.
b. Figures exclude thrift and rural banks.

Source : *East Asia: The Road to Recovery*, the World Bank, table 3.1.

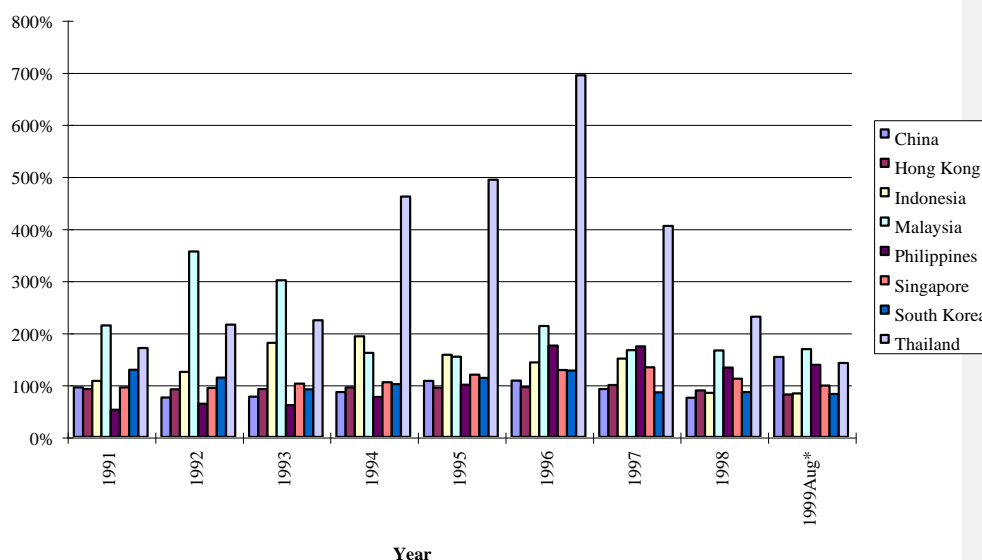
Financial liberalization in these countries actually created significant weaknesses in certain parts of the sector. In Thailand, finance companies that could not raise deposits had to rely on higher-cost funds, which created incentives for them to lend to riskier projects in order to generate higher returns. In Korea, the licensing and regulatory requirements for merchant banks permitted business groups to own both these banks and other group companies to which the banks lent, thus violating one of the key prudential banking regulations. In Indonesia, the number of banks expanded so rapidly that authorities had little time to screen the integrity and credit worthiness of the owners and managers. Many of the banks were also poorly capitalized (World Bank 1998, 9, 35-36). Also, as in Korea, many Indonesian banks were owned by politically well-connected individuals (or corporations) who used the banks to heavily finance the operations of affiliated companies (Radelet and Sachs 1998, 13).

In particular, rapidly growing nonbank financial institutions (NBFIs) – finance companies in Thailand and merchant banks in Korea – relied heavily on foreign-exchange borrowings. The NBFIs were generally less regulated and subject to weaker supervision than banks were, and their growth both in terms of numbers and in terms of credit expansion towards the mid-1990s directly exacerbated the systems' fragility (World Bank 1998, 36).

Past government policies in some of the countries also raised the issue of moral hazard within the financial sector. Financial crises had occurred in Thailand during 1983-87, in Malaysia during 1985-88, and in Indonesia during 1994. In all these cases, the crises were resolved through partial or full government bailouts. This reinforced the perception of an implicit government guarantee on deposits or even other bank liabilities, and probably resulted in all parties (including the financial institutions as well as their depositors/creditors) having even less regard for market discipline (World Bank 1998, 36).

Finally, by 1996, following significant growth in international capital inflows, the external exposures (foreign liabilities as a percentage of foreign assets) of the banking sector alone (not including NBFIs) had expanded to very high levels in many countries: close to 700% in Thailand, to about 200% in Malaysia, and to over 100% in Korea and Indonesia (Figure 4.2).

Figure 4.2. Banking Sector External Exposure (foreign liabilities/foreign assets)



Note: *Data of Malaysia is for July 1999

Source: *International Financial Statistics*, January 1999, IMF.

It is estimated that the external exposure levels of the NBFIs were even higher, particularly in Thailand and Korea, where they had been allowed to borrow foreign debt extensively. Moreover, as mentioned earlier, short-term debts accounted for the bulk of the foreign liabilities, thus creating maturity mismatches within the banking sectors and further compounding the risks they faced with regard to any capital reversals (World Bank 1998, 40-41, Figure 3.7).

By the time of the crisis, the combined effects of financial-sector liberalization, lagging regulation and supervision, loose market discipline, and heavy external exposures had rendered the financial sectors highly vulnerable to any economic downturn and to instability in the international capital markets.

3) High Corporate Leverage, and Protectionism

Weaknesses also built up in the corporate sectors. One of the distinguishing features of corporations in many Asian countries is the high level of leverage compared to that

of corporations on average in developed countries. Between 1991 and 1996, leverage doubled in Thailand and Malaysia and increased by one-third in Korea. The increase was particularly noteworthy in Korea, since Korean companies already had very high leverage levels. The World Bank reported that by 1996, leverage for the median firm had reached 340% in Thailand and 620% in Korea, compared to an average of 80% for the United Kingdom, 100% for the United States, and 160% for Japan (World Bank 1998, 55).

At the same time, profitability was declining. From 1991 to 1996, return on assets dropped from 8% to 1% in Thailand and generally declined in Indonesia and Korea, though at a slower rate. Among the Asia-5 countries, profitability increased only in Malaysia during this period (World Bank 1998, 55).

The high leverage ratios within the corporate sector were in many ways the outcome of these countries' growth strategies and often protectionist government policies. The countries generally pursued aggressive export-oriented strategies as the basis for economic growth. Exporters were often provided with incentives such as credit facilities, subsidized loans, and tax breaks.

This was most prominent in the case of Korea, where corporate leverage levels were generally the highest. A World Bank study in 1993 reported that in order to promote the heavy and chemical industries, for example, the Korean government provided high levels of tax exemptions and directed banks to extend preferential policy loans to the sector. It was estimated that during the height of the government's promotion effort in 1977, 45% of the total domestic credit of the banking system (which was at that time substantially owned and controlled by the government) was directed towards supporting the heavy- and chemical-industry sector. Even though the promotion was later abandoned during 1979-81, policy-related lending continued within the banking sector. It has been estimated that in 1993, about 40% of total domestic credit in Korea was still policy related (World Bank 1998, 55). Favoritism in credit allocation provided the large Chaebols with significant subsidies and fostered their growth. However, as the rate of return among the Chaebols fell, this practice of "cronyism" increasingly resulted in a misallocation of investible funds and slower economic growth (Krueger 1999).

It has been argued that protectionism in various forms among many Asian countries, ranging from import tariffs to crony capitalism (favoritism shown by the government to business groups), shielded the domestic economies from market competition and international best practices and standards, and ultimately created weaknesses and resource misallocation within the corporate sector which contributed to the crisis (Greenwood 1999).

The World Bank (1998, 56-60) outlined a number of factors contributing to protectionism and the lack of market discipline in corporate financing in many of the Asian countries:

1. Banks continued to suffer directly and indirectly from government involvement, and the pressure to lend to priority sectors and favoured corporations often weakened banks' efforts to ensure that borrowers were

creditworthy. In addition, interlocking ownership among banks and corporations also contributed to reducing the banks' independence and market discipline. Diversified conglomerates closely held, controlled, and managed by families were common in many Asian countries, and many such families also controlled banks, which in turn lent to the conglomerates.

2. Sources of long-term financing, typically in the form of pension and provident funds, were underdeveloped in many of the Asian countries. This lack of institutional investors left the task of enforcing market discipline almost entirely in the hands of the banking sector, which, as mentioned above, was often unable to exercise independent credit judgements.

3. The role of foreign banks in imposing international standards of credit evaluation and corporate governance was also limited. Most of the countries had a policy of protecting domestic banks from foreign competition by limiting the number of banking licenses granted to foreign banks and by imposing restrictions on such banks' activities.

4. Even among foreign banks and institutional investors, international standards of transparency, corporate governance, and credit measures were often overlooked in the face of Asia's rapid economic growth and buoyant financial markets. Country ratings were either stable or improving in each of the Asian-5 countries between 1995 and 1997, and did not fall until after the onset of the crisis (Radelet and Sachs 1998, 23). Also, reflecting the favourable outlook of international banks and investors, loan and bond spreads for borrowers in many of the Asian countries during the 1990s were generally lower than they were for other emerging markets, and they continued to decline up until the onset of the crisis.

5. The legal and regulatory framework for supervising corporations was not fully developed in many of the Asian countries. Corporate governance and disclosure requirements were often weak, even for publicly held companies.

4) Credit Expansion and Overheating

The combination of financial-sector liberalization and international capital inflows led to high liquidity and rapid credit expansion in many Asian countries. The World Bank reported that in Malaysia and Thailand, both bank and nonbank credits to the private sector began growing more quickly and on a sustained basis during the period of capital influx (1988-89 to 1996). The annual average credit growth rate as a ratio of GDP growth reached over 1.5 during this period in Malaysia, compared to under 1 during the previous five-year period. In Thailand, the ratio rose to above 2 for both the bank and the nonbank sectors, compared to about 2 for banks and under 1 for nonbanks previously. In Indonesia, on the other hand, credit growth to the private sector was lower during 1990-96, in part since financial reform had already taken place prior to this period, and also since the private corporate sector often directly accessed offshore foreign capital. In Korea, credit growth did not vary significantly during the period of international capital influx (1991-96) (World Bank 1998, 39, Figure 3.5). The credit-expansion trend became especially noticeable towards the

onset of the crisis. According to the World Bank, in 1996 and 1997, broad money (M2) expanded at a near 20% annual rate in the Asia-5 countries – nearly twice the rate of the PRC, Taiwan, Hong Kong, and Singapore (World Bank 1998, 7).

There is evidence that in some of the countries an increasing portion of the credit expansion was directed towards the nontraded rather than the traded sectors. In 1996, 31% of all loans and advances by the banking sector in Indonesia were to the service industry, compared with 18% in 1990. In Thailand, the proportion of total loans and advances to the construction, finance, real estate, and household (consumer credit) sectors increased from 36.8% to 41.9% from 1990 to 1995, and in Korea from 32.9% to 40.1% from 1990 to 1996 (Radelet and Sachs 1998, 21, Table 8) (Table 4.5).

Table 4.5. Loans and Advances by Sector (%Share)

<i>Sectors</i>	<i>Indonesia</i>		<i>Malaysia</i>		<i>Philippines</i>	
	1990	1996	1990	1996	1990	1996
Agriculture and Mining	9.0	6.0	6.4	2.4	13.8	6.5
Manufacturing	35.0	27.0	21.3	22.0	38.5	32.3
Construction			7.0	8.9	2.7	3.9
Trade and Transportation	34.0	24.0	16.5	12.1	18.2	22.2
Finance, and Real Estate			39.5	39.2	16.9	21.8
Service Rendering Industry	18.0	31.0				
Households: Consumer Credit			2.4	3.7		
Others	3.0	11.0	6.9	11.8	10.0	13.3

Korea

<i>Sectors</i>	<i>Total</i>		<i>Banks</i>		<i>Other Institutions</i>	
	1990	1996	1990	1996	1990	1996
Agriculture and Mining	6.6	5.0	10.3	9.9	1.1	0.5
Manufacturing	44.0	39.9	42.0	39.2	46.9	40.6
Construction	13.1	9.8	16.5	7.4	8.1	12.0
Trade and Transportation	12.8	11.7	10.1	10.4	16.6	12.9
Finance, and Real Estate	4.8	6.6	5.6	2.1	3.6	10.6
Households: Consumer Credit	15.0	23.7	12.2	28.3	19.1	19.6
Others	3.8	3.3	3.3	2.7	4.5	3.8

Thailand

<i>Sectors</i>	<i>Total</i>		<i>Banks</i>		<i>Finance Companies</i>	
	1990	1995	1990	1995	1990	1995
Agriculture and Mining	6.2	3.5	7.2	4.3	1.3	0.8
Manufacturing	23.7	23.1	25.1	25.8	17.1	14.3
Construction	3.8	4.1	4.0	4.4	2.7	3.1
Trade and Transportation	25.5	21.7	28.3	25.4	12.1	9.6
Finance, and Real Estate	19.2	21.5	17.0	17.4	29.6	35.0
Households: Consumer Credit	13.8	16.3	10.6	12.3	28.9	29.6
Others	7.9	9.7	7.8	10.4	8.2	7.7

For Indonesia: Banking System Credit by Economic Sector.

For Korea: Loans and Discounts of Deposit Money Banks and Other Financial Institutions.

For Malaysia: Loans and Advances of Commercial Banks.

For Philippines: Loans Outstanding of Commercial Banks.

For Thailand: Bills, Loans and Overdrafts of Commercial Banks and Finance Companies.

Source: Steven Radelet and Jeffrey Sachs, *The East Asian Financial Crisis: Diagnosis, Remedies, Prospects*, Harvard Institute for International Development, April 20, 1998, table 8.

Since an increasing portion of the credit expansion supported by capital inflows was directed towards the nontraded sectors, this weakened the countries' ability to service their foreign debt and thus increased their vulnerability.

At the same time, the overall quality of investment as measured by the incremental capital output ratio (ICOR) also dropped within this period. The ICOR (calculated as the ratio of the value of new investment to the change in output in a given year) for

Indonesia, Malaysia, and Thailand generally increased during the period 1993-95, indicating a deterioration in investment quality, as more investment spending was needed to support a given increase in GDP (Radelet and Sachs 1998, 22-23, Table 11) (Table 4.6).

Table 4.6. Incremental Capital-Output Ratios, 1987-1995

Country Name	1987-89	1990-92	1993-95
Indonesia	4.0	3.9	4.4
Korea, Rep.	3.5	5.1	5.1
Malaysia	3.6	4.4	5.0
Philippines	3.3	22.8	6.0
Thailand	2.9	4.6	5.2
Chile	2.9	3.3	4.4
Colombia	4.3	4.7	4.1
India	3.2	6.0	4.7
Mexico	8.9	6.5	11.7
Pakistan	2.8	2.9	4.9
Turkey	6.8	5.4	9.2

Source: Steven Radelet and Jeffrey Sachs, *The East Asian Financial Crisis: Diagnosis, Remedies, Prospects*, Harvard Institute for International Development, April 20, 1998, table11.

As the quality of investment deteriorated, earnings available to service the borrowings for the investment also declined, leading to weaknesses within the corporate sector. As mentioned earlier, corporate profitability showed a downtrend during the period leading up to the crisis. The corporate sector's excessive borrowings compared to its earnings meant that a large share of profits had to cover interest costs. By 1995, the share of firms whose interest expenses exceeded their profits had risen sharply for Thailand and Korea. By 1997, over one-third of all firms in the two countries were in this position. In both countries, electronics registered the lowest profitability in 1996, and in Korea, the industry also had the highest share of firms unable to cover interest on loans (World Bank 1998, 55-56). Declining profitability and rising interest costs generally reflected past overinvestment in production capacity.

In many of the Asian countries, the rapid credit expansion had led to overinvestment and to speculation in the real estate sector as well as in stock markets. Available data on central business-district real estate in key Asian cities showed high vacancy rates in a number of cities (especially Jakarta and Bangkok) in 1997 and relatively low rental yields, indicating a supply surplus (Table 4.7).

Table 4.7. Central Business District Office Vacancy Rates and Rental Yields

	Vacancy Rates		Rental Yields
	1997	1998-99	June-97
Seoul			9.50%
Jakarta	10.0%	20.0%	7.2%
Kuala Lumpur	3.0%	20.0%	5.80%
Manila	1.0%	3.0%	9.30%
Singapore	8.0%	12.0%	3.90%
Bangkok	15.0%	20.0%	6.80%
Hong Kong	6.0%	10.0%	3.50%
Shanghai	30.0%	40.0%	8.0%
Taipei			4.80%

Note: 1997 figures for vacancy rates are estimates; 1998-99 figures are forecasts.
Source: JP Morgan, *Asian Financial Markets*, January 1998.

Stock market indices also rose quickly in most countries in the region during 1990-96, although the markets had reached their peaks in Thailand and Korea in 1993 and 1994, respectively, and had started to drop (Corsetti, Pesenti, and Roubini 1998, Tables 9, 10) (Table 4.8).

Table 4.8. Stock Market Price Indices (year-end)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	Korea
Korea	696	610	678	866	1027	882	651	376	562	
Indonesia	417	247	274	588	469	513	637	401	398	
Malaysia	505	556	643	1275	971	995	1237	594	586	
Philippines	651	1151	1256	3196	2785	2594	3170	1869	1969	
Singapore	948	1214	1240	2087	1854	1917	1992	1508	1393	
Thailand	612	711	893	1682	1360	1280	831	372	356	
Hong Kong	3024	4297	5512	11888	8191	10073	13451	10722	10048	
China (Shenzhen) (Shanghai)	127	110 292	241 780	244 833	140 647	113 555	327 917	381 1194	343 1146	
Taiwan	4530	4600	3377	6070	7124	5173	6933	8187	6418	

D. Adverse External Developments

In addition to structural weaknesses and problems of overheating created by excessive monetary growth, many of the Asian economies also faced a deteriorating external environment in two major areas: 1) deteriorating terms of trade, and 2) the recession of the Japanese economy.

1) *Deteriorating Terms of Trade, and Current Account Deficits*

Trade has been a major source of growth among Asian countries. According to a World Bank report on the crisis, trade as a share of GDP increased considerably in East Asia (Asia-5 countries plus the PRC, the Hong Kong SAR, Singapore, and Taiwan) over the three decades prior to the study, rising from 15% in 1970 to over 50% in 1995 (World Bank 1998, 4). Exports reached a peak during first quarter 1995. Export growth (in U.S. dollars) reached over 20% in Thailand, Korea and Malaysia, and 13% in Indonesia. Starting in the latter part of 1995, however, growth began to decelerate rapidly. By 1996, export growth had slowed to 4% for Korea, 10% for Indonesia, and 6% for Malaysia, and it actually contracted 1% in Thailand. (World Bank 1998, 20, Table 2.1) (Table 4.9).

Table 4.9. Export Growth (dollar %)

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Thailand	14.9	23.2	14.2	13.2	22.7	25.1	-1.3	3.3	-5.1
South Korea	4.2	10.6	6.6	7.3	16.8	30.3	3.7	5.0	-2.9
Indonesia	15.9	15.1	14.6	8.7	8.8	13.4	9.7	7.3	-8.6
Malaysia	17.4	16.8	18.5	15.8	24.7	26.0	5.8	0.7	-6.9
Philippines	4.0	8.7	11.2	13.7	20.0	31.6	16.7	22.8	10.7
China	18.2	15.8	18.1	7.1	33.1	22.9	1.6	21.0	-3.9
Hong Kong	12.3	20.0	21.2	13.2	11.9	14.8	4.0	4.0	-7.5
Singapore	18.1	11.9	7.6	16.6	30.8	22.1	5.7	0.0	-10
Taiwan	1.6	13.4	6.9	4.0	9.6	20.2	3.7	5.3	-9.4
Japan	8.2	7.1	6.3	3.7	9.6	11.6	-7.3	2.4	-5.8
United States	5.0	9.5	8.0	6.6	10.3	14.1	6.9	10.2	-0.9
World	15.0	3.3	6.6	-0.3	13.6	19.5	4.1	3.4	-1.3

Source: *International Financial Statistics*, January and December 1999, IMF,

<http://www.stat.gov.tw/main.htm>

The following reasons for the slowdown have been noted (World Bank 1998, 20-22):

a) A large drop in world trade growth

World export growth had fallen by 20% (in U.S. dollars) from its 1995 peak to about 4% in 1996 – the largest drop in the past fifteen years.

