

THE ECONOMIC CRISIS IN EAST ASIA: CAUSES, EFFECTS, LESSONS

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1. INTRODUCTION

The East Asian economic crisis is probably the most important economic event in the region of the past few decades and will probably be so for the next few decades as well.

Beyond this, there is as yet no unanimity about its root causes nor about the solutions. The differences of view are being debated in academic circles and reflected in the media.

One thing though is certain: the earlier optimistic expectation that it would last only some months has been proved wrong. Instead the financial crisis has been transformed into a full-blown recession or depression, with forecasts of GNP growth and unemployment becoming more gloomy for affected countries. Moreover the threat of depreciation has spread from a few countries to many in the region, and has also affected other areas such as Russia, South Africa, South America and Eastern Europe.

2. THE CAUSES, PROCESSES AND SOME ECONOMIC EFFECTS OF THE CRISIS

The great debate on causes centres on whether the blame should be allocated to domestic policies and practices or to the intrinsic and volatile nature of the global financial system.

In the first phase of the crisis, as it spread from Thailand to Malaysia, Indonesia, the Philippines, then to South Korea, the international establishment (represented by the IMF) and the G7 countries placed the blame squarely on domestic ills in the East Asian countries. They cited the ill judgment of the banks and financial institutions, the over-speculation in real estate and the share market, the collusion between governments and businesses, the bad policy of having fixed exchange rates (to the dollar) and the rather high current account deficits. They studiously avoided blaming the financial markets, or currency speculation, and the behaviour of huge institutional investors.

This view was difficult to sustain. For it implied that the "economic fundamentals" in East Asia were fatally flawed, yet only a few months or even weeks before the crisis erupted, the countries had been praised as models of sound fundamentals to be followed by others. And in 1993 the World Bank had coined the term "the East Asian Miracle" to describe the now vilified economies.

However, there rapidly developed another view of how the crisis emerged and spread. This view put the blame on the developments of the global financial system: the combination of financial deregulation and liberalisation across the world (as the legal basis); the increasing interconnection of markets and speed of transactions through computer technology (as the technological basis); and the development of large institutional financial players (such as the speculative hedge funds, the investment banks, and the huge mutual and pension funds).

This combination has led to the rapid shifting of large blocks of short-term capital flowing across borders in search of quick and high returns, to the tune of US\$2 trillion a day. Only one to two percent is accounted for by foreign exchange transactions relating to trade and foreign direct investment. The remainder is for speculation or short-term investments that can move very quickly when the speculators' or investors' perceptions change.

When a developing country carries out financial liberalisation before its institutions or knowledge base is prepared to deal with the consequences, it opens itself to the possibility of tremendous shocks and instability associated with inflows and outflows of funds.

What happened in East Asia is not peculiar, but has already happened to many Latin American countries in the 1980s, to Mexico in 1994, to Sweden and Norway in the early 1990s. They faced sudden currency depreciations due to speculative attacks or large outflows of funds.

A total of US\$184 billion entered developing Asian countries as net private capital flows in 1994-96, according to the Bank for International Settlements. In 1996, US\$94 billion entered and in the first half of 1997, \$70 billion poured in. With the onset of the crisis, \$102 billion went out in the second half of 1997. The massive outflow has continued since.

These figures help to show: (i) how huge the flows (in and out) can be; (ii) how volatile and sudden the shifts can be, when inflow turns to outflow; (iii) how the huge capital flows can be subjected to the tremendous effect of "herd instinct," in which a market opinion or operational leader starts to pull out, and triggers or catalyses a panic withdrawal by large institutional investors and players.

In the case of East Asia, although there were grounds to believe that some of the currencies were over-valued, there was an over-reaction of the market, and consequently an "over-shooting" downwards of these currencies beyond what was justifiable by fundamentals. It was a case of self-fulfilling prophecy.

It is believed that financial speculators, led by some hedge funds, were responsible for the original "trigger action" in

Thailand.

The Thai government used up over US\$20 billion of foreign reserves to ward off speculative attacks. Speculators are believed to have borrowed and sold Thai baht, receiving US dollars in exchange. When the baht fell, they needed much less dollars to repay the baht loans, thus making large profits.