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b) Appreciation of the U.S. dollar relative to the yen

The sharp depreciation of the yen starting in the second half of 1995 led to a worsening of cost competitiveness in those Asian countries whose currencies were effectively pegged to the dollar and whose export structure is similar to Japan's—in particular Korea.

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c) Real effective exchange-rate appreciation

Although effective exchange rates were stable in the region during the 1990s, some of the countries started to experience appreciation of the real effective exchange rate beginning in mid-1995 and continuing until the second quarter of 1997, leading to a fall in cost competitiveness. During this period, the real exchange rate appreciation in Thailand reached 12%, and in Indonesia 11%.

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d) Declining export prices

Export prices for a large number of industrial products declined starting in 1995. There were particularly sharp declines in the electronics industry, including in computers, semiconductors, and telecommunications. Korea, which had a heavy concentration in electronic products, was extremely hard hit.

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e) Devaluation of the yuan

It has been suggested that the over 30% devaluation of the official yuan exchange rate in 1994 adversely affected the export competitiveness of other Asian countries. The official exchange rate was lowered from 5.8 per U.S. dollar to the swap-centre rate of 8.7 per U.S. dollar in a unification of the dual exchange rates prevailing in the PRC at the time. However, the yuan's effective devaluation was actually much smaller. Since the swap centres already accounted for about 80% of the PRC's current-account transactions, the devaluation of the effective exchange rate (the weighted average of the official and swap centre rates) from 1993 to 1994 was estimated at only about 11%. Furthermore, between 1994 and 1996, the effective exchange rate actually appreciated by about 4% (Wong and Wong 1997). Therefore, it is not likely that China's devaluation had much of an adverse impact on other Asian economies during this period.

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A combination of the factors discussed above led to declining imports and widening current-account deficits. By 1996, current-account deficits reached about 3% of GDP in Indonesia, about 4% in Korea, about 4% in Malaysia, and about 8% in Thailand (although Malaysia and Thailand had already experienced large current-account deficits during the past decade) (Corsetti, Pesenti, and Roubini 1998, 12-17, Table 1) (Table 4.10).

Table 4.10. Current Account (% of GDP) NIA Definition

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Korea	-0.79	-2.83	-1.25	0.29	-0.96	-1.74	-4.42	-1.71	12.64
Indonesia	-2.61	-3.32	-2.00	-1.33	-1.58	-3.18	-3.37	-2.27	4.22
Malaysia	-2.03	-8.69	-3.72	-4.66	-6.23	-9.70	-4.63	-4.90	
Philippines	-6.08	-2.28	-1.89	-5.55	-4.60	-2.67	-4.77	-5.23	1.98
Singapore	8.33	11.25	11.91	7.21	16.09	16.95	15.64	15.61	20.86
Thailand	-8.37	-7.69	-5.65	-5.07	-5.56	-8.12	-7.98	-2.63	12.79
China	3.13	3.32	1.36	-1.94	1.28	0.23	0.88	3.29	3.04
Japan	1.48	2.00	3.03	3.08	2.78	2.16	1.43	2.25	3.19

Source: Calculated based on data from *International Financial Statistics Yearbook* 1998 and 1999, IMF

2) The Role of Japan

Japan plays a significant role in the region. During the 1990s, Japan was the major source of funds for many of the Asian countries as well as their major export market. The slow growth of the Japanese economy in the 1990s and recession during 1997-98 also adversely affected the Asian economies.

Major Source of Capital

Both bank loans and direct investments from Japan were major components of the massive flow of international capital into Asia in the 1990s. During this period, the government's easy monetary policy combined with the slow pace of growth of the domestic economy to encourage Japanese banks to expand aggressively overseas. According to BIS reports, Japanese banks accounted for about 13% of total international claims of reporting banks worldwide as of end June 1998, second only to Germany. In Asia, Japanese banks accounted for US\$98.5 billion (or about 30%) of total claims, far distancing other international banks (German banks accounted for 13%, French 11%, UK 9% and US 7%) (Bank for International Settlements 1999) (Table 4.2). In addition, Japanese companies have also been major investors in the region. According to the World Bank, Japan's FDI flow to Asia reached about US\$11 billion in FY1996 (The World Bank 1998, 118).

Key Export Market

Japan has also been an important export market for Asia. In 1996, it accounted for 27% of the total exports of Indonesia, 17% for Thailand, 14% for Korea and 13% for Malaysia. The World Bank estimates that 80% of these exports comprise intermediate inputs to products ultimately destined for the US and the European Union (The World Bank 1998). However, starting in 1997, the downturn of the Japanese economy adversely affected the export growth of its key trading partners in Asia.

The Asset Bubble and its Aftermath

Problems with the Japanese economy started in the second half of the 1980s with the burst of the asset bubble. Asset prices, most notably stock and land prices, rose sharply during this period and then declined rapidly during the first half of the 1990s. By 1996, asset prices were at about their levels of 10 years ago. During this period, the Nikkei 225 Index rose from under 15,000 to over 35,000 and dropped back to around 15,000. The Japan Real Estate Institute's land price index rose from about 40 to 100 in 1990 and then dropped back down to about 50 (Ito 1996, 215).

The creation of the bubble is often traced to the loose monetary policy pursued during the second half of the 1980s. The yen appreciated sharply from about 260 (per US Dollar) in February 1985 to 150 in August 1986. Under the currency agreements of 1985 (the Plaza Agreement) and 1987 (the Louvre Accord), the Japanese government agreed to purchase US dollars to halt the yen's appreciation. The subsequent creation of yen in the domestic market caused monetary growth to accelerate to about 12% p.a. from an earlier level of around 8% p.a. (Greenwood 1999). The official discount rate was lowered from 5.0% to 2.5% between 1985 and 1987 and was maintained at that low level until 1989 as there were little signs of inflation. Excess liquidity was created in the market. At the same time, the financial sector was being partially liberalized. While interest rates and credit expansion were rigidly controlled in the past, these were being de-regulated towards the latter half of the 1980s. Meanwhile, a new supervisory system more appropriate to the de-regulated environment had not been fully implemented. As a result, bank lending grew sharply during this period, particularly within the real estate sector, and land prices soared. (Ito 1996, 216-217)

During 1989-90, concerns about excessive land prices finally led to a turn around in monetary policy. Interest rate was raised five times between May 1989 and August 1990. Measures introduced to reduce the overheating included the introduction of a ceiling on bank lending to the real estate sector and tax revisions. While these measures finally put a halt to the increase in asset prices, they also triggered the burst of the bubble.

The result of the collapse of the bubble was that many financial institutions were severely affected. Many banks had lent extensively to real estate developers and construction companies during the bubble period. When these borrowers could not service their debts after the bubble burst, non-performing loans started accumulating

in the banks' portfolios. Corporations which had invested heavily in real estate and stocks also suffered losses. In addition, many of the banks and corporations had cross holdings of each other's stocks, especially those belonging to the same Keiretsu (horizontally or vertically integrated business groups). The sharp drop in the value of their shareholdings created additional strains on their balance sheets. These factors combined to produce negative impacts on both credit extension by the banking sector and investment by the corporate sector.

For the country as a whole, the negative wealth effect of the burst of the bubble, exacerbated by the sharp appreciation of the yen during 1993-95 which affected exports, led to an extended period of slow growth and eventual economic contraction. During 1992-94, Japan's growth rate did not rise above 1 percent. While the economy grew about 3% annually during 1995-96, it contracted during 1997 and 1998 with negative growths of -0.3% and -2.8% respectively.

These negative developments adversely affected the Asian countries. Exports to Japan slowed as its economy slid into recession. At the same time, Japanese banks, besieged by problems in their domestic market, started to withdraw capital from Asia, thus depriving the region of a major source of funds.

E. Instability in Capital Markets

The massive international capital flows into the region during 1994-96 were translated into excessive monetary growth in countries where government policies supported managed or pegged exchange rates. This was exacerbated by structural weaknesses inherent in many of the Asian economies and led to significant overheating. While these factors all contributed to the Asian crisis, it has also been argued that the severity, contagion and wide swings in capital flows that characterized the crisis can be traced to the inherent instability in international capital markets (Radelet and Sachs, 1998).

A number of causes have been suggested to explain the instabilities. These include:

- 1) Sudden shifts in market expectations and confidence; and
- 2) Globalization of financial institutions and advances in financial products.

1) Sudden Shifts in Market Expectations and Confidence

There is considerable evidence that international lenders and investors, many of whom were either new to Asia or only significantly expanded their exposure in the area in the 1990s, had built up expectations and confidence about Asian countries and borrowers during this period without having conducted sufficient due diligence. Once the weaknesses in the economies and institutions became known, their expectations shifted suddenly, leading to widespread panic and massive withdrawals of capital.

Loan and bond spreads — indications of perceived credit quality — had been lower for nonsovereign borrowers in many Asian countries than they had been for other

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emerging markets, mainly owing to the successful record of economic growth in the region. The World Bank (1998, 39) reported that:

Spreads declined even faster relative to borrowers from other emerging markets during the 1990s, and in late 1996 and early 1997 were often only marginally above those for long-maturity loans to U.S. corporations. This decline in spreads was often accompanied by poor evaluations of risk and performance; as late as May 1997, for example, investors were buying large amounts of short-term paper from Indonesian corporations with only a few days of due diligence.

It can be argued that when international lenders and investors channelled capital to Asia under the attraction of its impressive growth record, many did so without being fully familiar with conditions in the region. Most of the developed markets operated in various degrees within the "Anglo-Saxon model", under which economic activities were to be arms-length, market driven and regulated, and citizens, consumers and shareholders were to have ultimate sovereignty over governments and firms. These assumptions were carried over into the Asian markets. When problems started to emerge among some of the banks and corporations within the region, and the crisis was triggered, investors began to focus on structural weaknesses within the Asian economies and realized that the Asian growth model was in many ways different from the "Anglo-Saxon model" (Greenwood 1999). This realization led to a complete reversal of market sentiments and confidence. Country ratings dropped dramatically, lenders and investors panicked, and massive amounts of capital were withdrawn from the region.

According to the IMF report on international capital markets (1998c, 20-23), at end September 1997, spreads for Thai sovereign issues had risen slightly to 174 basis points, those for Indonesia were still favourable at 150 basis points, and those for Korea were 106 basis points. These spreads were still low compared to the all-time low of 335 basis points measured by the benchmark Emerging Markets Bond Index (EMBI; which is dominated by Latin American sovereign credits) during the first week of October. By the period December 1997-January 1998, however, spreads for Thailand, Indonesia, and Korea had shot up to peaks of 555, 979, and 890 basis points, respectively, while the EMBI spread remained at about 500 to 600 basis points. Evidently, after October, market sentiments had undergone a complete reversal with regard to the affected Asian countries, and had overreacted in the opposite direction. Over the first few months of 1998, spreads eventually settled to a lower level: 300 basis points for Thailand and about 400 for Korea. Spreads for Indonesia remained volatile for a longer period.

This dramatic reversal was prompted to a considerable extent by rating agencies' sharp shifts in country ratings. The agencies had maintained their generally high ratings for many of the Asian countries up to and even beyond the onset of the crisis. Once they lowered their ratings, they triggered a massive outflow of funds and arguably exacerbated the crisis. Korea, which was rated "investment grade" even when major bankruptcies started to appear in January 1997, provided a particularly dramatic example. The first downgrade occurred in October, at which point the

country was downgraded by only a notch. Only in December did a round of unanimous downgrades take place (International Monetary Fund 1998c, 52-53). When the rating agencies downgraded Korea to “junk-bond” status, it created a sudden shift in investor sentiments and an almost instantaneous exodus of funds. In Thailand, neither the severe attacks on the baht in May 1997 nor the floating of the currency in July had any effect on the country’s sovereign rating. A series of rating downgrades occurred only starting in September, and was followed by sharp increases in spreads. By end 1997, however, the ratings of Korea, Indonesia, and Thailand had all dropped from investment-grade to junk-bond status. Bond issues for Asia dropped from US\$14 billion during third quarter 1997 to only US\$2.7 billion during the fourth quarter (International Monetary Fund 1998c, 26-27, table 2.3). In an analysis of its record in rating Asian countries before and during the crisis, Fitch IBCA (1998), a Europe-based international rating agency, admitted that it had made mistakes in determining its previous ratings.

Another prominent feature of rating agencies’, investors’, and banks’ credit evaluations was their tendency to lump developing countries into a general “emerging market” category, and their frequent failure to make sufficient distinctions among countries or regions. Problems in one country could therefore easily trigger similar reactions in another, thereby exaggerating shifts and movements in capital and creating contagion across countries in the region. Thus, once the weaknesses in some Asian countries were identified, the sudden shifts in sentiment and the massive withdrawal of funds exerted severe pressure on economies across the region.

IMF statistics show that in 1996, total net private capital inflows into Asia reached a record high of US\$110.4 billion, of which the Asia-5 countries accounted for US\$ 72.9 billion. In 1997, net private capital inflows to Asia dropped to US\$13.9 billion. The Asia-5 countries experienced a net outflow of US\$11 billion. Only a significant net inflow of official loans to these countries, plus continued net inflows of foreign direct investments and portfolio investments, were able to partially offset a net outflow of US\$32.3 billion in the other areas (primarily bank loans) (International Monetary Fund 1998c, 13, Table 2.1) (Table 4.1). Some of the most dramatic reversals were in interbank loans, which were primarily short term and accounted for an important share of bank lending to Asian countries. BIS statistics showed that about US\$18 billion in interbank loans was withdrawn from Thailand alone during the last two quarters of 1997, and that US\$17.5 billion was withdrawn from Korea during the last quarter, representing about 30% of total interbank loans outstanding in the country at the beginning of the quarter (International Monetary Fund 1998c, 30-31, Table 2.4).

2) *Globalization of Financial Institutions, and Advances in Financial Products*

The globalization of financial institutions, aided by technological development, has allowed players in international capital markets to move substantial amounts of funds across borders and around the world almost instantly, thus creating the possibility of massively disrupting the markets.

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This potential for instability is exacerbated by the proliferation of financial products with higher risk profiles as well as linkages across different markets. The IMF reported that one of the major inflows of capital in the region was in the form of cross-currency “carry trade”, which was started as early as 1991-92 by international money centre banks in Malaysia. Carry trades were designed to take advantage of high domestic interest rates maintained by central banks to counter inflation, while keeping exchange rates stable. One of their common techniques was to borrow in U.S. dollars or yen in the interbank market, and convert the proceeds into local currency for on-lending in the local short-term interbank market or for investing in local money-market instruments. It was reported that as long as currencies were stable, carry trade generally yielded higher spreads than investments in the mature markets did. Once Asian currencies depreciated or the yen appreciated, however, the losses could be substantial and would trigger the withdrawal of funds.

By 1993, carry-trade activities had shifted from Malaysia to Thailand and Indonesia, at which point investment banks, which had expanded rapidly into the region (some setting up operations for the first time), became heavily involved. With increasing competition, more and more of the capital flows became invested in entities that were further down on the “credit spectrum” (from sovereign credits, to top-tier domestic banks, and then to finance companies and corporations), raising questions about the extent and quality of the due diligence performed by international lenders and increasing their exposure.

Domestic banks and corporations reportedly also engaged in carry trade on their own. In addition, they entered widely into cross-currency swaps with international banks to effectively lower the costs of their domestic currency borrowings (International Monetary Fund 1998c, 40-44). This extensive use of derivatives also greatly increased their exposure.

Finally, the frequent and often extensive use of leverage allowed market participants to take even larger positions than they normally could with their own funds, thus further magnifying movements in the market.

Leverage was widely used in the Asian and global capital markets. A prominent example of the extent of risks involved was the case of Long-Term Capital Management LP (LTCM), which was reported to have leveraged over 20 times and had to be rescued with a US\$4 billion package in September 1998, since there was serious concern as to whether its collapse or any uncontrolled unwinding of its positions would trigger a system risk in global financial markets. (Siconolfi, Raghavan and Pacelle 1998). A subsequent report commissioned by the United States government in the aftermath of the LTCM incident revealed that hedge funds were not alone in using leverages extensively. The report estimated the leverage levels of the top five U.S. investment banks to average 27 times, even higher than that of LTCM.

F. Conclusion

In the aftermath of the crisis, a number of key economic issues had been re-examined. There had been much discussion about the relative merits and weaknesses of fixed

and floating exchange rate regimes, and in particular the pegging of exchange rate for small open economies. It is arguable that rather than attempting to maintain their currency pegs in the face of massive capital inflow, many of the affected Asian countries should have instead allowed their currencies to appreciate. As it turned out, the capital inflows were translated into excessive monetary growth which, together with existing structural weaknesses in the economies, led to significant overheating and excess capacity. These economic problems were further aggravated by the countries' deteriorating terms of trade and a contracting Japanese economy. Once the crisis occurred, the instability in international capital markets, triggered by the realization of weaknesses in the structure and growth model of the Asian economies, led to severe economic downturns across the region with worldwide ramifications.

Concern with the instability of the international capital market also led to some support for imposing capital controls during periods of instability in order to halt the outflow of capital. This was expected to provide the affected countries with a “cooling off” period during which they could institute reforms and pursue measures which would otherwise be ruled out under the disruptions caused by speculative attacks and capital flight. Malaysia had pursued this option during the crisis.

To address the structural weaknesses in many of the Asian economies, significant reforms and restructuring in the financial and corporate sectors are required. At the same time, to reduce instability in international capital markets, the strengthening of regulatory measures for financial markets worldwide and greater coordination among countries and multilateral agencies will have to be explored. These issues are reviewed in the next chapter.

Chapter 5. Recovery from the Crisis, and Its Implications for Future Growth

A. Introduction

Recovery from the crisis was generally slow in 1998 but picked up remarkably in 1999. One of the main reasons for the slow recovery in 1998 was the slower than expected growth in exports which was originally earmarked as the key to the region's recovery from the crisis. In order to compensate for slow export growth, governments had to rely on expansionary policies to spur economic growth.

Recovery in many of the affected countries was faster than expected in 1999, largely due to a number of internal as well as external factors. First, monetary and fiscal policies remained generally expansionary throughout the year. Second, overall increase in trade demand both within and outside the region boosted exports. Japan's economy also showed signs of turning around starting the first half of the year. Third, reforms in the banking and corporate sectors were underway, although progress had been slower than expected in many areas. Finally, capital started to flow back into the region and provided some of the much needed financing.

This section reviews the progress of recovery among the various countries and their degree of success in restructuring the financial and corporate sectors. It also examines the progress that Japan has made in reviving its own economy and reforming its banking and corporate sectors, and the overall impact on the region's recovery. Finally, this section reviews capital flow trends as well as efforts within the international community to address issues raised by the crisis.

B. Asian Economies¹

Almost all the Asian economies that were affected by the crisis contracted in 1998 but recovered significantly in 1999, with a number of exceptions. The World Bank (2000b) provided 1998 GDP performance, 1999 growth estimates and 2000 projections for the more affected countries as follows: :

	1998 (%)	1999(%)	2000 (%)
Thailand	-10	4	5
Korea	-5.8	10.7	6
Indonesia	-13.7	0.5	3
Malaysia	-7.5	5.4	6

Export Growth

Exports had primarily led growth in most of the Asian economies in the past and were once again expected to lead the economies out of the crisis. However, export performance in the immediate aftermath of the crisis had been generally sluggish. The World Bank (1998, 28) estimated real currency depreciation to reach about 40% in

¹ The exchange rates used in this chapter are 8500 rupiah, 1100 won, 3.8 ringgit and 39 baht respectively to one U.S. dollar.

Thailand, about 57% in Korea, about 55% in Malaysia, and about 80% in Indonesia between July 1997 and July 1998. However, export performances in these countries were much worse than expected. In 1998, Korea's exports dropped less than others, having fallen to 4.9%, while that of Thailand, Malaysia and Indonesia were down 6.8%, 6.9% and 10.5%, respectively (World Bank 2000a).

One of the main reasons for the disappointing performance can be traced to the trade structures in these countries, and to the growing role of intraregional trade in total exports, in particular. The World Bank reported that in 1996 the share of intraregional trade accounted for about 40% of total exports in East Asian countries (Asia-5 countries plus PRC, Hong Kong, Singapore, and Taiwan), compared to only 32% in 1990. If Japan were included, the share would rise even higher, to 50%. About three-quarters of intraregional trade was in intermediates and capital goods, reflecting the complementary nature of the trade. As a result, contraction in the economies affected by the crisis caused a drop in export volumes in the region. In 1998, imports also generally declined. For Korea and Indonesia, imports dropped substantially, by 35.5% and 34.4%, respectively (World Bank 1998, 28). For Thailand, the decline was less severe, at 11.04%.

Other reasons cited for the decline in exports in the affected countries include: lower export prices as a result of greater competition, difficulties in obtaining financing as a result of problems in the banking sector, and problems with operating in a generally high-interest-rate environment.

In 1999, however, with the overall increase in global trade, the same regional interdependence that adversely affected exports earlier was largely responsible for spreading economic recovery throughout the region. Led by the strong performance of the U.S. economy, global trade was estimated to have expanded 5% during the year. In particular, the rapid rise in world demand in the electronics and semiconductor industries was a major source of export growth for a number of countries, especially Korea and Taiwan. The Japanese economy also started to turn around during the first half of the year and provided further support to the region's exports. Growth generated by these developments spread throughout the region through intraregional trade. As a result, export growth started to turn positive starting the second quarter of 1999 for Thailand, the fourth quarter for Indonesia, and was estimated to have reached 12% for Korea and 13% for Malaysia for the year (World Bank 2000a).

Expansionary Fiscal Policy

With severe economic contractions and failing export performances during 1998, the affected countries increasingly relied on expansionary fiscal policies to sustain their economies. These policies continued into 1999 and pathed the way for overall recovery.

The IMF agreed to budget deficits of 4.5% of GDP for Indonesia, 2.4% for Thailand, and 5% for Korea for 1998. The IMF agreed that budget deficits would continue into 1999: 3.0% of GDP for Thailand, 5.75% for Indonesia, and 5.1% for Korea (International Monetary Fund 1999b). The Malaysian government reported government budget deficits equivalent to 2- 3% of GNP in both 1998 and 1999.

Recapitalizing and Reforming the Banking Sector

One of the factors affecting economic growth is the ability and willingness of banks and financial institutions to lend again. In all of the affected countries, the restructuring and revitalization of the financial sector are crucial to restoring credit flow and to ensuring future economic growth.

Some of the first steps towards achieving this goal have been taken since the onset of the crisis. However, to fully rebuild the financial sector, a number of measures will need to be effected. These include:

- a) closing or merging weaker institutions;
- b) writing off and /or making sufficient provisions for bad debts; and
- c) recapitalizing the banks and financial institutions

In view of the extensive effects of the crisis on the financial sector, funding for the government to recapitalize the sector and complete the restructuring will require substantial resources both from multilateral agencies and from capital markets. The World Bank (1998, 49) has estimated that the costs of financial restructuring for some of the governments could reach as high as 30% of GDP.

Thailand

Thailand closed fifty-six of its ninety-one finance companies between June and August 1997 and set up the FRA and the AMC in October to manage and sell the financial sector's nonperforming assets. In addition, tighter loan classification and provisioning rules and capital adequacy standards were introduced. The Central Bank set capital reserves requirement at 8.5% of risk assets and ruled that all banks must be fully provisioned against problems loans by end 2000 and 40% provisioned by June 1999. The government's efforts eventually helped stabilize the banking system.

The FRA proceeded to liquidate the assets it took over from the fifty-six closed finance companies by selling them in auctions to both foreign and local buyers. Up to end 1999, proceeds from the asset liquidation by the FRA totalled 186 billion baht (US\$4.77 billion), representing a recovery rate of 27.98% on the 664.8 billion baht (US\$17.05 billion) outstanding principal balance of the assets it sold (World Bank 2000a). A portion of the assets, however, was purchased by the AMC as a bidder of last resort. Auctions of the FRA's remaining assets have been planned. Proceeds from the sales were to be distributed to the creditors of the closed finance companies.

In order to set up a legislative framework for financial institutions and buyers of their assets to enforce claims on borrowers and/or foreclose on underlying assets, the government introduced a number of bills during 1998-99, including bills to set up a specialized bankruptcy court, to streamline bankruptcy procedures, and to strengthen foreclosure rules. There were, however, delays in passing and implementing these bills.

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At the same time, as the economy continued to contract during 1998, the amount of bad debt multiplied. Nonperforming loans reached a peak of almost 48% in May 1999 (World Bank, 2000b) before declining to about 39% by year-end 1999, which was equivalent to about 2 trillion baht or about US\$51.3 billion. This still very high level of nonperforming loans has weighed down heavily on the financial sector. It forced banks to focus on keeping adequate funds to meet capital-adequacy ratios rather than on extending new loans. As a result, outstanding bank credits have been on the decline, despite the fall of lending rates to thirty-year lows. The amount of credit outstanding had dropped from 6.93 trillion baht at end June 1998 to 5.93 trillion baht at the end of the year (Fitch IBCA 1999) and continued to decline by another 5% during 1999. The contraction of credit had even more of a dampening effect on economic growth. To help alleviate the situation, the government has initiated the elimination of tax disincentives in order to encourage banks to establish Asset Management Companies to take over the nonperforming loans.

Six of Thailand's fifteen banks have been nationalized since the onset of the crisis. Privatization of these banks has been on the government's agenda as a means of introducing new funds and management into the sector. Efforts included the sale of a 75% stake in Nakornthon Bank to Standard Chartered Bank and 75% stake in Radanasin Bank to United Overseas Bank. However, the sale of two other major private banks - Bangkok Metropolitan and Siam City - had been repeatedly delayed. The sale of 75% of Bangkok Metropolitan to HSBC Holdings was only agreed in April 2000. At the same time, the privatization and/or restructuring of state-owned banks have also been pursued.

The remaining private banks, including two that were taken over by foreign partners (Thai Danu Bank by the Development Bank of Singapore and Bank of Asia by ABN Amro), are in urgent need of new funds to offset large nonperforming loans. The government has been pressuring the banks to recapitalize. All banks were required to submit recapitalization plans during January 1999. Five of the major banks were found to have sufficient capital to meet the government's minimum requirements until the middle of the year. The others had to sign agreements with the government that would bind them to recapitalization plans. To raise fresh capital, these banks had to either take up the government's recapitalization programme, form partnership with foreign investors and/or tap the capital markets. Under the government's recapitalization program, the banks have two options. The first calls for equity injection (Tier 1 capital) by the government, in which case the government would become a shareholder. The second is to take debt aid (Tier 2 capital) from the government, in which case a bank would exchange its long-term bonds for similar government bonds. The capital adequacy ratio for both Tier 1 and Tier 2 capital have to be kept at 8.5%.

In order to meet the June 1999 deadline for 40% loan loss provisioning, private banks had been turning to complex financing instruments to raise Tier 1 capital in the market while limiting their new lending. The World Bank (World Bank 2000a) reported that since January 1997, banks and finance companies in Thailand raised 817 billion baht (US\$20.95 billion) in capital, of which 762 billion baht (US\$19.54 billion) was Tier 1. Only three financial institutions, however, have received Tier 1 capital injections

from the government, with matching funds coming from private investors. In order to meet the deadline of end 2000 for full loan provisioning, banks had to update their recapitalization plans again in January 2000. It is expected that fund raising activities will further intensify during the year. While access to capital markets was initially difficult in the aftermath of the crisis, with the increase of capital inflow and market recovery in 1999, more banks are expected to be able to tap the market for funds.

Finally, the government has been reviewing draft laws to reform the financial system, including the Financial Institutions Law which would standardize the regulatory framework for the financial sector, and the Central Bank Act which would strengthen the operation of the central bank.

Korea

Korea closed down fourteen merchant banks between December 1997 and April 1998. A special fund was set up in August 1997 under the Korea Asset Management Corporation (KAMCO) to buy impaired assets from the financial sector, and banks were asked to submit plans for recapitalization in early 1998. All banks have been required to meet the minimum capital ratio of 8% by December 2000. In addition, the government has passed legislation to strengthen the role of the Financial Supervisory Commission and also set new criteria for loan classification and provisioning to be implemented by end 1999.

In general, the government has played an active role in the restructuring of the sector. Two major banks were nationalized in 1998, and a third in 1999. Mergers are being arranged or encouraged in order to help the industry consolidate. In June 1998, for example, the Financial Supervisory Commission ordered the closure of five weak banks and appointed five stronger banks to take over the closed institutions. A number of other mergers have taken place, and others are being discussed among the remaining banks.

As part of the process of financial-sector reform, Korea significantly liberalized foreign ownership in an effort to bring new funds and management expertise into the sector. The government attempted to sell two of the banks it nationalized — Seoul Bank and Korea First Bank. It reached agreement in September 1999 to sell 51% share of the latter to Newbridge Capital of the United States, and approved Deutsche Bank as an adviser to Seoul Bank in April 2000 after failing to close its sale. A 29.26% stake in the Korean Exchange Bank (27% owned by the government) was sold to Commerzbank in 1998, with ownership subsequently increasing to 30.4%. Allianz of Germany also took a 12.5% stake in Hana Bank in February 2000. Other foreign banks and investors have also engaged in discussions about taking equity interests in some of the other Korean banks. Foreign ownership and/or control of some of the major Korean banks is expected to introduce greater competition and to effect changes in the banking system in areas such as management, transparency, and credit-based rather than collateral or government-directed lending.

The government committed 64 trillion won (about US\$58.18 billion) to recapitalize and buy bad loans from financial institutions. KAMCO purchased about 55 trillion

won (US\$50 billion) in nonperforming loans from financial institutions during 1998-1999 for 23 trillion won (US\$20.9 billion). As of October 1999, it recovered more than 9 trillion won (US\$8.18 billion) through international auctions, issuance of domestic asset backed securities and sale of assets. More international auctions and domestic security placements have been planned and the recovery rate is expected to rise to 50% from 35% in earlier sales. In addition to on-going disposal efforts, KAMCO also plans to set-up joint venture asset management companies with foreign partners to purchase additional nonperforming loans and manage them (World Bank 2000b). Some banks are also considering setting up corporate restructuring vehicles with third parties to manage their own nonperforming loans.

As of September 1999, total nonperforming loans in the financial sector, including those acquired by KAMCO, were reported at 113 trillion won (about US\$102.73 billion), or about 18% of total loans outstanding (World Bank 2000b). However, with the Daewoo group undergoing debt restructuring, the level of nonperforming loans is expected to rise again.

Restructuring work will need to be further stepped up in the non-banking financial institutions sector (including merchant banks, investment trusts, and life insurance and fund management companies) which accounts for 57% of the total assets of the country's financial system.

Indonesia

The government closed sixteen small banks in November 1997 and another seven in April 1998. The Indonesia Bank Restructuring Agency (IBRA) was created in January 1998 to take over the management of weak banks and to dispose of nonperforming loans in the financial sector. IBRA also provided approximately US\$14 billion in emergency credit lines to fourteen banks during the crisis, in return for pledge of assets. The credit was to be repaid either by cash or by sale of the assets. The authorities also announced a sharp increase in minimum capital requirements for banks and tightened loan classification and provisioning guidelines for banks in January 1998, although these had to be revised.

The central bank also announced a series of tighter bank regulations aimed at reducing the banks' foreign exchange and credits risks. These included: lowering the allowed net foreign-exchange open position from 25% of a bank's capital to 20%, cutting the legal lending limit to related companies from 20% of a bank's capital to 10%, and reducing the legal lending limit to nonrelated groups from 30% to 20% over four years. In particular, the reduction of the legal lending limit to related companies was a much-needed reform aimed at addressing a widespread problem within the financial sector.

Out of 237 banks, 65 were eventually closed, 13 were nationalized, seven private banks were recapitalized, and the seven state banks had to be merged into four. The IBRA has been given responsibility for restructuring banks that were taken over by the government, many of which were judged too big to be allowed to fail. IBRA's plans include: selling Bank Bali (previous sale unsuccessful) and Bank Niaga; raising

capital for Bank Central Asia; and integrating the remaining banks into Bank Danamon which is to be privatized. The four remaining state banks would need to be recapitalized along with plans for management changes.

The government announced a plan to inject a total of 300 trillion rupiah (US\$35.29 billion) to recapitalize the banking sector. Some of the amount will go to state and regional development banks. The balance will be provided to selected private banks and is intended to comprise 80% of the amount needed to recapitalize these banks to meet the capital-adequacy ratio, on the condition that the private owners put up the remaining 20%.

However, the implementation of the programme is not likely to be smooth. First, the sources of funding required for the programme were not certain. Asset injection by the government into private banks would be in the form of bonds in return for nonvoting equity. The interest payments on the bonds would provide fresh funds to the banks. It was estimated that 34 trillion rupiah (US\$4 billion) would be needed to service interest in the 1999-2000 fiscal year. Of this amount, 17 trillion rupiah (US\$2 billion) would be provided from the budget, which would place a heavy strain on the government. The remaining 17 trillion rupiah was to be raised by the IBRA through debt collection and asset sales.

The reform of the financial sector is expected to continue to place a heavy burden on government budget and the economy as a whole. The cost to the government of restructuring the banking system has been estimated at up to 650 trillion rupiah (US\$76.47 billion). Total government bonds issued for bank restructuring are already estimated to reach 500 trillion rupiah (US\$58.82 billion) by March 2000, close to 60% of total central government debt (World Bank 2000b). Interest payment on these bonds will place a heavy burden on government budget. The government therefore faces significant pressure to continue to privatize and sell assets in order to raise funds and reduce deficit financing.

Despite the government's efforts, however, significant issues remain within the financial sector. Market sources estimate the level of nonperforming loans at 60-80% of total loans outstanding.

Malaysia

The Malaysian government has been taking an active and effective role in reforming the financial sector and in containing the effects of the economic downturn on the industry. In mid-1998 it set up an asset-management company, Pengurusan Danaharta Nasional, with proposed funds of 25 billion ringgit (US\$6.58 billion), to take over nonperforming bank loans, and a special-purpose vehicle, Danamodal Nasional, with proposed funds of 16 billion ringgit (US\$4.21 billion), to fund the recapitalization of banking institutions.

In July 1998, the government announced a plan for the consolidation of the financial industry covering 58 financial institutions (21 banks, 25 finance companies and 12 merchant banks), in order to improve the competitiveness of the domestic banking

industry and avoid bankruptcies. Initially, the program was formulated around anchor banks designated by the government, but this policy was subsequently revised in October 1999 to allow the banks to form their own groups. A total of ten groups were identified as of January 2000, and the mergers were to be completed by end 2000.

The level of nonperforming loans was reported at about 24% of total loans outstanding in December 1999, including loans transferred to Danaharta (World Bank 2000b). Danaharta has been working on the purchase of nonperforming loans from banks at about a 50-60% discount. By December 1999, it had acquired a total of 45.5 billion ringgit (US\$11.97 billion) in nonperforming loans from the banking system, reportedly completing the bulk of its purchases. By June 1999, Danamodal had injected a total of 6.4 billion ringgit (US\$1.68) into ten banking institutions. With the recovery of the economy, estimates for further recapitalization needs were revised downward (World Bank 2000b).

With its higher rating in the market and the alleviation of capital control in 1999, Malaysia is in a relatively favourable position compared to the other Asia-5 countries in terms of raising financing from both domestic and international capital markets to cover its funding needs.

Restructuring the Corporate Sector

Debt restructuring within the corporate sector can reduce the amount of nonperforming loans within the financial sector and thus contribute to the financial sector's recovery. In addition, in countries where there is surplus capacity, mergers and/or asset sales are being encouraged in order to streamline capacity and reduce costs. Finally, in order to eventually reestablish the corporate sector on a sounder basis, accounting and disclosure standards at international levels, and better corporate governance, are also required.

However, in most of the affected countries, corporate restructuring has proceeded slowly. One of the main reasons for this is the lack of adequate bankruptcy and foreclosure rules and procedures needed for creditors to enforce their claims. Also, whether in debt restructuring or in mergers, companies are often unwilling to relinquish ownership and control. These issues will need to be resolved before the economies can fully embark on the path of long-term recovery and stable growth.

Thailand

The government's position has been not to provide public support to corporate debt. Overall, the corporate debt-restructuring process had been very slow. Under the government's Corporate Debt Restructuring Advisory Committee (CDRAC) programme covering 6210 target cases with 2.3 trillion baht (US\$58.97 billion) in nonperforming loans, relatively few restructuring agreements have been reached (World Bank 2000b). Both within and outside the programme, the amount of corporate debt already restructured amounted to only a relatively small portion of the total amount of nonperforming loans still outstanding.

The progress of corporate debt restructuring has been slow owing to a number of factors: (1) reluctance on the part of debtors to relinquish shareholding and control; (2) unwillingness on the part of creditors to write down their loans, particularly in the case of Thai banks which are already undercapitalized; and (3) the still weak legal regime for debt recovery and collection. As a primary example of the delays encountered, Thai Petrochemical Industry (TPI), which had outstanding loans amounting to US\$3.5 billion, was only able to reach an apparent agreement with its creditors in early 2000 after more than two years of negotiation with its 148 lenders. The agreement allowed creditors to acquire a 30% stake in the company in exchange for conversion of a portion of its outstanding interest payments and also rescheduled principal repayments. However, the principal shareholder and chief executive of the company subsequently reneged on the agreement and creditors had to apply to court to declare the company insolvent and appoint a receiver. The court's decision in favour of the creditors served as a landmark for the country's corporate debt restructuring efforts. The ability to work out some of these highly visible debt restructurings might help speed up other cases under negotiation.