A report in Business Week in August 1997 revealed that hedge funds made big profits from speculative attacks on Southeast Asian currencies in July 1997. In an article titled "The Rich Get a Little Richer," the business weekly reported on the recent profit levels of US-based "hedge funds", or investment funds that make their money from leveraged bets on currencies, stocks, bonds, commodities. According to Business Week, in the first half of that year, the hedge funds performed poorly. But in July (the month when the Thai baht went into crisis and when other currencies began to come under attack) they "rebounded with a vengeance" and most types of funds posted "sharp gains". The magazine says that a key contributing factor for the hedge funds' excellent July performance was "the funds' speculative plays on the Thai baht and other struggling Asian currencies, such as the Malaysian ringgit and the Philippine peso." As a whole, the hedge funds made only 10.3 percent net profits (after fees) on average for the period January to June 1997. But their average profit rate jumped to 19.1 percent for January-July 1997. Thus, the inclusion of a single month (July) was enough to cause the profit rate so far that year to almost double. This clearly indicates a tremendous profit windfall in July.

In some countries, the first outflow by foreigners was followed by an outflow of capital by local people who feared further depreciation, or who were concerned about the safety of financial institutions. This further depreciated the currencies.

The sequence of events leading to and worsening the crisis included the following.

(a) Financial liberalisation

Firstly, the countries concerned carried out a process of financial liberalisation, where foreign exchange was made convertible with local currency not only for trade and direct-investment purposes but also for autonomous capital inflows and outflows (i.e. for "capital account" transactions); and where inflows and outflows of funds were largely deregulated and permitted. This facilitated the large inflows of funds in the form of international bank loans to local banks and companies, purchase of bonds, and portfolio investment in the local stock markets. For example, the Bangkok International Banking Facilities (BIBF) was set up in March 1993 to receive foreign funds for recycling to local banks and companies, and it received US\$31 billion up to the end of 1996. South Korea recently liberalised its hitherto strict rules that prohibited or restricted foreign lending, in order to meet the requirements for

entering the Organisation for Economic Cooperation and Development (OECD). Its banks and firms received large inflows of foreign loans, and the country accumulated US\$150 billion of foreign debts, most of it private-sector and short-term. In Indonesia, local banks and companies also borrowed heavily from abroad.

(b) Currency depreciation and debt crisis

The build-up of short-term debts was becoming alarming. What transformed this into crisis for Thailand, Indonesia and South Korea was the sharp and sudden depreciation of their currencies, coupled with the reduction of their foreign reserves in anti-speculation attempts. When the currencies depreciated, the burden of debt servicing rose correspondingly in terms of the local-currency amount required for loan repayment. That much of the loans were short-term was an additional problem. Foreign reserves also fell in attempts to ward off speculative attacks. The short-term foreign funds started pulling out sharply, causing reserves to fall further. When reserves fell to dangerously low levels, or to levels that could not allow the meeting of foreign debt obligations, Thailand, Indonesia and South Korea sought IMF help.

(c) Liberalisation and debt: the Malaysian case

Malaysia also went through a process of financial liberalisation, with much greater freedom for foreign funds to invest in the stock market, for conversion between foreign and local currencies, and for exit of funds abroad.

The Central Bank however retained a key control: private companies wanting to borrow foreign-currency loans exceeding RM5 million must obtain the Bank's approval. This is generally given only for investments that would generate sufficient foreign exchange receipts to service the debts. Companies are also not allowed to raise external borrowing to finance the purchase of properties in the country (Bank Negara Annual Report 1997, pp.53-54). Thus there was a policy of "limiting private sector external loans to corporations and individuals with foreign exchange earnings" which according to Bank Negara "has enabled Malaysia to meet its external obligations from export earnings." According to a private-sector leader, this ruling saved Malaysia from the kind of excessive short-term private-sector borrowing that led the other three countries into a debt crisis.

As a result of these controls, Malaysia's external debt has been kept to manageable levels. Nevertheless the debt servicing burden in terms of the local currency has been made heavier by the sharp ringgit depreciation.

The relatively low debt level, especially short-term debt, is what distinguishes Malaysia from the three countries that had to seek IMF help. The lesson is that it is prudent and necessary to limit the degree of financial liberalisation and to continue to limit

the extent of foreign debt, and moreover to in future keep the foreign debt to an even much lower level.

(d) Local asset boom and bust, and liquidity squeeze

The large inflows of foreign funds, either as loans to the banking system and companies directly, or as equity investment in the stock markets, contributed to an asset price boom in property and stock markets in East Asian countries.

With the depreciation of currencies, and expectations of a debt crisis, economic slowdown or further depreciation, substantial foreign funds left suddenly by withdrawing loans and selling off shares. Share prices fell. Thus the falls in currency and share values fed off each other. With weakened demand and increasing over-supply of buildings and housing, the prices of real estate also fell significantly.

For the countries afflicted with sharp currency depreciations and share market declines, the problems involved:

** The much heavier debt servicing burden of local banks, companies and governments that had taken loans in foreign currencies;

** The fall in the value of shares pledged as collateral for loans by companies and individuals, and the fall in the values of land, buildings and other real estate property. This has led to financial difficulties for the borrowers;

** The higher interest rates caused by the liquidity squeeze and tight monetary policies have brought about added financial burdens on all firms as well as on consumers that borrowed;

** As companies and individuals face difficulties in servicing their loans, this has increased the extent of non-performing loans and weakened the financial position of banks, and

** Higher inflation caused by rising import prices resulting from currency depreciation.

Moreover, in order to reduce the current account deficit, or in following the orthodox policies of the IMF, governments in the affected countries reduced their budget expenditure. The main rationale was to induce a reduction in the current account deficit, which had been targetted by currency speculators as a weak spot in the economy. Added to the higher interest rate and the tightening of liquidity, this budget cut also added to recessionary pressures.

(e) The fall in output

In the region, the financial crisis has been transformed to a full-blown recession in the real economy of production. Worst affected is Indonesia, with a 6.2% fall in GDP in the first quarter of 1998, and a newly projected negative growth for 1998 of 15%, inflation of 80% and expected unemployment of 17% or 15 million. South Korea's GDP fell 3.8% in the first quarter of 1998. Thailand's 1998 GDP is expected to drop 4 to 5.5% in 1998. Hong Kong's GDP fell 2% in the first quarter. Singapore enjoyed 5.6% growth in the first quarter but is expected to slip into negative growth sometime in the second half of 1998. In Malaysia, real GDP fell 1.8% in the first quarter of 1998 (compared to 6.9% strong growth in 4th quarter-1997).

A bright spot for the region is a turnaround in the current account of the balance of payments. However this improvement came with a heavy price. The increased trade surplus was caused more by a fall in imports than by a rise in exports, especially in real (or volume) terms. Thus the trade surplus indicates the effects of recession on falling imports, rather than an expansion of exports. Another point to note is that an improvement in the current account need not necessarily mean a healthy overall balance of payments position unless there is also a positive development in the capital account. A possible weakness here could be an outflow of short-term funds, by either foreigners or local people. To offset this, a repatriation of funds owned by local companies or people back to the country should be encouraged.

(f) Easing of fiscal and monetary policy

Recently there has been an easing of fiscal and monetary policy in the affected countries in response to the depth of the recessionary conditions. These actions would hopefully have the effect of improving economic conditions and ease recessionary pressures.

3. THE RECENT DEBATE ON THE ROLE OF THE IMF

As the East Asian crisis continues to deepen, the debate on the role of the International Monetary Fund's policies has heated up. The IMF's top officials continue to defend their macroeconomic approach of squeezing the domestic economies of their client countries through high interest rates, tight monetary policies and cuts in the government budget. Their argument is that this "pain" is needed to restore foreign investors' confidence, and so strengthen the countries' currencies.

However, some economists had already warned at the start of the IMF "treatment" for Thailand, Indonesia and South Korea that this set of policies is misplaced as it would transform a financial problem that could be resolved through debt restructuring, into a

full-blown economic crisis.

The prediction has come true, with a vengeance. The three countries under the IMF's direct tutelage have slid into deep recession. Partly due to spillover effects, other countries such as Malaysia and Hong Kong have also suffered negative growth in the year's first quarter. Even Singapore is tottering on the brink of minus growth.