To accelerate the corporate debt restructuring process, the CDRAC created two civil contracts: the Debtor Creditor Agreement and Intercreditor Agreement, setting out procedures for negotiations, information sharing and approvals, as well as for mediation, compliance enforcement and court filings. As of November 1999, the agreements had been signed by 84 financial institutions and over 406 debtors (World Bank 2000a).

Korea

Since the onset of the crisis, the Korean government has taken steps to facilitate the restructuring of the corporate sector. These include liberalizing foreign investment, clarifying mergers and acquisitions rules, and providing tax incentives for and clarifying tax treatment of restructured debts.

The key to corporate-sector reform in Korea is the restructuring of the Chaebols, which have in the past been the country's main engines of growth, and which dominated the economy. Primarily family controlled, over the years the Chaebols built up extensive and diversified businesses that in recent years became highly inefficient and unprofitable. The top forty Chaebols reportedly accounted for 97% of the country's GDP. The five largest Chaebols are estimated to be responsible for more than a third of the country's entire sales and almost half of all its exports. Reform will primarily involve streamlining their businesses to reduce excess capacity and focusing on a few core industries in which they are internationally competitive, and at the same time improving their financial health.

Throughout 1998, however, moves to restructure were slow among the Chaebols, and they often met with resistance, prompting the government to assume a more active role. In December 1998, it reached agreement with the five largest Chaebols (Hyundai, Samsung, LG Group, Daewoo, and SK Group) on restructuring their business. The Chaebols agreed to reduce the number of their subsidiaries from 264 to 130 and their debt-to-equity ratio from about 250-380% as of end 1998 to 200% by

end 1999. In addition, they agreed to eliminate by the year 2000 all in-group cross-payment guarantees, which in the past had allowed the Chaebols to continue to borrow to expand without actually raising capital. The groups have also been requested to reorganize major industries in which they are involved in order to reduce excess capacity. These industries include the automobile, semiconductor, rolling stock, ship engine, petrochemical, oil refining, aircraft, and electricity-generation industries. Six “Big Deals” have been agreed upon to rationalize these sectors and another is under discussion. The government estimates that the deals can reduce 2.3 trillion won (US\$2.09 billion) of over-capacity and 8.9 trillion won (US\$8.09 billion) of debt through the sale of excess assets and foreign capital investment (World Bank 2000a).

To apply further pressure, the government restricted credit supply to the Chaebols. The groups had to submit restructuring plans acceptable to their creditors in order to maintain their credit lines. Despite promises to streamline their businesses, large Chaebols such as Daewoo and Hyundai had instead expanded during 1998 through mergers and acquisitions. Their debt levels also increased accordingly. Daewoo’s debt-to-equity ratio subsequently rose to nearly 400%, much higher than government guidelines. Under increasing pressure from the government and its creditors, the group was finally forced to announce plans for large-scale asset sales that would significantly reduce its size. In August 1999, Daewoo entered into a formal workout process with its creditors in a complex restructuring that involved more than 100 group companies with almost 200 foreign lenders and US\$54 billion in debt. Hyundai also announced plans to split the group into five smaller entities by 2003. However, there is still pressure to reduce the group’s overall size. The group has been slow in implementing its capital structure improvement plan and needs to speed up its asset sale process. The other groups are expected to meet their plans.

The Chaebols’ bond issues were also to be restricted so as not to crowd out smaller companies. (During 1998, the top five Chaebols accounted for over 70% of all bond issues.) Any bank or insurance company was to hold not more than 10% of its bond portfolio in bonds issued by any single Chaebol. Investment-trust companies also had to limit their holdings of any one group to no more than 15% of its total corporate bond holdings.

Another way that the government maintained pressure on the Chaebols was by stepping up supervision. It empowered the Fair Trade Commission (FTC) to probe the bank accounts of the top thirty Chaebols to ensure that they were not supporting nonviable units in order to maintain dominance. The FTC also imposed penalties on the five top Chaebols for purchasing securities of their subsidiaries above market price in order to shore up the companies.

Aside from direct intervention, the government is also resorting to introducing greater competition to keep the Chaebols in check and to force them to reform. It set up the Corporate Restructuring Fund with 1.6 trillion won (US\$1.45 billion) under its control to provide capital for small and medium-sized firms. In addition, past restrictions on foreign ownership of businesses were also relaxed. The level of foreign direct investment is expected to rise significantly, especially in view of Korea’s country rating once again attaining investment grade in February 1999. The government

reported foreign direct investment commitments to reach over US\$15 billion in 1999, compared to US\$8.9 billion in 1998 (World Bank 2000a).

Korea's public sector is also undergoing significant change. In order to raise funds for the restructuring of the economy, the government has agreed to privatize eleven state-owned companies and their subsidiaries. It successfully sold shares in Korea Telecom and Korea Electric Power in 1999. Other state-owned companies to be privatized include Pohang Iron & Steel (the world's second-largest steelmaker, which is already 40% owned by foreign investors) and Korea Heavy Industries. It is estimated that at least US\$8 billion will be raised from privatization. In addition, to increase transparency, the twenty-one state-owned companies and their affiliates will begin to fully disclose their financial statements.

Indonesia

Corporate-sector restructuring in Indonesia proceeded more slowly than it did in other countries. To begin with, the total amount of foreign debt involved was much greater than was that in other countries, since the bulk of the country's foreign debt was in the private nonbank sector. (According to BIS data, Indonesia's private nonbank-sector foreign debt reached US\$39 billion, or 68% of the country's total foreign bank debt at end 1997.) Few companies have made payments on their foreign debt since the beginning of 1998, when the rupiah plummeted and the amount of debt in local currency terms escalated.

More important, the country's legal and regulatory framework for corporate-debt restructuring was inadequate. The Jakarta Initiative Task Force (JITF) set up in 1998 lay down procedures for negotiations between debtors and creditors but had little enforcement power. As of end 1999, only some 320 companies, accounting for a total debt of US\$23 billion (compared to total estimated corporate indebtedness of US\$118 billion in late 1998), had entered into debt negotiations under the JITF. Of this number, only six companies had successfully restructured their debt, which totalled less than US\$1 billion (World Bank 2000b). At the same time, Indonesian laws on the foreclosure of assets and bankruptcy did not provide clear guidelines to creditors on the enforceability of their positions. The government has made amendments to the bankruptcy law to set up a new bankruptcy court. However, few significant cases have been successfully processed. The only significant case of successful debt restructuring, PT Asrtra (which restructured debts of US\$1.1 billion), was concluded outside of the official restructuring framework.

To accelerate the process, the government undertook a more proactive strategy toward end 1999: (1) it set up the Financial Sector Policy Committee (FSPC) to oversee bank and corporate restructuring, reporting directly to the President; (2) it gave the IBRA, a major creditor, a more active role in the restructuring process, including the ability to seize assets and file insolvency petitions; and (3) it provided for cases not led by IBRA to be either directed by the FSPC to the JITF, which will enforce a time-bound mediation process, or to be referred to the Attorney General for the initiation of bankruptcy proceedings. In March 2000, the IBRA reported that it was finalizing the

restructuring of a total of 14.4 trillion rupiah (US\$1.69 billion) of debts with 144 corporate debtors (World Bank 2000b).

The government has also been working on facilitating regulatory approvals of measures that might be utilized in corporate-debt restructuring, such as foreign stakes in local companies, debt-equity swaps, and new share issuance. Nevertheless, few creditors have been willing to swap debt for equity. Debtors have also been unwilling to concede equity in view of the significant depreciation of the rupiah.

The corporate sector is also expected to undergo restructuring in other areas. In February 1999, to address concerns about the prevalence of politically well-connected groups' monopolies of key sectors and strategic industries, the government passed an antimonopoly law that will become effective one year following its passage. The law would prohibit one company from holding more than 50% of the national market share, and two or three companies from holding more than 75% of the market share between them. In addition, the law would prohibit a majority shareholder in a company from holding shares in other companies that are active in the same business so that the combined market share is 50% or more. Although state enterprises would be exempt, a number of big-business groups would be affected and would be expected to divest.

During fiscal year 1998-99, the government had also planned to privatize fourteen state-owned companies and firms it had taken over, but only three were sold, and only US\$381 million was raised, compared to the original target of US\$1 billion. Progress was slow during the year due to continuing political and economic uncertainties and unresolved regulatory issues. The government had to scale down its plan to sell stakes in only ten state-owned companies during the 1999-2000 fiscal year, and to postpone further sales to the next fiscal year. As markets recover, the government expects revenue from privatization to reach 8.6 trillion rupiah (US\$1.01 billion) during fiscal year 1999/2000 and 6.5 trillion rupiah (US\$0.76 billion) during April-December 2000, including revenue from the successful privatization of the telecommunication sector.

Malaysia

At the onset of the crisis, the Malaysian government set up a Corporate Debt Restructuring Committee (CDRC) to monitor the progress of the corporate-sector restructuring. As of January 2000, 67 firms had applied for help in reworking debts worth 36.3 billion ringgit (US\$9.55 billion). Of this total, only 19 restructuring schemes totalling 14 billion ringgit (US\$3.68 billion) had been completed (World Bank 2000b). Progress has been slower than expected.

Danaharta has also been playing a role in restructuring the nonperforming loans it acquired from the financial sector. As of end 1999, it had 52 companies under Special Administration (which involved overseeing the companies' management) and had been involved in restructuring loans of up to 17.6 billion ringgit (US\$4.63 billion) at face value. Danaharta has also been holding tenders of part of its foreign loan and property portfolio (World Bank 2000b).

A number of major corporate debt restructurings are also taking place outside of the CDRC and Danaharta framework. However, some of the restructuring plans surrounding large corporate groups have given rise to controversy concerning the government's intentions to bail out politically connected business groups.

Longer-Term Requirements

While most of the countries affected by the crisis recovered significantly during 1999, many of the weaknesses which hastened if not directly caused the crisis remain within their economies. In order to establish a firmer basis for future growth, the affected Asian countries will need to review their policies and practices in a number of key areas, as follows.

a) Monitoring foreign capital flows

Short-term bank loans and portfolio investments were among the most volatile forms of capital flows and had largely eluded central bank monitoring in the period before the crisis. The countries need to develop better information on these capital flows while reassessing their own pace of capital-account liberalization in order to ascertain whether tighter control may be required.

At the same time, other more stable forms of capital flow will need to be encouraged. Foreign Direct Investment (FDI) flows, for example, dropped only slightly during the crisis and comprised one of the major sources of foreign-capital inflows both during and after the crisis. For the Asia-5 countries, IMF (International Monetary Fund 1999c) reported that while net total private capital flows continued to be negative at -US\$22.13 billion, -US\$29.61 billion and -US\$18.11 billion during 1997-99 for each of the respective years, net direct investment flow remained stable at US\$10.33 billion, US\$9.7 billion and US\$9.37 billion, respectively. In contrast, net portfolio investment flow during the same period was volatile at US\$12.88 billion, -US\$7.31 billion and US\$4.48 billion, respectively.

b) Rebuilding the financial sector

Measures that need to be taken or further reinforced include:

- phasing out state involvement in funds allocation and credit control
- strengthening the regulatory framework by adopting international standards in reporting requirements, loan classification and provisioning, disclosure requirements, and capital-adequacy ratios
- strengthening bank governance by involving outside directors and investors
- improving credit management
- upgrading the legal framework for resolving the situations of distressed financial institutions and nonperforming assets

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- reducing restrictions on foreign ownership to introduce management expertise and greater competition

| c) Upgrading the corporate sector

Measures that need to be taken or further reinforced include:

- increasing accountability by enforcing international accounting and disclosure standards
- instituting corporate governance requirements
- improving performance by introducing greater competition both among domestic corporations and through foreign investments

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| d) Developing longer-term domestic capital markets

Short-term debt and foreign-bank borrowings accounted for significant weaknesses of many of the affected Asian economies, and for their vulnerability to market instability. Governments need to encourage the growth of domestic pension and provident funds as long-term investors, and to develop domestic capital markets through the issue of government and corporate bonds.

Starting in 1999, bond issues have picked up in many of the local markets. This development both filled the funding needs of local institutions as well as allowed them to diversify from bank borrowings which had become difficult to obtain in view of the restructurings within the financial sectors. The development was also made possible by the drop in interest rates in the aftermath of the crisis, which rendered local currency bond issues more attractive.

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| e) Reevaluating export competitiveness

In view of major currency realignments that have come about as a result of the crisis, the affected Asian countries also need to reexamine their export profile and competitiveness. The currency realignments are likely to have caused shifts in the relative positions of individual countries, and to have repositioned the competitiveness of various industries across the region in both international and regional trade.

Also, while significant currency depreciations improved the overall price competitiveness of many Asian countries, their current dependence on regional trade and growing competition from areas such as China, the NAFTA countries, and Eastern Europe might offset some of their price competitiveness, and more investments might be required in areas that would allow them to ascend the technology and value-added ladder.

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C. The Role of Japan

As Asia's major capital source and export market, Japan has a key role to play in the region's recovery. However, weaknesses in the Japanese economy have become increasingly evident after the burst of the asset bubble. Its financial sector has suffered from long periods of domestic economic weakness and is in need of thorough reforms. Other structural issues across the economy also need to be addressed. In the aftermath of the crisis, these issues have become even more acute and the country is under increasing pressure from the international community to reflate its economy and institute the necessary reforms.

Expansionary Policies

Since the burst of the bubble, the government had continued to pursue loose monetary policy and kept interest rates low in order to mitigate problems in the financial and corporate sectors as well as prompt economic growth. The Bank of Japan had dropped its discount rate from 3.75% in March 1992 to a record low of 0.5% in September 1995, with a policy of guiding overnight rates toward zero. Real interest rates had become negative starting in 1997.

The government's fiscal policy has been more controversial. After its success in spurring economic growth during 1995-96 through deficit spending, fiscal policy turned contractionary in 1997 with tax increases - including a 2 percent hike in the consumption tax rate and withdrawal of earlier income tax relief - and sharp cuts in public investments. Private consumption (which accounts for about 60% of GDP) fell in response to the fiscal measures as well as to uncertainties in employment and economic outlooks. The government eventually relaxed fiscal policy again during 1998-99. A number of emergency public spending programs were introduced to help boost the economy. The budget for fiscal year 2000-01 will continue to be expansionary in order to sustain initial signs of recovery. It provides for government spending of 84.99 trillion yen, up 3.8% from the initial budget for the previous fiscal year.

Stimulated primarily by substantial government spending during the year, the economy grew 0.3% in 1999, reversing the contractionary trend of the previous years. Nevertheless, contraction during the second half of the year showed that the public sector led recovery had yet to spread to the private sector, particularly to private consumption. Growth is expected to continue to be positive (about 1%) for 2000-2001. However, repeated expansionary budgets over a three-year period will place a heavy burden on public financing. The total central and local government debt is estimated to reach 645 trillion yen (US\$5.9 trillion) by March 2001, the highest among industrialized countries.

While government stimulus may spur growth in the short term, the protracted nature of the slowdown during the 1990s, the actual contraction of the economy during 1997-98, and subsequent slow recovery in spite of repeated expansionary policies all raised further questions regarding underlying weaknesses in the economy. In order for

growth to be sustainable, it has become increasingly evident that more basic structural reforms would be needed and that one key area requiring urgent attention is the reform of the banking sector.

Financial Sector Reform

The Japanese economy has been highly dependent on banks for financial intermediation. Corporations have traditionally grouped around their “Main Banks” which would take the lead within the sector to provide for their comprehensive banking needs. The dependence on banks is particularly acute among small and medium enterprises which, unlike the larger corporations, have little access to other domestic or overseas capital markets. After the burst of the bubble, the government had generally taken a position of “regulatory forbearance”, basically maintaining a low interest rate environment and hoping that the banks would lend and grow their way out of their loan problems. However, as economic growth faltered and bankruptcies grew, the balance sheets of the banks continued to deteriorate instead.

In 1998, the government finally recognized that greater intervention and supervision were required. The equity of Japanese banks is estimated to have declined to a level well below the Basle Accord of 8%, and the government estimated total non-performing loans in the sector to reach 87 trillion yen (US\$725 billion). Also, the public had begun to lose confidence in banks and had started to transfer their savings to insurance funds, foreign banks, the government’s Postal Savings system and even to overseas investments. As the banks’ equity declined and loanable funds decreased, credit extension came almost to a standstill and even started to contract. The banking sector had been failing in their intermediation role. (Posen 1998, 92-105)

The government set up an independent Financial Reconstruction Committee and Financial Supervisory Agency (responsible for bank inspection) in June 1998. Later in the year, it nationalized the Long-Term Credit Bank and Nippon Credit Bank, both of which had liabilities exceeding their assets and were deemed unable to be turned around. (These banks were later put up for sale.) The Agency also started to inspect smaller regional banks and took over Kokumin Bank in April 1999. Moreover, the Financial Reconstruction Committee had been pressuring banks to write off their bad loans by fiscal year end March 1999. To re-capitalize the banks and allow them to replenish their capital reserves as they write off bad loans, the government had set up a program for public funds injection. Under a 60 trillion yen plan to resuscitate the banking sector, 25 trillion yen would be available for funds injection.

At end March 1999, the Committee had approved to inject a total of 7.45 trillion yen (US\$63 billion) into 15 banks which applied for the funds, including 14 of the country’s 17 leading banks and one regional bank. To receive the funds, the banks would issue preferred shares or subordinated bonds to or take out subordinated loans from the Resolution and Collection Bank set up by the government. The banks are expected to pay back the public funds in 5-12 years. As a condition for the funding, the banks had to submit restructuring plans to show not only what amounts of bad loans they would write off but also how they were going to boost corporate lending and regain profitability. The plans included proposals to streamline operations and reduce the banks’ workforce by a total of 13.8% over a four-year period. The

Committee would monitor the progress of the plans and hold bank management responsible. In addition to the injection of government funds, the banks were also expected to raise another 2-3 trillion yen in the market.

While writing off loans and re-capitalization would solve some of the banks' immediate problems, it remains to be seen whether they would start lending again and resume their intermediation role. A number of changes would need to take place in order to improve their operation and profitability. These would include restructuring to reduce the over-capacity in the sector (including branch closures and mergers), better credit management (including less reliance on collateral and relationships), and enforcement of international accounting standards and greater transparency (including valuing the substantial amounts of cross-shareholdings at current rather than book value and stricter criteria for calculating capital adequacy ratios).

The restructuring of the Japanese banks, which were the most active lenders in Asia prior to the crisis, has a direct impact on the region. In the aftermath of the crisis, many Japanese banks were unwilling to write down their loans due to their own balance sheet constraints, and in many cases were reported to have held up debt restructuring negotiations with Asian borrowers. Therefore, unless the financial health of the Japanese banks were restored, many of the Asian borrowers would continue to have difficulties re-scheduling their debts and obtaining much needed new financing.