The three affected countries had faced initial problems resulting from currency depreciation and stock market decline, such as debt repayment and a great financial weakening of the corporate and banking sectors. But then came a second set of problems resulting from the high interest rates and tight monetary and fiscal policies that the IMF imposed or advised.

For companies already hit by the declines in currency and share values, the interest rate hike became a third burden that broke their backs.

But even worse, there are many thousands of firms (most of them small and medium-sized) that have now been affected in each country. Their owners and managers did not make the mistake of borrowing from abroad (nor did they have the clout to do so). The great majority of them are also not listed on the stock market.

So they cannot be blamed for having contributed to the crisis by imprudent foreign loans or fiddling with inflated share values.

Yet these many thousands of companies are now hit by the sharp rise in interest rates, a liquidity squeeze as financial institutions are tight-fisted with (or even halt) new loans, and the slowdown in orders as the public sector cuts its spending.

In Thailand, "domestic interest rates as high as 18 percent have been blamed for starving local businesses of cash and strangling economic growth," according to a Reuters report of 3 June. In South Korea, thousands of small and medium companies have gone bankrupt as a result of high interest rates. Although the country has about US\$150 billion in foreign debts, its companies in January also had double that (or more than US\$300 billion) in domestic debt. According to the Wall Street Journal (9 Feb), the Korean economy was facing fresh agony over this huge domestic debt as thousands of companies file for bankruptcy as they find it harder to get credit. "To blame for the tighter liquidity are higher interest rates, a legacy of the IMF bailout that saved Korea's economy from collapse, and a sharp economic slowdown." In Indonesia, whilst top corporations with foreign currency loans have been hit hardest by the 80 percent drop of the rupiah vis-a-vis the US dollar, the majority of local companies have been devastated by interest rates of up to 50 percent. The rates were raised as part of an IMF agreement and were aimed at strengthening the rupiah. However the rupiah has not improved from its extremely low levels, whilst many indebted companies are unable to

service their loans.

In Malaysia, which has fortunately not had to seek an IMF loan package, interest rates are lower than in the three IMF client countries.

Nevertheless, the initial interest rate hike and the reluctance of many banks to provide new loans caused serious difficulties for many firms and consumers. This led to open complaints against the financial institutions by the business sector, and to calls by political leaders, including the Prime Minister, to find measures to reduce the lending rates.

In this matter, countries subjected to currency speculation face a serious dilemma. They have been told by the IMF that lowering the interest rate might cause the "market" to lose confidence and savers to lose incentive, and thus the country risks capital flight and currency depreciation.

However, to maintain high interest rates or increase them further will cause companies to go bankrupt, increase the non-performing loans of banks, weaken the banking system, and dampen consumer demand. These, together with the reduction in government spending, will plunge the economy into deeper and deeper recession. And that in turn will anyway cause erosion of confidence in the currency and thus increase the risk of capital flight and depreciation.

A higher interest rate regime, in other words, may not boost the currency's level but could depress it further if it induces a deep and lengthy recession.

It is also pertinent to note that a country with a lower interest rate need not necessarily suffer a sharper drop in its currency level. Take the case of China. Since May 1996, it has cut its interest rates four times and its one-year bank fixed deposit rate was 5.2 percent in May (according to a Reuters report). But its currency, which is not freely traded due to strict controls by the government, has not depreciated.

It has also been pointed out by the United Nations Conference on Trade and Development's (UNCTAD) chief macroeconomist Yilmaz Akyuz that "although Indonesia and Thailand have kept their interest rates higher than Malaysia, they have experienced greater difficulties in their currency and stock markets." According to Akyuz, there is not a strong case for a drastic reduction in domestic growth (as advocated by the IMF) to bring about the adjustment needed in external payments.

Indeed it is very strange that the IMF as well as the leaders of Western countries are shrilly criticising Japan for not doing more to reflate its ailing economy. They are calling for more effective tax cuts so that Japanese consumers can spend more and thus kick the economy into recovery.

The yen had been sharply dropping, causing grave concerns that this would trigger a deeper Asian crisis or world recession. These concerns led the United States to intervene in the foreign exchange market to stop the yen's further decline.

Yet neither the IMF nor the Western leaders have asked Japan to increase its interest rate (which at 0.5 percent must be the lowest in the world) to defend the yen. Instead they want Japan to take fiscal measures to expand the economy.