Other Structural Reforms

Over the longer run, broader structural reforms across the economy would be required in order for the Japan to sustain growth and play an effective role in the region's economy.

One increasingly common view is that the "Japanese model", which served the country so well in the earlier decades and was followed as a growth model in various ways by other Asian countries, has had a diminished role in the 1990s. In many aspects it might have actually presented obstacles to the recovery of the economy. Contrary to the "Anglo-Saxon model", citizens, consumers and shareholders are effectively excluded in the "Japanese model" from much of the political and economic decision-making process. The corporate sector is heavily protected by intertwined and mutually beneficial relationships among corporations, banks and bureaucrats which dominate policy making. Government intervention in business is prevalent (Greenwood, 1999).

The main features of the Japanese system and the problems they now present are outlined below: (Ito 1996)

- a. Lifetime employment provided for on-job training and employment security but lacked flexibility under the current more dynamic environment of rapid technology change and industry restructuring. Also, while it allowed for a pool of younger workers to provide for deferred payments to retiring workers in times of rapid growth, the system can no longer be sustained in a slow growth and aging economy. Although some changes to the system are taking place, the need

to maintain lifetime employment is still slowing down the restructuring process within the corporate and financial sectors.

- b. The Main Bank system based on close interlocking relationships with business groups provided reliable long-term financial support to the corporate sector. However, the importance of this system is also diminishing as corporations gain increasing access to wider domestic and overseas capital markets. Also, while the business sector previously relied on the Main Banks for credit monitoring, in the aftermath of the asset bubble, the latter had shown that they had failed in their role and had become ineffective as financial intermediaries.
- c. The Keiretsu had provided Japanese manufacturers with close relationships to their suppliers and greater production efficiency. However, as manufacturers increasingly move their activities offshore and service industries play an increasingly larger role in the economy, the value of the Keiretsu has also declined.
- d. The government's past industrial and export promotion policies were the driving force behind the country's growth in the earlier decades. However, their roles have waned as a result of controversial levels of trade surpluses and resulting conflicts with the US, particularly in the late 1980s and early 1990s.

The country's past protectionist policy has also come under scrutiny and is seen to have prevented much needed restructuring by allowing industries that were no longer competitive to become entrenched in the economy. During the 1970s and 1980s, for example, industries such as aluminum, petrochemicals, shipbuilding, textiles and basic steel which were no longer price competitive in the international market remained protected since they accounted for about half of the country's output and a third of its manufacturing workforce. The comparatively high prices of their products had to be absorbed by the domestic economy. (Katz 1998, 2)

The primary source of Japan's rapid growth in the past had been the high rate of productivity growth in the manufacturing sector and the shift of resources to that sector. In particular, the productivity growth rate of the tradable sector within the manufacturing industries was the highest. The non-tradable sector (including energy, transportation, construction, distribution, finance and services) had lagged due to rigid regulations, barriers to entry and protection against foreign investment. Inefficiencies and low productivity in this sector had kept domestic prices high (Ito 1996, 212-213).

Japan needs to develop new industries as areas for future growth. The export sector which had provided the key to growth in the past had increasingly moved production offshore due to high domestic prices and the appreciation of the yen. As the sector "hollowed out", the possible role of the export sector in resuscitating the domestic economy had diminished. The economy had become increasingly dominated by its low productivity non-tradable sector. The key to future growth would therefore lie instead in increasing the productivity of the non-tradable sector through de-regulation and greater competition (Ito 1996). A certain degree of de-regulation has already taken place, such as the "Big Bang" reforms in the financial sector, allowing new entries

into the airlines industry and the opening of international services in the telecommunications sector. Also, foreign direct investments and mergers and acquisitions among both domestic and foreign companies have significantly increased in the financial, services and manufacturing industries. However, there is further room for de-regulation and greater competition (including from foreign investors) across all industries, and particularly in the non-tradable sector.

D. The International Community

The Asian Crisis and its reverberations in global markets have focused the attention of the international community on the instabilities of international capital markets and on the potential for widespread systemic risks.

The meeting of G7 finance ministers and central bank governors in October 1998 placed renewed emphasis on building up international standards as preventive measures and initiated processes to reexamine the “financial architecture” of the international capital markets with the aim of increasing market stability (International Monetary Fund 1998a).

It was agreed that the following efforts to build international standards would be made. All of these initiatives are scheduled for completion within 1999:

- The IMF to complete development of a code of conduct on monetary and financial policy;
- The IMF to provide more comprehensive information on reserves and improved statistics on a country’s external debt;
- The Organization of Economic Cooperation and Development(OECD) to develop a code of principles of sound corporate governance and structure;
- The International Accounting Standards Committee (IASC) to propose a full range of internationally agreed-upon accounting standards;
- The Bank for International Settlements (BIS) to review appropriate transparency and disclosure standards for private-sector financial institutions involved in international capital flows, including investment banks, hedge funds, and other institutional investors.

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Those in attendance at the meeting also agreed on the following, with respect to maintaining the stability of the international financial system:

- To effect a more comprehensive exchange of information and increased co-operation in order to strengthen financial-sector surveillance among international institutions and national authorities.
- To strengthen risk-management systems and prudential standards within the financial sectors of the G7 countries, with particular focus on leveraged international financial organizations such as hedge funds and offshore institutions.

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- To ensure that capital markets in emerging economies be opened in a careful and well-sequenced manner in order to minimize disruptions while countries benefit from access to markets.

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- To encourage programmes to assist countries in crisis to pay attention to social costs and provide social safety nets.

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The G7 countries further called for the private sector's increased involvement, particularly in the following areas:

- Inclusion of "collective action clauses" in financial contracts to facilitate orderly workout arrangements;
- Setting up frameworks within countries for working out insolvency and debtor-creditor regimes;
- Providing contingent financing in times of crisis.

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The meeting also recommended that the IMF set up a facility that would provide a contingent short-term line of credit for countries pursuing strong IMF-approved policies. Countries would be able to utilize this facility on a timely basis when they needed to do so, rather than having to conduct negotiations with the IMF and other sources when crises arose. Agreement was subsequently reached to set up such a facility.

In their February 1999 meeting, the G7 countries also set up a Financial Stability Forum to meet twice a year with representatives from G7, some of the developing countries, international regulators such as the Basle Committee of Bank Supervision and the International Organization of Securities Commissions, the IMF, and the World Bank. Its initial targets were to: 1) formulate effective financial and regulatory policies to alleviate systemic risk; 2) develop international rules and standards of best practice and regularly check to ensure that market players are complying with them; and 3) ensure the continuous flow of information among supervisory authorities.

Within the wider international financial community, a number of specific measures have been proposed to encourage better monitoring of capital-market activities. For example, the Basle Committee of Bank Supervision is being encouraged to change its rules so that banks must put aside more capital when they lend to riskier countries, and to hedge funds and other highly leveraged investors. The IMF has set up the Special Data Dissemination Standard which demands better information covering international reserves from its member countries. It is also encouraging the countries to provide more information on the level, structure and composition of their external debt.

Another possibility being considered is that hedge funds be required to disclose more about their financial positions, although such a requirement may be difficult to enforce, as most of the funds are located offshore from key financial centres. Based on a report it commissioned on the Long-Term Capital Management incident, the United States government has called for quarterly disclosure of summary portfolio information by hedge funds to the public. In addition, leading international banks, together with the U.S. Federal Reserve and Securities and Exchange Commission,

have agreed to try to set voluntary guidelines for the extension of credit to participants in derivatives markets.

Measures to “bail-in” the private sector in times of crisis, and thus to minimize moral hazard, have also been proposed. In the case of Korea, for example, the U.S. government successfully applied pressure on international banks to roll over their loans during the crisis. One possible way to formalize the “bail-in” would be to include in IMF loan conditions the requirement that private lenders and investors also continue to lend. For example, in Ukraine in October 1998, the government asked foreign investors to reschedule payments when the IMF insisted that using the country’s exchange reserves to pay the maturing debt would violate a condition of its loan, which had set a minimum reserve level. The IMF is also working with Pakistan, Romania and Ecuador on various arrangements to involve the private sector in debt restructurings.

Another possibility is to change the wording of typical bond contracts to make restructuring debts possible under certain conditions. The IMF reports that it is exploring the feasibility of recommending the inclusion of contract clauses that would facilitate debt restructuring agreement among investors, such as provisions for sharing, majority-voting, minimum-legal threshold, nonacceleration and collective representation.

E. Conclusion

The international community is reviewing measures to prevent or at least mitigate a similar crisis. Japan is promoting growth and reforms in its domestic economy, which would have a significant positive impact on the region’s economy. At the same time, growth has picked up among the Asian countries.

Many of the fundamentals which led to Asia's past rapid growth remain sound, even though the financial markets have caused severe damages to many economies during the crisis. Through a combination of expansionary policies and reforms, the affected countries have tried to redress the imbalances and weaknesses within their economies. As a result, when trade demand surged and capital inflow resumed in 1999, the region has been able to recover quickly from the crisis, although progress varies among countries.

The main concern facing countries which are slower in recovering is the availability of financing required to continue to pursue expansionary fiscal policies, to reform the banking sector, as well as to finance corporate sector needs. As savings in these countries have been negatively affected by the crisis, financings in the amounts required will have to be obtained largely from external sources. This is particularly true in Thailand and Indonesia. During and immediately after the crisis, one important and readily accessible source has been official channels: IMF and other multilateral and bilateral loans. However, in the longer run, private capital will have to fill this need.

The countries' access to foreign private capital has varied. Bank financing, which previously represented the major component, has dropped significantly from the height it reached in 1997. Portfolio capital, though showing increases in 1999, has not recovered to its previous levels. Foreign direct investments, on the other hand, continued to drop in countries such as Indonesia which are still facing serious economic and political problems, although they are playing key roles in countries such as Korea and Thailand. Overall, the amounts of capital inflow are still small compared to the scale of financing required to fully reform the banking sectors as planned in some of the countries. More resources would be required from international capital markets which played such a significant role in the area's growth in the past.

Despite the overall recovery in the region, however, many structural issues still have to be addressed in order for economic growth to be sustainable over the longer run. These mainly include much needed financial and corporate sector reforms and more vigorous regulatory measures. On an international level, the crisis presented an opportunity for the world community to review weaknesses in the capital markets. Even though the Asian economies appear to have recovered, unless the key issues highlighted by the Asian crisis are properly evaluated and addressed, the prospect of further crises in the future will remain.

Chapter 6. Implications for the PRC ²

During the Asian crisis, the PRC exhibited many of the problems found in other economies in the region. But, although its economic performance was affected, the country was largely able to avoid the more devastating impact of the crisis felt by some of the region's other economies. Nevertheless, the problems the PRC faces will need to be addressed to ensure that it avoids a similar crisis occurring in the future. The issues involved and their implications for the country's future economic development are reviewed below.

A. Signs of Weakness

The PRC economy performed well in 1997 even though the Asian crisis was already under way. Although GDP growth had slowed to 8.8%, compared with double-digit growth rates during the 1992–95 period, the current account registered a record surplus of US\$29.7 billion (3.24% of GDP), and foreign exchange reserves were reported at US\$139 billion. Nevertheless, a number of signs pointed to underlying weaknesses within the economy.

First, the government revealed that over 20% of total assets within the banking system were problem loans; among these 5% to 6% were nonperforming. The market generally believed that the actual situation was even worse. Second, signs of overheating were prevalent in the stock markets and the real estate markets of many large Chinese cities. For example, rental yields in Shanghai's business district were reported at only 8% in June 1997 (compared with the then-existing interest rate of 8.55% to 9.00%), with a vacancy rate of 30%. (See Figure 6.1.) (The vacancy rate rose further, to 40%, during 1998–99, at which time it ranked among the highest for large Asian cities.) Stock market prices also soared during this period. (See Figure 6.2.) However, the relatively small size of the market reduced its impact on the overall economy. In 1997, it was estimated that the total market value for A shares (for domestic investment) accounted for only 7.5% of GDP, while that for B shares (for foreign investment) was estimated to be even lower — only 0.4% of GDP. (This is compared with a figure of 44% of GDP for Korea and 34% of GDP for Malaysia at the time.)

Comment [rb1]: Is this correct? Or should it be 34 %?

² The contents and data in this chapter are primarily based on Lin (1999).

Figure 6.1 : Central Bank Base Interest Rate of China (Less than 20 days)

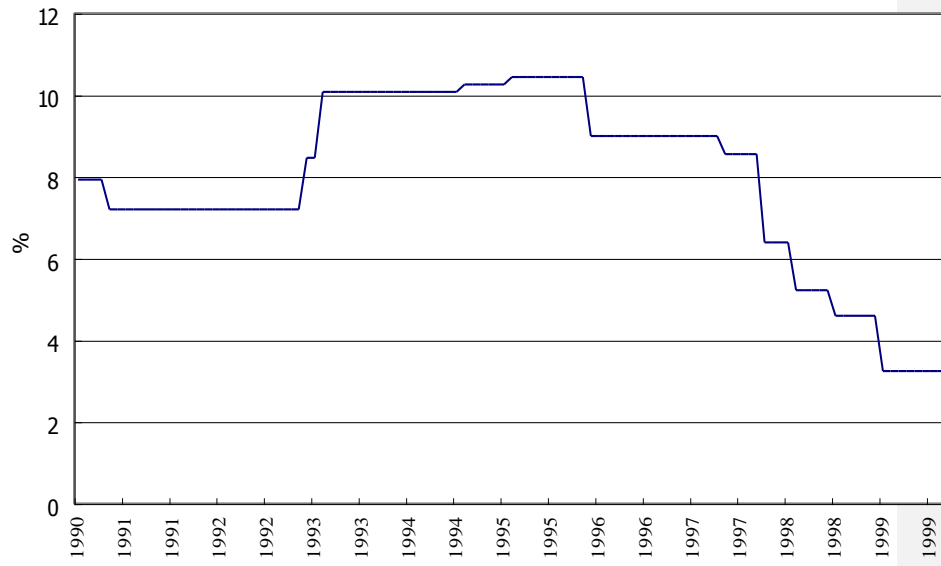
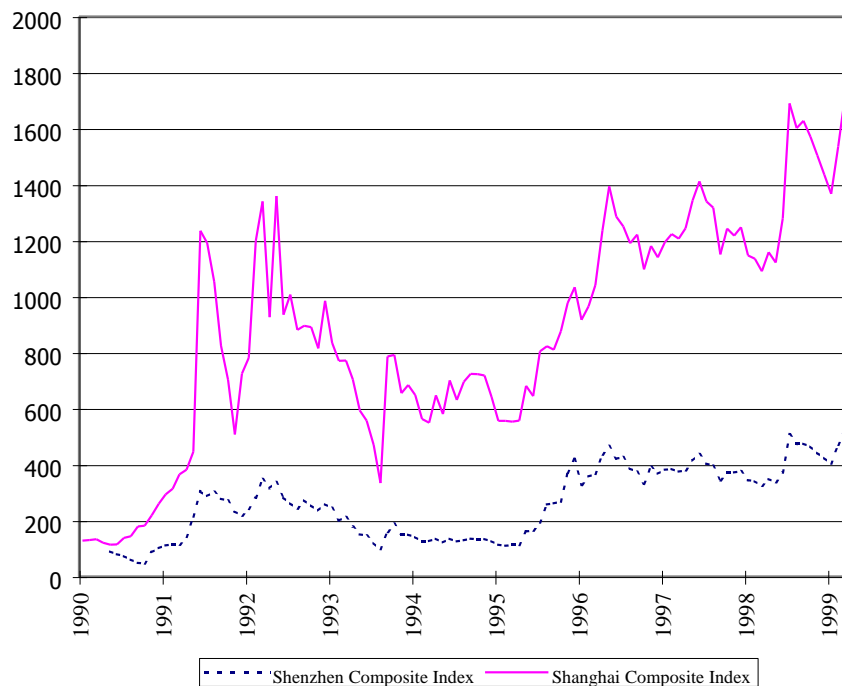


Figure 6.2: Stock Market of China



Despite these signs of weakness, however, the government's strict control over the capital account prevented excessive inflows of foreign capital during this period, thereby shielding the country from the adverse impact of the sudden withdrawal of foreign capital, which other more open Asian economies experienced during the crisis.

B. Impact of the Asian Crisis

In spite of its relatively strong position, the PRC was still indirectly affected by the crisis during 1998 and the first half of 1999. The ways in which it was affected are discussed below.

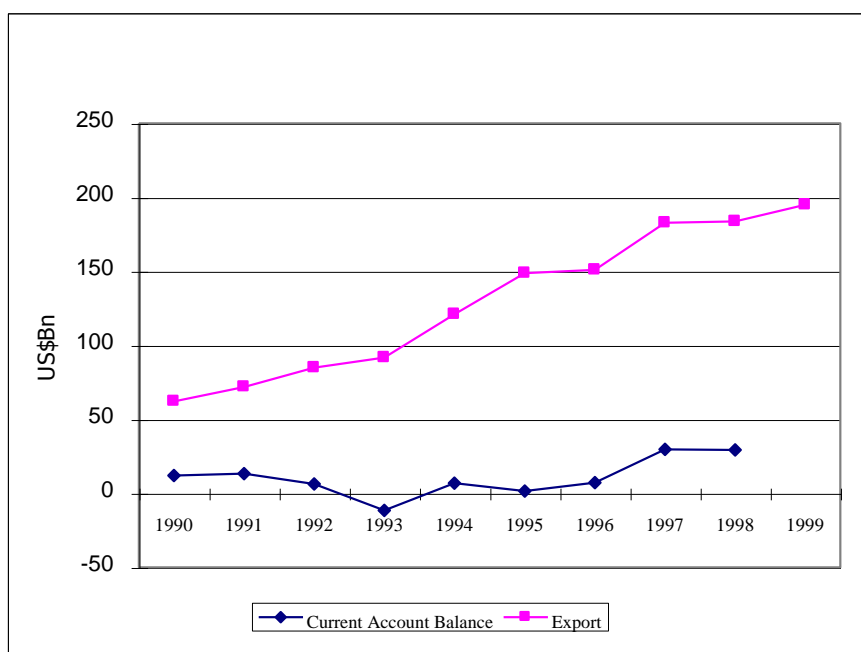
1) Deteriorated Borrowing Terms

Because the terms of borrowing for emerging markets generally deteriorated following the crisis, the cost of raising funds in international capital markets increased. In September 1998, the differential between PRC and U.S. government bonds of similar maturity (year 2006) reached 400 basis points, up from 200 basis points before the crisis. The differential later narrowed to 288 points by end 1998. However, that was still higher than the pre-crisis level.

2) Slowed Export Growth

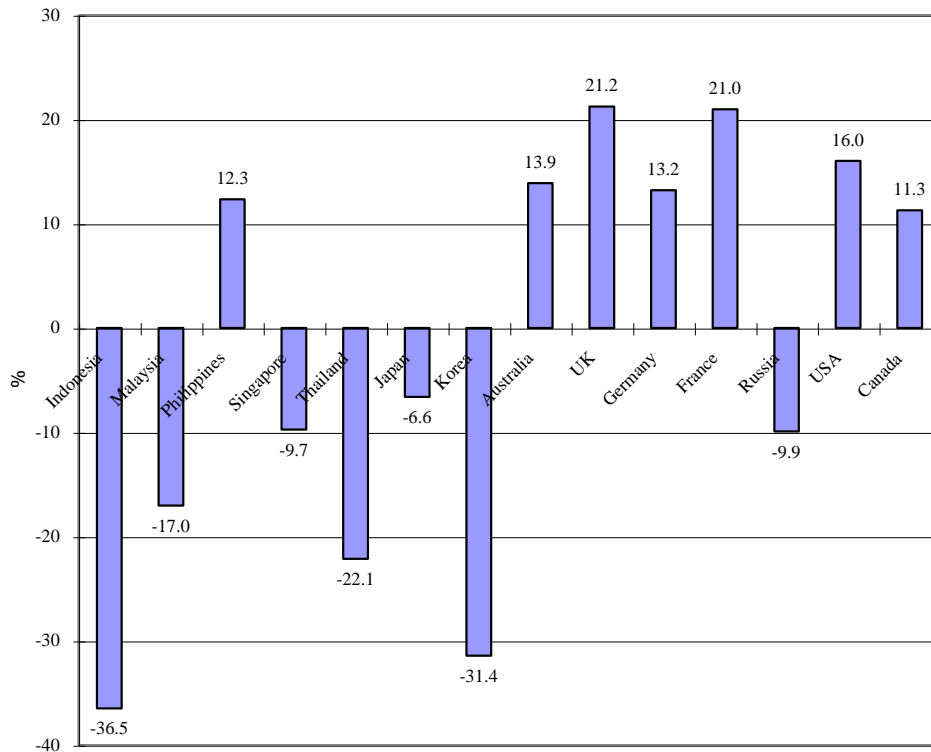
Since exports accounted for 20.3% of the country's GDP in 1997, any slowdown in export growth would have a dampening effect on the economy. Export growth started to slow during the second quarter of 1998 and became negative toward year end. As a result, exports were flat for the year compared with 1997. Exports continued to decline during the first half of 1999 and picked up only during the second half of the year, as Asian economies started to recover. (See Figure 6.3.)

Figure 6.3: Export and Current Account Balance of China



The major factor contributing to the slowdown in the PRC's exports was the decline in exports to other countries in the Asia region (which accounted for over 50% of the PRC's total exports) as these economies contracted in the aftermath of the crisis. (See Figure 6.4.) During the same period, exports to Europe and North America continued to grow, indicating that the PRC remained competitive in exports despite large-scale currency devaluations in the affected Asian countries. Many of these countries' exports had import contents of up to 60%, which would largely offset the price advantages gained by the devaluation of the countries' currencies. Moreover, many of these countries' exporters reported difficulty in obtaining credit facilities to finance their operations in the aftermath of the crisis.

Figure 6.4: China's Export Growth in 1998 by Major Destinations



3) Capital Flow Affected

Throughout 1998 and the first half of 1999, both trade and non-trade monthly cumulative foreign exchange settlement income by banks declined on a year-on-year basis. Capital account income also showed negative growth starting in mid-1998. Foreign direct investment recorded U.S.\$45.58 billion, only a 0.6 % increase over 1997, reflecting investors' concerns with problems in the economy as well as with possibilities of RMB devaluation as a result of the Asian crisis. Moreover, the faster growth of non-trade and capital account expenditure during the year indicated that more capital was actually flowing out as enterprises increasingly kept foreign exchange income abroad rather than remitting it into the PRC. (One estimate placed illegal capital outflow in 1998 at U.S.\$43 to 60 billion, which exceeded the amount of foreign direct investment for the year.)

4) Further Slowing of Economic Growth

The PRC's real GDP growth rate had continued to decline since 1994. Moreover, the retail price general index had been dropping since the fourth quarter of 1997, indicating continued deflation in the overall economy. (See Figure 6.5.) The drop in export growth as a result of the Asian crisis further exacerbated the slowdown in economic growth. GDP grew by 7.8% in 1998 and by 7.1% in 1999. (See Figure 6.6.)

Figure 6.5: China's Retail Price Index

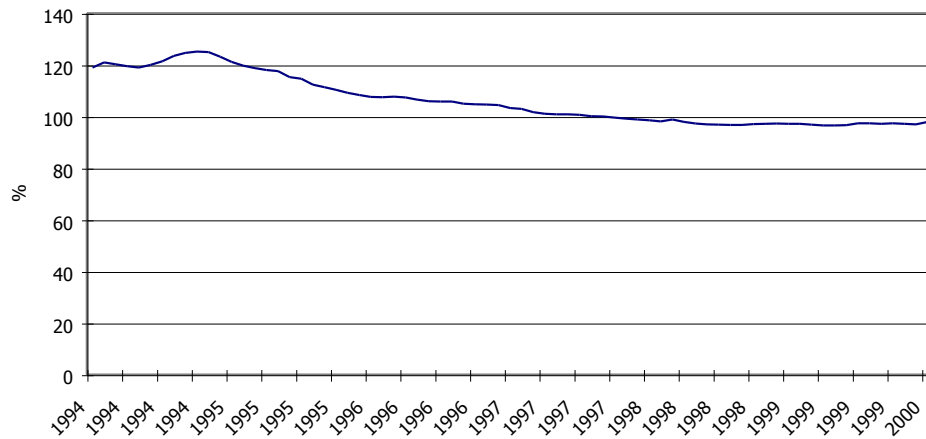
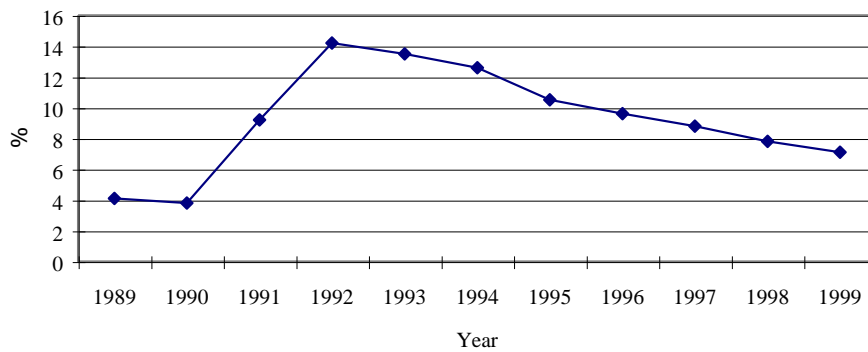


Figure 6.6. GDP Growth of China



C. The Government's Policy Response

Starting in the second half of 1997, the government adopted a series of measures to stimulate the economy in order to counterbalance the negative effects of the Asian crisis. These measures included the following:

- Easing monetary policy
Lowering deposit and lending rates eight times, increasing currency supply, loosening credit control, greatly reducing real statutory reserve against deposits, and levying interest tax.
- Implementing an expansionary fiscal policy
Implementing deficit budget and expanding fiscal expenditure (particularly in infrastructure); issuing 100 billion yuan in government bonds for infrastructure construction.

The government also kept the fixed RMB exchange rate unchanged throughout the crisis. This policy achieved the stabilizing effect of avoiding another round of competitive devaluation of the region's currencies during 1998. However, over time it came into conflict with the government's expansionary macroeconomic policies and the need to boost exports. As it was unwilling to devalue the RMB, which would have allowed exports to be more price competitive, the government had to resort to tax reimbursements and to eliminating export quotas in order to encourage exports.

D. Underlying Issues in the Economy

While the government's expansionary policies helped stabilize the economy in the aftermath of the Asian crisis, their effectiveness in stimulating growth was compromised by underlying structural problems in the economy. Investment did not pick up, as the manufacturing sector already had significant excess capacity. Consumption also remained weak, since workers continued to save their income owing to their concerns about employment security. Economic growth had slowed since 1994, and deflation became a major problem during 1998–99. In order to boost growth, basic weaknesses in the economic structure will need to be addressed.

Comment [rb2]: Correct?

1) *The Government's Role, and Problems in the Industrial Sector*

Like some developing countries and former socialist countries, the PRC has been pursuing a "catch-up" strategy in economic development, with an emphasis on heavy industries and large and medium-sized enterprises. In the past, the government had determined the pace and structure of industrial development under central planning and had allocated resources accordingly. The state-owned enterprises (SOEs) in the industrial sector operated in a heavily protected environment with fiscal support from the government and output targets and pricing set under a state plan.

Beginning in the 1980s, when economic reforms first went into effect, market elements were introduced into the economy, and many SOEs that were accustomed to

operating under government protection became noncompetitive. However, the government continued to support the SOEs through the financial system by directing state banks to lend to them. The government's role was prominent in generating the high economic growth rates the country experienced during 1992–94. Rapid credit expansion through the financial system during this period led to average annual increases in fixed asset investment of 36.9% during the Eighth Five-Year Plan (1990–94), up from 16.5% under the previous five-year plan. Double-digit inflation during this period also greatly lowered borrowing cost. As market discipline was still nascent, many industrial projects were poorly planned at their outset and inefficiently run subsequently. The rush to invest led to significant overcapacity in the industrial sector and lowered enterprises' overall return. It was reported that in 1993, 28.5 % of all large and medium-sized SOEs operated at a deficit. By 1998, this figure had risen to 55.1 %. (It was estimated that large and medium-sized SOEs accounted for more than three-quarters of SOEs' total deficit.)

As more enterprises became unprofitable and bad debts became increasingly common, banks began to be more cautious about lending. At the same time, enterprises that operated below capacity had to reduce their use of labor, which in turn decreased workers' income and lowered overall consumer demand. This led to a vicious cycle of weak consumption and low investment demand, which slowed down economic growth.

2) Financial Sector Weaknesses

As SOEs' financial conditions worsened, problems in the industrial sector extended to the financial sector, with broad ramifications for the economy as a whole.

During the 1980s, as the economy underwent reform and decentralization, the government's role in supporting SOEs shifted from offering fiscal support to providing financial support through the banking system. In order to ensure continued support for the SOEs, the government exerted control over the scale and allocation of bank credit as well as over interest rate levels. Banks were required to subsidize SOEs through various policy loans and by holding down interest rates. Furthermore, reflecting government policy, the banks' credit extension favored large and medium-sized SOEs over smaller SOEs, and SOEs in general over non-state and private enterprises. Moreover, the concentration of credit allocation through state banks to support SOEs also led to discrimination against smaller and regional financial institutions and further distorted the development of the financial sector.

The government's policies and heavy involvement led to distortions and a high degree of vulnerability within the financial sector. Since assets within the banking system had been tied up primarily with large and medium-sized SOEs, as their deficits expanded, the quality of bank assets deteriorated. The level of problem loans within the banking system is generally estimated to be higher than the official figure of 20% of total bank assets.

3) Fixed RMB Exchange Rate and Capital Control

In view of the vulnerability of its industrial and financial sectors, the government's policy of maintaining a fixed RMB exchange rate had to be combined with strict capital control in order to avoid potential disruptions to the economy similar to those experienced by the more open Asian economies during the crisis. However, this need to strictly control international capital flow also deprived the economy of freer access to this important source of funds to support future growth.

E. Direction for Future Development

Although the PRC economy ostensibly operates under a different system, many of the underlying issues, such as government intervention, protectionism, and weaknesses within the financial sector, are similar to those encountered by several of the Asian economies affected by the crisis. While, thanks to the largely closed nature of its economy and its strict control over import and foreign capital flows, the country was able to avoid the direct impact of the crisis, unless these issues are satisfactorily resolved, the possibility of an internally triggered financial and economic crisis will continue to exist.

Of more immediate concern, with the country's accession to the World Trade Organization (WTO), it will need to further open its economy to world trade and international capital flows. Addressing the structural problems underlying the PRC's industrial and financial sectors therefore becomes even more pressing.

1) Financial Liberalization and Reform of the Banking System

One of the most important aspects of reform would be the commercialization of the banking sector and the phasing out of government intervention. Existing state banks should be allowed to conduct their own credit evaluation and to allocate funds more efficiently to enterprises that are competitive and profitable. To this end, the government began lifting control over the banks' credit allocation in 1997.

The government also took an additional step by taking problem loans out of the balance sheets of the state banks so that they could start commercial operation on a sounder basis. It set up an Asset Management Company (AMC) for each of the four main state banks to take over and manage their nonperforming loans. As of January 2000, the four AMCs were reported to have signed debt-equity swap deals with 78 SOEs totaling 112.2 billion yuan. The government reported targeting the AMCs to eventually take over a total of 400 billion yuan in nonperforming assets from the banking system. However, at this stage, it appears that the nonperforming loans are merely being transferred from one institution to another. The government could consider selling these loans (or shares, after the debt-equity swaps) at discounts to outside parties, including international banks or funds, as did some other Asian countries. This would both generate income for the government and introduce third-party creditors or shareholders to restructure the SOEs and oversee their management.

The financial sector should also be further diversified through the development of medium-sized and small banks on a local and commercial basis in order to meet the financing needs of a wide range of medium-sized and small SOEs, as well as of local and private enterprises. These banks should operate independently from local governments.

To operate on a commercial basis, the banks would first need to set up a sound credit analysis and management system. Also, as the experiences of some Asian countries have demonstrated, the government would need to strengthen its supervision of the financial sector and upgrade the regulatory framework by adopting international standards for reporting and disclosure as well as loan classification and provisioning. In addition, the required legal framework for the enforcement of security, foreclosure, and bankruptcy would have to be put in place.

2) Revisiting Industrial Policy and Restructuring SOEs

Ultimately, solutions to the problems underlying the banking system lie in the realignment of the industrial sector and the restructuring of SOEs.

To improve efficiency and increase return in the industrial sector, the government should reevaluate its past "catch-up" strategy of developing heavy industries by supporting large and medium-sized SOEs and should dismantle the protectionist measures that were put into place to support this sector. By introducing a greater degree of market competition into the economy, it would encourage a more efficient allocation of resources. This could result in the development of industries that utilize the country's comparative advantage — labor, as well as in the growth of small and medium-sized enterprises. The growth of small and medium-sized enterprises, particularly at the local level or in the private sector, could in turn help absorb workers released under the restructuring of SOEs.

The development of local and private enterprises would need to be supported by the financial sector through the commercialization and diversification of the banking system as well as through access to capital markets as an alternate source of funds. Even though the government has recognized the role of private enterprises, loans to private enterprises currently still account for an insignificant portion of total bank lending. Private enterprises are also restricted in their ability to raise funds in the equity market. (The overwhelming majority of the over 900 companies listed in the country's stock exchanges are SOEs.) Listing requires official approval, and the government has generally regarded raising funds through the stock market as an alternative to bank loans for SOEs, especially as banks have increasingly ceased to be under the government's direct control. These issues will need to be resolved in order to allow local and private enterprises greater access to the financial markets.

As the experiences of several of the Asian countries affected by the crisis has demonstrated, the key to the reform of the industrial sector lies in eliminating protectionism and in introducing greater competition, including foreign investments, into the domestic economy. Reform also entails increasing management accountability at the enterprise level. The government would need to establish and enforce

international accounting and disclosure standards as well as to institute corporate governance requirements. Moreover, by letting the banks and capital markets become more commercialized, the government would also be allowing these institutions to play a monitoring role in the enterprises' performance.

3) Exchange Rate System and Macroeconomic Policies

Under the current fixed exchange rate system, if control over the capital account were to be relaxed, the government would need to sterilize capital flows into the country using macroeconomic policies, such as through open-market operations or by lowering the money multiplier. However, in order for these policies to be fully effective, the banking system and financial markets would need to be better developed.

To ensure the long-term stability of the RMB, the government should aim at setting a flexible exchange rate policy based on an effective real exchange rate. However, as demonstrated by the Asian crisis, until the industrial and financial sectors undergo the necessary reforms and proper regulatory systems are in place, it is likely that a certain amount of control over the capital account will still be required in order to avoid potential disruptions caused by international capital flows.

F. Conclusion

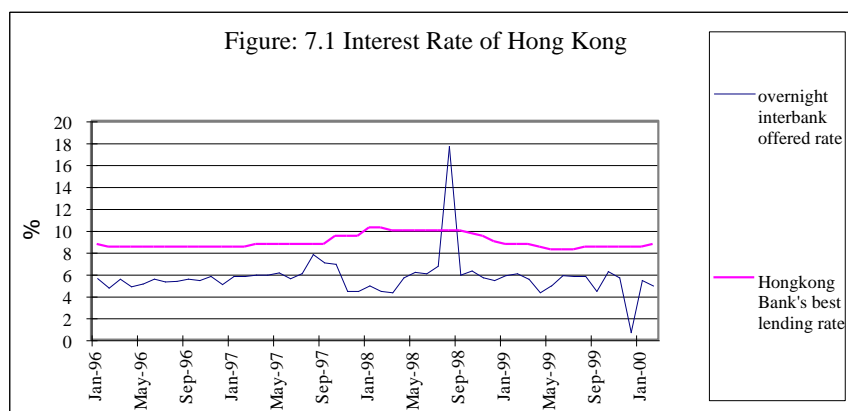
The PRC was able to avoid the direct impact of the Asian crisis mainly because of its control over the capital account. However, many structural problems, similar to those existing in several of the affected Asian countries, continue to weaken economic growth; they pose the threat of a domestic crisis unless they are properly addressed. While the restructuring of the financial and industrial sectors has started, much work remains to be done to resolve existing problems as well as to build up the regulatory and legal framework required for these sectors to operate soundly and efficiently.

Chapter 7. Implications for the Hong Kong SAR

A. Effects of the Crisis

As an open economy with trade volume equivalent to as much as 232% of GDP in 1997, and lacking any capital control, Hong Kong was more seriously affected by the Asian crisis than the PRC was. On the whole, the government had only limited leeway to employ macroeconomic policies to stabilize the economy. The Hong Kong dollar had been linked to the U.S. dollar since 1983 under a currency board system. Under this "linked exchange rate" system, Hong Kong's monetary policy, managed by the Hong Kong Monetary Authority (HKMA), has to essentially follow that of the United States.

When the Hong Kong dollar came under attack in October 1997, the HKMA came to its defense by raising Hong Kong dollar interest rates, a mechanism that had previously proven successful (notably during the 1994–95 Mexican peso crisis), by raising borrowing costs to discourage speculators who had to borrow Hong Kong dollars in order to sell. The interbank offer rate soared as high as 300% on 23 October 1997. However, the rise in interest rate did not successfully curb speculation. During the Asian crisis, speculation against Hong Kong dollars in the spot market was only part of a wider scheme to profit from short positions taken on the stock index futures and the Hong Kong dollar forward markets. Therefore, even as interest rates rose to defend the Hong Kong dollar, speculation continued in view of profits in the other markets. Meanwhile, interest rates rose to unprecedented levels. The prime lending rate had stood at 10.25% for some time and inevitably caused severe disruptions to the economy. (See Figure 7.1.)



During the 1990s, interest rates had to be kept artificially low in order to remain in line with U.S. interest rates under the linked exchange rate system, even though Hong Kong experienced high inflation. The resulting negative real interest rates and capital inflows (from both the PRC and overseas) fueled asset price inflation in the stock and real estate markets. The sharp rise of interest rates during the crisis led prices in both markets to drop dramatically (by about 60% and 50%, respectively, at their lows). The significant negative wealth effects from this drop pulled down aggregate demand and sent the economy into recession in 1998.