This tolerance of low interest rates in Japan as well as the pressure on the Japanese government to pump up its economy is a

very different approach compared to the high-interest austerity-budget medicine prescribed for the other ailing East Asian countries.

Could it be that this display of double standards is because it is in the rich countries' interests to prevent a Japanese slump that could spread to their shores, and so they insist that Japan reflate its economy whilst keeping its interest rate at rock bottom? Whereas in the case of the other East Asian countries, which owe a great deal to the Western banks, the recovery and repayment of their foreign loans is the paramount interest?

In the latter case, a squeeze in the domestic economy would reduce imports, improve the trade balance and result in a strong foreign exchange surplus, which can then be channelled to repay the international banks.

This is in fact what is happening. The main bright spot for Thailand, South Korea, Indonesia and Malaysia is that as recession hits their domestic economy, there has been a contraction in imports resulting in large trade surpluses.

Unfortunately, this is being paid for through huge losses in domestic output and national income, the decimation of many of the large, medium and small firms of these countries, a dramatic increase in unemployment and poverty, and social dislocation or upheaval. A price that is far too high to pay, and which in the opinion of many economists (including some top establishment economists) is also unnecessary for the people of these countries to pay.

They argue that instead of being forced to raise interest rates and cut government expenditure, the countries should have been advised by the IMF to reflate their economies through lower interest rates and increased government spending.

Recently the Financial Times (London) carried a strongly worded opinion article entitled "Asian water torture" with this sub-heading: "Unless the IMF allows the region's economies to reflate and lower interest rates, it will condemn them to a never-ending spiral of recession and bankruptcy."

Written by Robert Wade, professor of political economy in Brown University (US), the article notes that the IMF imposed very high interest rates on the basis that a sharp rise in rates would stabilise currency markets, dampening pressures for competitive devaluations and making it easier for client governments to repay foreign creditors. The argument has a theoretical basis, says Wade, but it assumes conditions not present in Asia. When financial inflows did not resume, the Fund's response was to give it more time and make the pain sharper.

"Investors on the contrary took the high rates as a signal of great dangers ahead, making them all the more anxious to get out and stay out," says Wade. "High rates and the associated austerity policies have caused so much damage in the real economy as to validate the perception of great dangers."

Wade blames the IMF for failing to grasp the implications of imposing high interest charges on Asian companies that are typically far more indebted than Western and Latin American companies. "High rates push them much more quickly from illiquidity towards insolvency, forcing them to cut back purchases, sell inventories, delay debt repayment and fire workers. Banks then accumulate a rising proportion of bad loans and refuse to make new ones. The IMF's insistence that banks meet strict Basle capital adequacy standards only compounds the collapse of credit. The combination of high interest rates and Basle standards is the immediate cause of the wave of insolvency, unemployment and contraction that continues to ricochet around the region and beyond. The uncertainty, instability and risk of further devaluations keep capital from returning despite high real interest rates."

Wade finds the IMF's contractionary approach "puzzling" as the United States authorities after the 1987 stock market crash had acted to keep markets highly liquid whatever the cost, yet in Asia the Fund acted to contract liquidity.

"Is this because it knows only one recipe? Or because it is more interested in safeguarding the interests of foreign bank creditors than in avoiding collapse in Asia?"

Concluding that the IMF's approach is not working, Wade calls on governments in the region to change tack away from the current approach of very low inflation, restrained demand and high real interest rates as the top priorities. "They need to take a tougher stance in the rescheduling negotiations with the creditor banks, lower interest rates to near zero, and step on the monetary gas," he says.

This proposition might be found by many to be too bold. What if

the markets react negatively and the local currency drops further? To take this into account, Wade complements his proposal with another: that the governments have to reintroduce some form of cross-border capital controls. They should then channel credit into export industries, generate an export boom, and let the ensuing profits reinforce inflationary expectations and reflate domestic demand.

The West, meanwhile, should stop pushing developing countries to allow free inflow and outflow of short-term finance as they are simply not robust enough to be exposed to the shocks that unimpeded flows can bring. There should also be reconsideration of the constitution of money funds (whose priorities are short-term results) and over-guaranteed international banks, which lie at the heart of the problem of destabilising international financial flows.