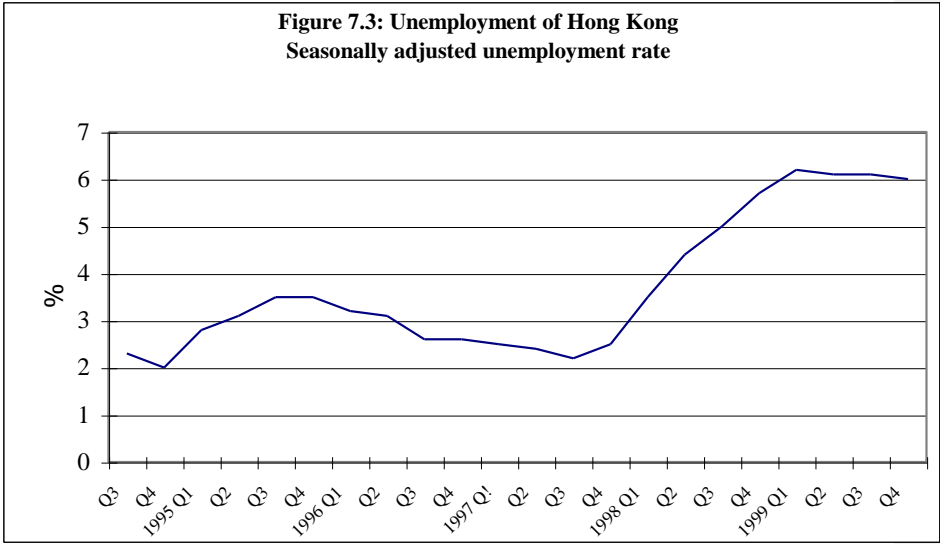
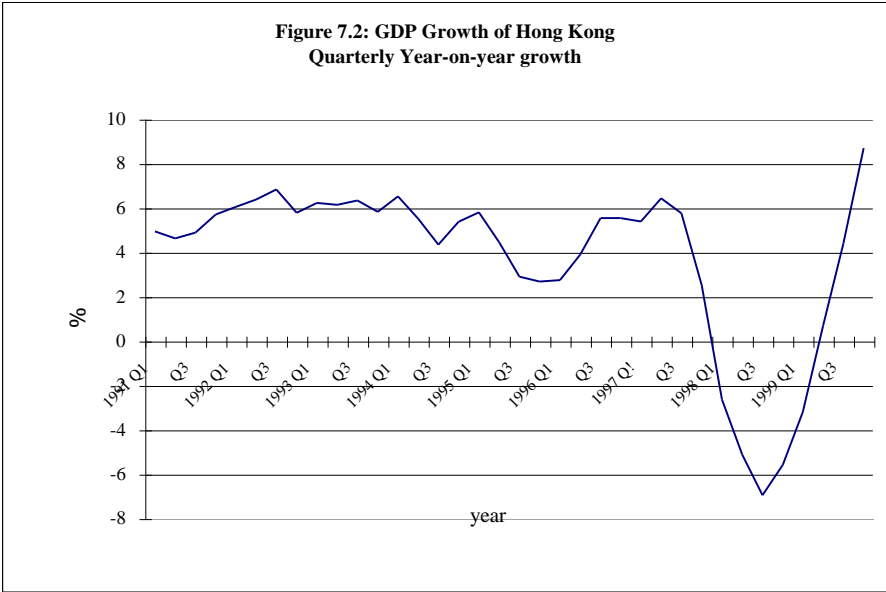
The corporate sector was adversely affected by the high interest rates and recession in the region, although not to the extent of other Asian countries. However, unlike the other more severely affected Asian countries, the SAR's financial sector remained essentially sound, and foreign exchange reserves stood at a high level of US\$96.5 billion at end June 1998, with relatively little external debt. Even though banks recorded substantial drops in profit, the level of nonperforming loans was relatively low, and balance sheets remained healthy.

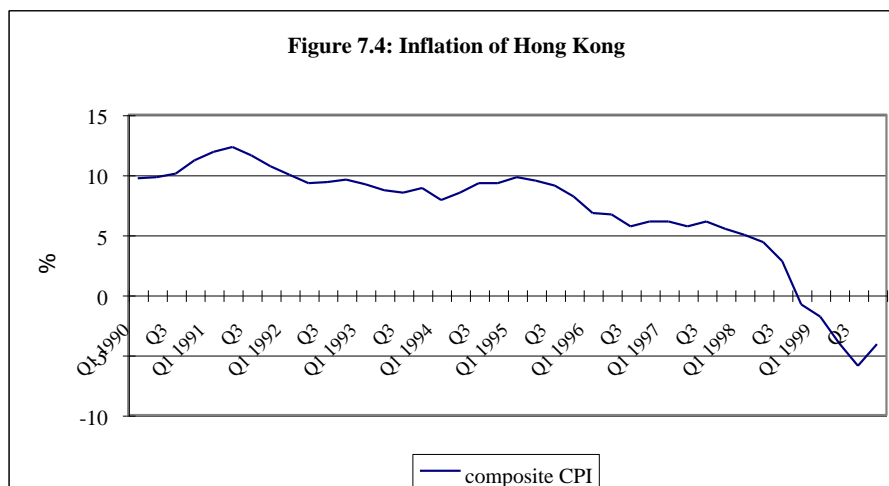
In August 1998, the government attempted to fight off speculation by purchasing an estimated US\$15.2 billion worth of shares to support prices in the stock and index futures market, hoping thereby to penalize speculators who had taken short positions. The government's intervention was controversial, not only because it was potentially damaging for an economy that had thrived on the reputation of the openness of its markets, but also because it actually weakened the SAR's position in maintaining the exchange link by reducing its exchange reserves by 15%. The intervention also raised problems of conflicts of interest, with the government acting as both a regulator and shareholder in thirty-three of the economy's largest companies.

Subsequently, in September 1998, recognizing that it had little room for effective maneuvering under previously available mechanisms, the HKMA strengthened its operations by instituting the "seven technical measures." The measures included a commitment to converting bank clearing accounts to U.S. dollars at fixed values as well as to implementing a smoother mechanism whereby banks could obtain liquidity, essentially enlarging the liquidity base and allowing interest rates to be lowered.

The currency crisis eventually waned toward end 1998, primarily because of major contagion developments in global capital markets (particularly in Russia and Latin America), which saw the weakening of the positions of hedge funds and investment banks. However, the crisis had already taken its toll in Hong Kong. GDP recorded negative growth of 5.1% during 1998. General price levels dropped, and unemployment rose to a high of 5%. Deflation began in the last quarter of 1998. (See Figures 7.2, 7.3, and 7.4.)

In 1999, the economy staged a significant turnaround. Quarterly GDP growth turned positive starting in the second quarter, recording 0.7%, and became strong in the fourth quarter at 8.7%, resulting in 2.9% GDP growth for the whole year. (See Figure 7.2.) The fourth quarter's high degree of growth was mainly export driven, which can be explained by the resurgence of demand in Asia as well as by continuing strong demand from the United States and Europe.





Toward the second half of 1999, with the steady recovery of the stock market, the government decided to dispose of the stocks it acquired in August 1998. The sale was packaged as the Tracker Fund and was well received, thus appropriately putting to an end its controversial participation in the stock market. The government even made a windfall gain because of the rise in stock prices, which substantially helped the 1999/2000 budget to achieve a surplus.

B. The Government's Responses

The severity of the economic downturn under the Asian crisis prompted the government to reevaluate its past role and policies in a number of major areas. It also had the positive effect of triggering discussions and measures about how to strengthen the SAR's competitiveness.

1) Readjusting Housing and Land Policy

One area that attracted a great deal of attention was the government's housing and land policy. In the years preceding 1997, land auction was limited to 50 hectares each year based on an agreement between the PRC and the British government. This limit on land supply during a period of economic boom helped fuel the asset price inflation of the 1990s. The government initially attempted to cool the overheating by announcing targets to provide more land and housing units (at least 85,000 per year) in the future. However, the sharp decline in property prices during the crisis subsequently took the initiative out of the government's hands. Concerned that any action might exert further downward pressure on the market and create additional negative wealth effect, the government announced instead a suspension of public land auction for nine months starting in April 1999. This helped ease the decline in property prices.

In addition, the government tried to stabilize the market by taking a less-stringent position on its housing policy in mid-1999 by recasting the supply of 85,000 housing

units as a long-term plan, thus leaving some room for the private sector to adjust supply according to demand. Furthermore, the government provided more incentives for home purchase by providing a new subsidy scheme to first-time home buyers. These measures, together with the retreat of the Asian crisis, seemed to help stabilize the market. Asset prices started to pick up slightly in late 1999.

Despite their substantial decline, property prices in Hong Kong are still high compared to those of neighboring countries. However, the government's focus in view of the severity of the economic downturn has been to arrest the decline in property prices in order to stabilize the economy. The SAR's competitiveness will need to be improved through other measures.

2) Upgrading the Financial Market

One of the weaknesses exposed by the crisis was the underdevelopment of capital markets within the region. As key financial centers, both Hong Kong and Singapore have been targeting to take the lead in this area by upgrading and developing their own markets.

The Hong Kong government has taken a number of steps to strengthen the operations and supervision of the local securities market. In January 1999, it provided for the upgrading of the stock exchange's settlement system to enable the settlement of securities denominated in other major currencies in order to encourage the listing of Japanese and European bonds. Its 1999 budget proposed to merge the stock and futures exchange markets, along with three clearing companies, into a single corporation in order to increase efficiency, reduce costs, and allow for better supervision. This plan was implemented in March 2000 with the setting up of Hong Kong Exchange and Clearing Company. In addition, the Growth Enterprise Market (GEM) was established in November 1999 to create a market in which relatively new local and overseas companies could raise funds. The establishment of GEM was timely, since it coincided with the growth of Internet-related businesses in Hong Kong and the region, and would be able to provide a platform from which these companies could raise money.

To deepen the debt market, the government has also been encouraging statutory bodies as well as local and overseas corporations to issue medium- to longer-term bonds in the domestic market. This would be complemented by the establishment of Mandatory Provident Funds for local companies starting in 2000, as these funds could act as long-term investors in the market. To further upgrade and develop the local capital markets, other measures would likely include tightening securities market regulations and corporate governance requirements, as well as introducing new financial instruments.

3) Reviewing the Monetary Regime

Before the crisis, the linked exchange rate system was seen as an important anchor for Hong Kong's economy in ensuring stability. The intensive speculative pressure on the Hong Kong dollar during the Asian crisis, however, revealed the weakness of the system and the vulnerability of the currency. Although the HKMA eventually

improved the system by introducing the aforementioned seven measures, discussions regarding the possibility of changing to a more effective and stable monetary system, including dollarization, continue among government, academic, and business circles.

Comment [rb3]: Correct?

Dollarization would eliminate the possibility of any attack on the local currency, as the Hong Kong dollar would be replaced by the U.S. dollar. However, if this scheme were to be formally implemented, it is likely that its benefits would be outweighed by the significant technical and legal hurdles that would have to be surmounted. Issues to be addressed would include setting up U.S. dollar payment and clearing systems, making arrangements for U.S. dollar notes and external liquidity support, and making changes to local rules and regulations and the Basic Law. In addition, the implementation costs of a total switch-over would be high. A possible downside risk could be a run on the banking system if the scheme were perceived as a collapse of the monetary system.

Instead of endorsing formal dollarization, the HKMA has decided to adopt the intermediate approach of gradually developing a U.S. dollar-based financial structure within the domestic economy. This will achieve the immediate purpose of further integrating the economy into the global U.S. dollar market while strengthening Hong Kong's position as a financial centre. At the same time, it will help prepare the economy to take up the option of dollarization in the future if circumstances should so warrant.

As part of the government's plan to develop a U.S. dollar-based financial structure, a U.S. dollar clearing system will be set up during the second half of 2000. The new system will be linked to the existing Hong Kong dollar clearing system to provide real time Payment versus Payment (PvP) settlement. In parallel, the Hong Kong Exchange and Clearing Company will also have a U.S. dollar clearing system for securities. When both systems are in place, Hong Kong's capital market will be able to offer local and global investors access to a full spectrum of U.S. dollar denominated products and the efficient settlement of U.S. dollar transactions. This will enhance Hong Kong's competitiveness as an international financial center, since U.S. dollar clearing services provided by other Asian countries, including Singapore, are currently still rather limited. From a monetary angle, setting up the U.S. dollar clearing systems will ultimately help to increase monetary stability by reducing the transaction volume between the Hong Kong dollar and the U.S. dollar and by taking pressure off the local currency, since it will no longer be used in nondomestic financial transactions.

4) Increasing Efficiency and Developing a Competitive Edge

The government has also embarked on a number of initiatives to improve the efficiency and cost effectiveness of government and semigovernment sectors, including privatizing statutory bodies and government departments and revamping the civil service system. The government has also focused on education reform and information technology training as major initiatives to increase the SAR's competitiveness.

In the area of industrial policy, where it had been primarily non-interventionist, the government is now actively seeking out industries, and in particular promoting

knowledge-based and technology-intensive industries, to provide direction for future growth. It has announced plans for the construction of a science park and set aside HK\$5 billion to finance technology and research projects, including a HK\$750 million venture capital fund for hi-tech start-ups. In the 1999 budget, it has further proposed to develop jointly with the Pacific Century Group a HK\$13 billion "cyberport" — a multimedia software and Internet hub to accommodate and facilitate the development of the communication industry and other information-related industries. In addition, the government also signed up with Disney, Inc., to develop its theme park in Hong Kong, with completion targeted for 2005.

C. Outlook for the Future

The region recovered rapidly from the Asian crisis in 1999. However, the pace of Hong Kong's recovery has lagged behind that of many other affected Asian countries, such as Korea, Malaysia, and Singapore. The primary reasons for these countries' rapid recovery are export growth and the renewed inflow of international capital. While Hong Kong's capital markets were able to benefit from the latter, the benefits from export growth have not kept pace.

One of the main reasons for this is that today the Hong Kong economy is predominantly a service economy rather than one led by domestic exports. Its service sector has expanded rapidly; it constituted 73% of GDP in 1986 and 83% in 1996. By comparison, Singapore's service sector's share in GDP rose only from 70% to 71% during the same period. The key factor behind the sector's rapid growth in Hong Kong is the expansion of producer services — intermediate inputs purchased by businesses to help produce other goods or services, which rose from 45% to 56% of GDP during this period (compared with a corresponding increase of 50% to 52% in Singapore).

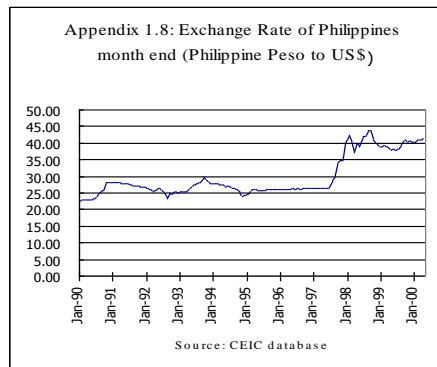
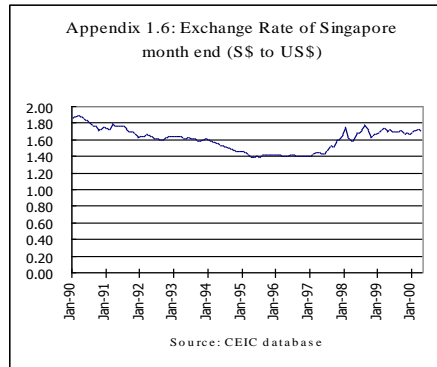
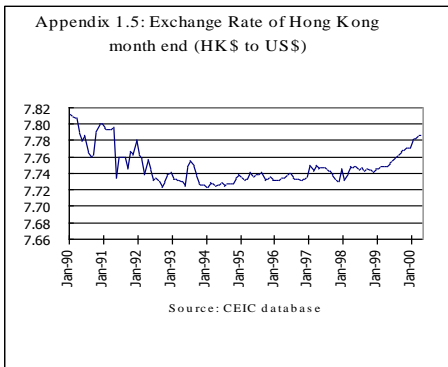
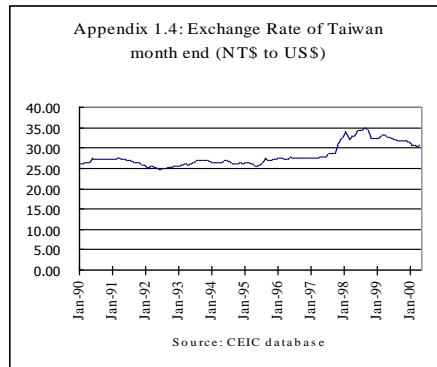
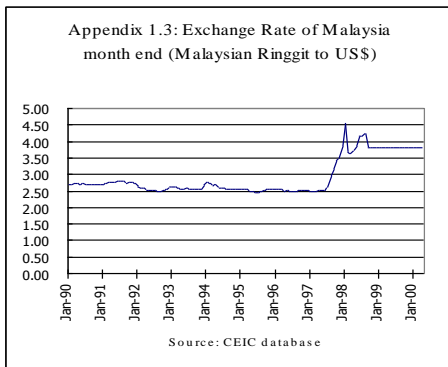
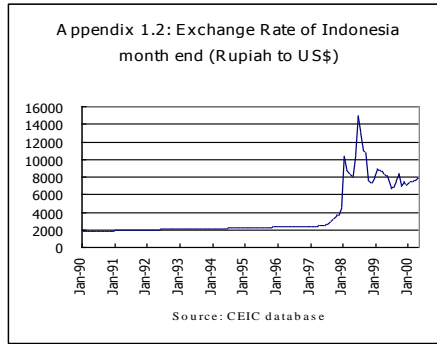
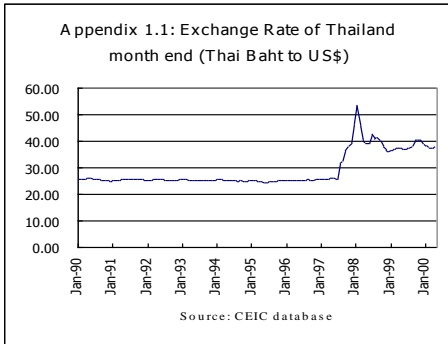
This development reflects the transition of the Hong Kong economy over the past two decades from an "enclave" economy heavily dependent on the export of domestically produced light manufacturing goods, to one that is highly integrated with the region and the PRC mainland and that increasingly concentrates on providing producer services to these areas. This is partially reflected in the shifting composition of Hong Kong's exports. In 1986, domestic exports accounted for 66% of total exports. In 1998, domestic exports only contributed about 13% of total exports, while re-exports — exports of goods and services from the PRC mainland and the region — accounted for the balance. This shift has been generated by the gradual relocation of physical production by the manufacturing sector away from Hong Kong starting in the 1980s to the PRC mainland and other countries in the region. By 1997, only 10% of production was taking place in Hong Kong, while 60 % was taking place in the PRC mainland, and 30 % was occurring elsewhere in the world.