"Until Asian governments lower interest rates, take control of short-term capital movements, and cooperate within the region, the crisis will go on and on like water torture. That will bring poverty and insecurity to hundreds of millions and turn parts of Asia into a dependency of the IMF and the US, its number one shareholder."

The Wade article is the latest in a growing series of academic articles calling for a change in IMF policies.

The Harvard professor, Jeffrey Sachs, has been attacking the IMF ever since early November 1997, when he predicted that the bailout packages for Thailand and Indonesia, if tied to orthodox financial conditions like budget cuts and higher interest rates, could "do more harm than good, transforming a currency crisis into a rip-roaring economic downturn."

The predicted downturn has now turned out to be much worse than anyone imagined.

Another prominent critic is Martin Feldstein, economics professor at Harvard University, president of the National Bureau of Economic Research and formerly chief economic advisor to the US government.

In the Foreign Affairs journal (March/April 1998), he says the IMF's recent emphasis on imposing major structural and institutional reforms, rather than focusing on balance-of-payments adjustments, will have short-term and longer-term adverse consequences.

The main thrust of his article is that the IMF has strayed from its mandate of helping countries resolve their balance of payments problems (which could be best done by organising debt rescheduling exercises between the countries and their foreign creditors) and instead has been imposing conditions relating to their economic, financial and social structures which are not relevant to resolving the debt and balance of payments problems at hand.

This is a subject that needs separate treatment.

However, Feldstein also criticises the IMF's short-term macroeconomic policies for Korea, which call for budget deficit reduction (by raising taxes and cutting government spending) and a tighter monetary policy (higher interest rates and less credit availability), which together depress growth and raise unemployment.

Asks Feldstein: "But why should Korea be required to raise taxes and cut spending to lower its 1998 budget deficit when its national savings rate is already one of the highest in the world, when its 1998 budget deficit will rise temporarily because of the policy-induced recession, and when the combination of higher private savings and reduced business investment are already freeing up the resources needed to raise exports and shrink the current account deficit?"

Feldstein notes that under the IMF plan, the interest rate on won loans was 30 percent whilst inflation was only 5 percent (at the time the article was written, earlier this year).

"Because of the high debt typical of most Korean companies, this enormously high real interest rate of 25 percent puts all of them at risk of bankruptcy," he says.

"Why should Korea be forced to cause widespread bankruptcies by tightening credit when inflation is very low, when the rollover of bank loans and the demand for the won depend more on confidence than on Korean won interest rates, when the failures will reduce the prospect of loan repayment, and when a further fall in the won is an alternative to high interest rates as a way to attract won-denominated deposits?"

"Although a falling won would increase the risk of bankruptcies among Korean companies with large dollar debts, the overall damage would be less extensive than the bankruptcies caused by very high won interest rates that would hurt every Korean company. Finally, why should Korea create a credit crunch that will cause even more corporate failures by enforcing the international capital standards for Korean banks when the Japanese government has just announced that it will not enforce those rules for Japanese banks in order to avoid a credit crunch in Japan?"

The questions raised by the IMF's policies, and now about the severe effects they are having in the region, are very serious indeed, as they relate to the shape of the national economies of East Asia and the very future of the countries.

Fortunately, Malaysia has not been forced by circumstances to seek an IMF rescue package, and thus we have more degrees of freedom to determine short- and longer-term policies to get out of the crisis.

For those countries already taking IMF loans, it is most difficult (if not almost impossible) to make or modify policies

or to change course if things go wrong, as the IMF is always ready to threaten to stop its loans (which are given in small instalments) if these countries try to veer even a little from the IMF path.

Malaysia's policy makers have an unenviable task of going through the pros and cons of each policy choice, for each policy option carries both advantages and disadvantages, and thus there are many trade-offs to carefully consider.

4. THE NEED TO REGULATE THE GLOBAL FINANCIAL SYSTEM

The East Asian crisis has shown up the threats of volatile and large short-term capital flows to the economic stability of developing countries. What is urgently needed is greater transparency of how the global financial players and markets operate, and reforms at both international and national levels to regulate these speculative flows.