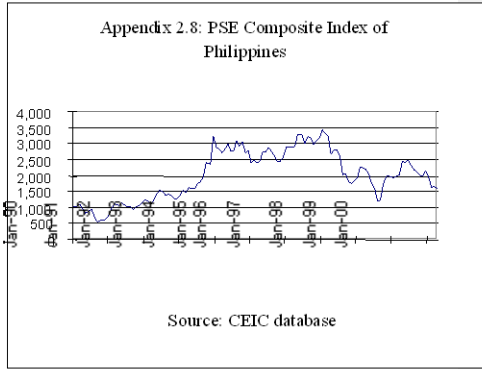
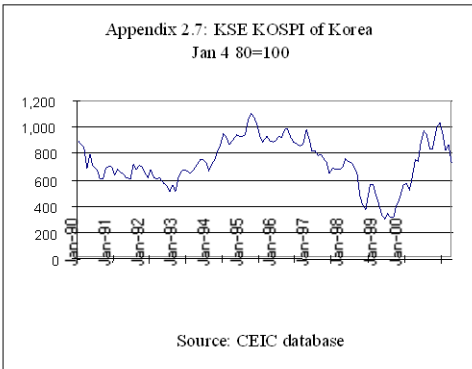
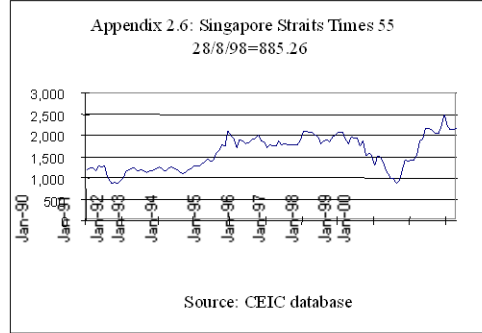
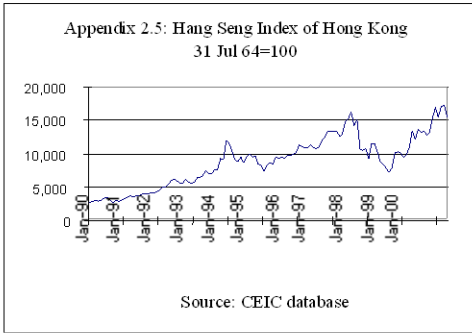
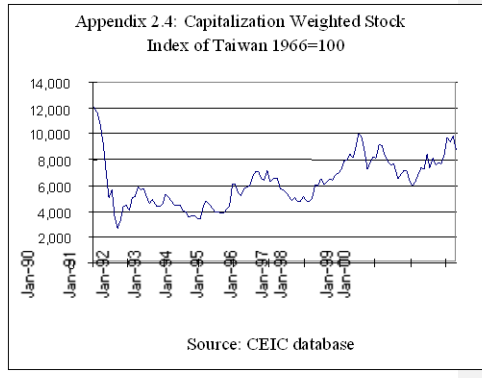
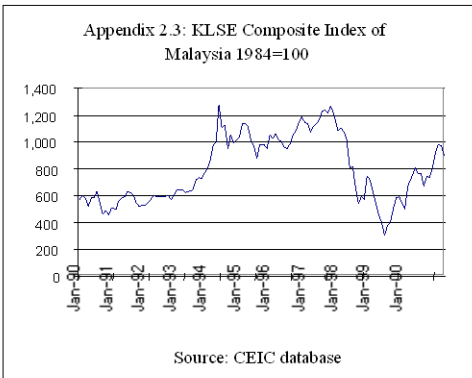
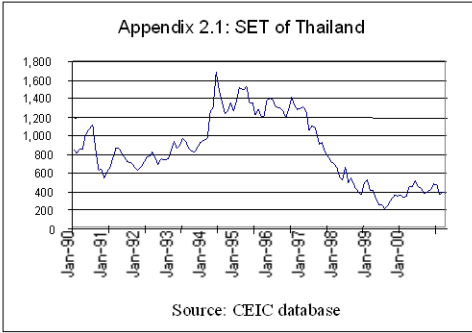
Today, Hong Kong is more like a "metropolitan" economy to the PRC and other areas in the region, providing many of the services that other large metropolitan areas such as New York, London, or Tokyo provide to their own countries and the rest of the world. Like these metropolitan areas, Hong Kong now concentrates on management, coordination, and financial and other professional services, in short, providing producer services rather than engaging in the actual production of goods. As a result

of its existing structure, the Hong Kong economy was only able to rebound from the Asian crisis after other countries, including the PRC, had recovered.

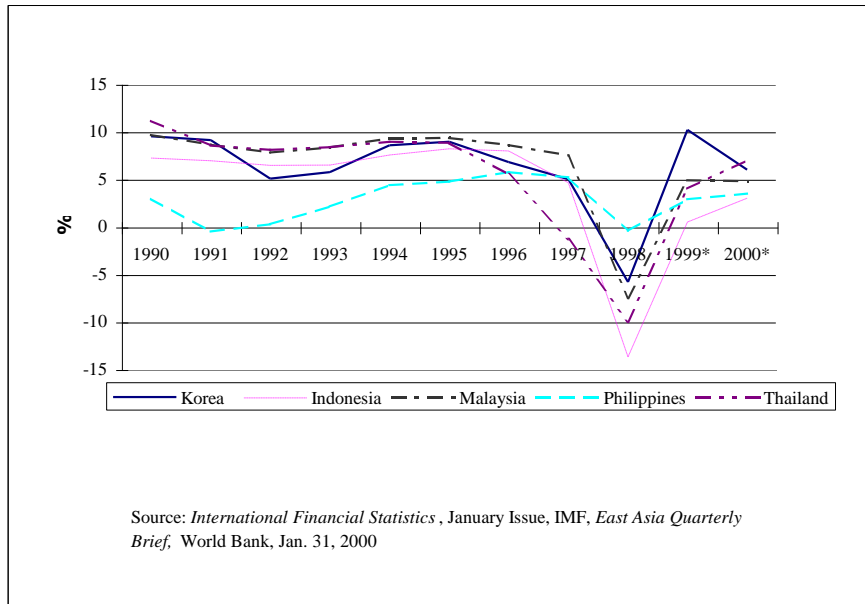
As a "metropolitan" economy, Hong Kong's future success will depend on its ability to continue to provide truly value-added services to the PRC and the region. To do so, it needs to rise to the challenges of key developments in world markets: increasing globalization, and the revolution in doing business that has been brought about by technology development and the Internet. This requires Hong Kong to integrate fully with the global market as well as to continue to upgrade itself as a knowledge-based and technology-intensive economy in order to maintain a competitive edge.

Under such a scenario, the government will first have to enhance the current regulatory and supervisory framework to ensure that domestic industries and markets meet international standards. It will also need to forge close linkages with other major markets in the world in order to become more integrated into the global economy. Finally, both the government and the private sector will need to invest heavily to develop the required infrastructure and human resources. The availability and quality of the latter, in particular, will be the key to developing a knowledge-based and technology-intensive economy.

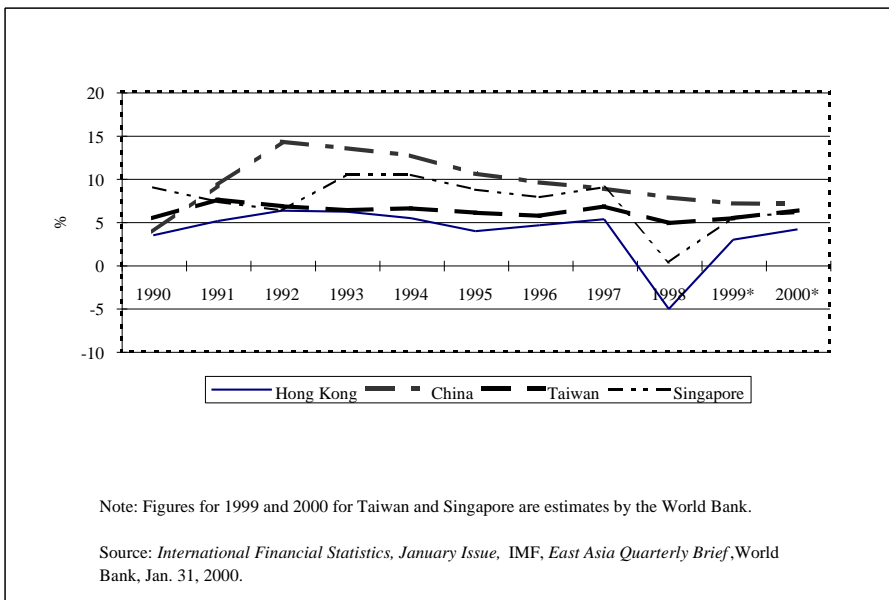


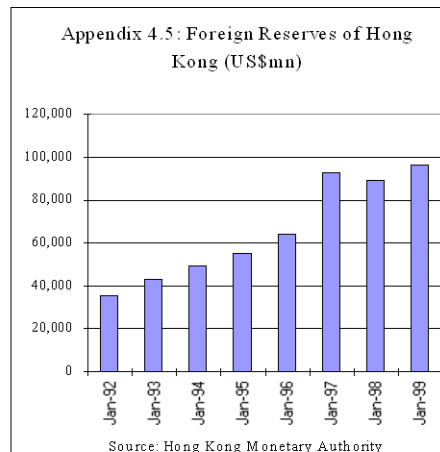
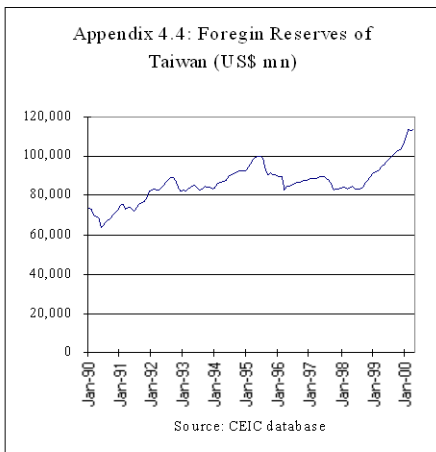
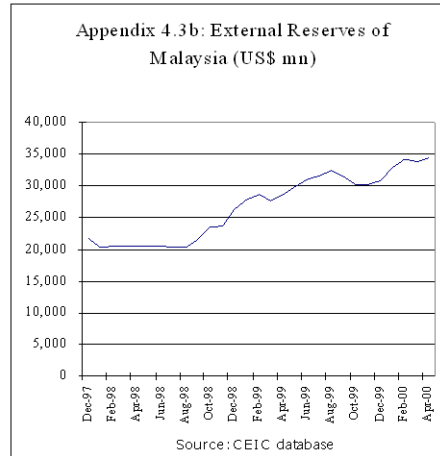
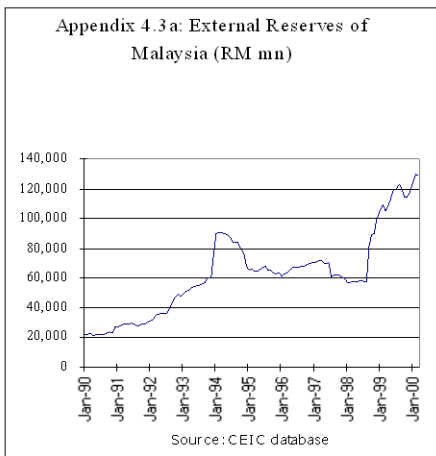
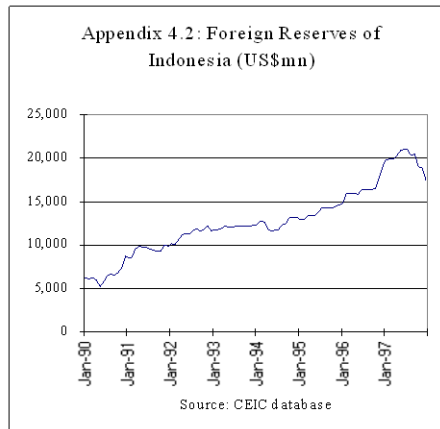
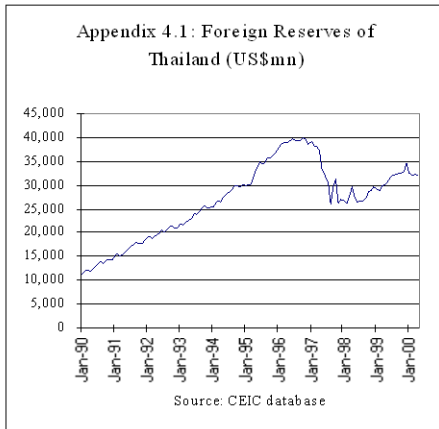


Appendix 3.1 Annual GDP Growth of Korea, Indonesia, Malaysia, the Philippines and Thailand

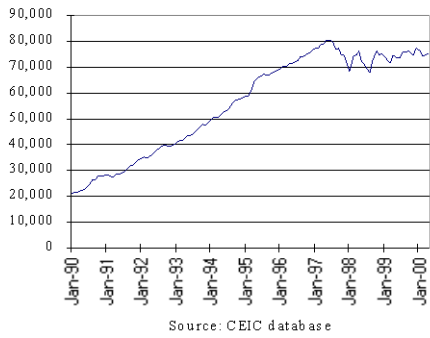


Appendix 3.2 Annual GDP Growth of Hong Kong, China, Taiwan and Singapore





Appendix 4.6: Foreign Reserves of Singapore (US\$ mn)



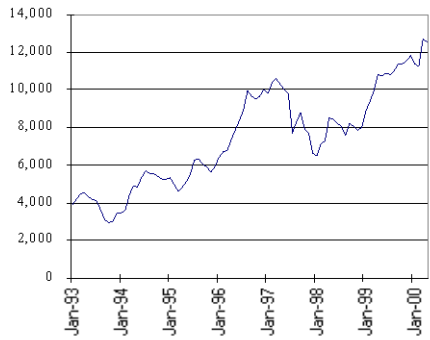
Source: CEIC database

Appendix 4.7: Foreign Reserves of Korea (US\$ mn)



Source: CEIC database

Appendix 4.8: Foreign Reserves of Philippines (US\$ mn)



Source: CEIC database

Appendix 5: Balance of Payment Current Account, 1990-98 (US\$mn)

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Indonesia	-2,988	-4,260	-2,780	-2,106	-2,792	-6,431	-7,663	-4,889	3,972
Korea	-2,003	-8,317	-3,944	990	-3,867	-8,507	-23,006	-8,167	40,552
Malaysia	-870	-4,183	-2,167	-2,991	-4,520	-8,469	-4,596	-4,792	
Philippines	-2,695	-1,034	-1,000	-3,016	-2,950	-1,980	-3,953	-4,351	1,287
Singapore	3,122	4,880	5,915	4,211	11,400	14,436	14,509	15,032	17,614
Taiwan	10,925	12,458	8,546	7,042	6,498	5,474	11,027	7,688	3,451
Thailand	-7,281	-7,571	-6,303	-6,364	-8,085	-13,554	-14,691	-3,024	14,230

Source: *International Financial Statistics Yearbook*, 1999, IMF,
Balance of Payment Quarterly, Central Bank of China, Taiwan.

Appendix 6: Real Exchange Rate

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999 July
Korea	100	98.81	102.03	103.03	99.68	94.14	96.29	111.57	157.20	126.98
Indonesia	100	100.84	100.51	94.58	91.61	89.96	90.45	103.00	233.89	130.66
Malaysia	100	101.51	92.53	92.95	93.75	87.36	87.23	97.24	129.04	130.92
Philippines	100	99.26	87.16	88.67	81.26	75.22	72.81	79.73	101.75	99.94
Singapore	100	96.09	91.23	91.09	85.74	80.36	81.21	85.80	102.46	105.49
Thailand	100	99.99	98.69	98.17	94.54	92.37	91.05	140.77	134.57	120.49
HK	100	93.12	87.41	82.96	78.92	74.47	72.10	69.79	74.03	81.41

Source: Calculated from the data in *International Financial Statistics*, December, 1999, IMF

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Asia-Pacific Economic Cooperation Study Centre

Established in 1998, the APEC Study Centre promotes research on issues relating to economic cooperation of Hong Kong and the Asia-Pacific region. A major part of the research work at the Centre is supported by members of the Faculty of Business and Economics at the University of Hong Kong.

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The China Center for Economic Research (CCER) affiliated with Peking University was founded in August 1994. The CCER aims to mobilize domestic and international resources to bring in a group of well-trained economists in making contributions to economic reform and development in China, and the development of modern economic theory.

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Asian Financial Crisis : Causes and Development

- The Asian crisis plunged many of the region's economies into severe recession during 1997-98 and called for massive rescue efforts by the IMF. It abruptly put to rest the rising claim that unique Asian values had been responsible for the region's spectacular growth and distinguished it from other countries and their economic cycles and problems.
- The period of rapid growth in Asia prior to the crisis during the 1990s coincided with the expansion of global capital markets and the increasing flow of capital to developing economies. Total net private capital inflow to Asia reached a peak of US\$110 billion in 1996.
- This massive capital inflow fueled economic growth but at the same time exacerbated the structural weaknesses already underlying many of the Asian economies, such as inadequate regulatory control, high corporate leverage and heavy reliance on short-term foreign debt. The continued rise in asset prices due to increasing liquidity also masked external problems which included slower export growth and a deteriorating Japanese economy.
- When banks and corporations started to fail in 1997, the abrupt change in investor and lender sentiments led to a major reversal of capital flows and triggered financial and economic crisis throughout the region. In Thailand, Indonesia and Korea, the IMF's austerity rescue programs arguably might have even exaggerated the economic downturn, and some of its policies had to be reversed.
- Economic growth resumed starting in 1999, spurred mainly by rising exports and growing global demand. Financial markets recovered in most countries, with some stock markets reaching or even surpassing the heights that they had attained prior to the crisis.
- Recovery, however, has been uneven. Thailand and Indonesia, in particular, are still saddled with high levels of nonperforming loans and need massive capital infusion. Even Korea, which had recovered remarkably, requires further restructuring of their financial and corporate sectors.
- For the region as a whole, broader issues exposed by the crisis still need to be addressed, including the need for better market regulation, greater transparency and improved corporate governance. The instability of international capital markets and its impact on developing economies also remain a concern.
- For the PRC and Hong Kong SAR, the Asian crisis has been a wake up call. While largely shielded from the crisis by capital control, the PRC faces similar needs to reform its financial and state enterprise sectors. These needs have been rendered even more urgent in view of its accession to WTO.
- The attack on Hong' Kong's linked exchange rate regime has prompted the introduction of new measures to strengthen the operation of currency board system. Hong Kong had survived the crisis well, but has lagged other economies in recovering from the crisis. With domestic exports playing a diminished role, the benefits from the increase in global trade had been channeled into the provision of producer services in its re-export trade activities. Hong Kong has become a "metropolitan" economy to the PRC and the rest of Asia. To be able to provide added value and remain competitive in this new role, it will need to continuously upgrade itself as a knowledge-based producer service oriented economy.

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