(a) Lack of Transparency

The workings and movements in the international financial markets and system have played the most important part in the East Asian financial crisis. The crisis is also manifesting itself now in Russia, South Africa and will likely spread to other countries.

It becomes obvious that this global system needs to be monitored and also reformed. Yet there is a great lack of transparency on what constitutes the financial markets, who the major players are, what are their decisions and how money is moved from market to market, and with what effect.

Financial crises cannot be prevented or resolved unless this lack of transparency is removed. That is a first step.

After greater transparency, there is the need to improve the system, to remove its worst aspects and excesses, and to put in place a system in which currency and other financial instruments (shares, bonds, etc) are used for legitimate trade or real-investment purposes and not for non-beneficial speculative gain.

Transparency and reforms are needed in the following areas:

** We need to know who the major institutions and players are in the ownership of financial assets, and their behaviour and operational methods, and the markets they operate in.

How do they gain their leverage? From where do they get their funds and credit and on what terms? How do they operate and through which channels? In particular, how do they view emerging markets and what are their methods to derive maximum profits there?

These institutions include hedge funds, mutual funds,

pension funds, investment banks, insurance companies, commercial banks and the finance departments of multinational and big companies.

** What is the system by which central banks of the major Northern countries regulate, deregulate (or decide not to regulate) the behaviour of funds, speculators and investors?

How do central banks coordinate among themselves? Do they (or some of them) coordinate among themselves to influence parameters such as exchange rates and interest rates? What is the role (or lack of role) of the Bank for International Settlements?

** The IMF is the major international financial institution, whose policies can determine the finances and fate of nations.

There is lack of transparency on how the staff (who wield considerable power in the institution) set their policies and conditions, globally and for each nation.

How do the staff determine the policy framework and the specific conditions for loans for each client country? Do they come under the political influence of particular countries (especially the US) and of the major shareholders, thus leading to a situation where decisions are not made only or mainly on professional grounds?

How do the major shareholders collaborate among themselves? What is the linkage of interests between the IMF secretariat, the

US Treasury and other major countries' finance ministries, and the international banks (whose interests they usually serve in getting loans repaid from developing countries)?

There are some studies relating to some of the questions above. However these studies are few. Much more investigation has to be done, so that some basic knowledge of the institutions and system can be gained. On that basis, proposals for changes and reforms can be made.

(b) The Need for Reform

The present system suits the interests of financial owners and speculators. These players have powerful backers in governments or in the U.S. Congress and other Parliaments in the North. Thus getting global reform going is an uphill task.

Nevertheless it is becoming daily more evident that the present system is very unstable and will continue to produce large-scale crises which are becoming too costly for the IMF or the Group of 7 rich countries (G7) to bear. Therefore the question of "a new financial architecture" is being raised by the G7 themselves.

However the G7 approach is to try as far as possible to have

business as usual. This means not reforming the present system of free and liberal flows of short-term or long-term capital. They do not want regulation at global or national level.

Their approach is to get national governments in developing countries to strengthen their banking systems so that the banks can withstand more shocks that volatile flows will bring in future.

The G7 countries' focus is to have "greater transparency" at national level (so that investors will not foolishly put money in weak spots) and tighter banking regulation so that there will be less chance of a systemic bank collapse.

Such an approach may of course be useful in itself, as no one doubts the importance of strengthening national policies and financial systems.

But surely this "national approach" in developing countries is grossly insufficient and needs to be complemented by a global approach to monitor and regulate cross-border financial flows. At national level, governments should also be allowed and encouraged to institute regulations to reduce the power of speculative funds (this needs to be done especially in the rich countries) and to reduce the volatile inflows and outflows of short-term capital.

There is a strong case (getting stronger by the day) for greater international and national regulation of financial flows, players and markets, as well as for reform of the IMF.

At global level, there should be a system of monitoring short-term capital flows, tracing the activities of the major players and institutions, so that the sources and movements of speculative capital can be publicly made known.

There can also be serious pursuit of a global tax on short-term financial flows, such as the well-known Tobin Tax, where a 0.25% tax is imposed on all cross-country currency transactions.

This will penalise short-term speculators whilst it will have only a very small effect on genuine traders and long-term investors. The advantage is that not only will speculation be discouraged, but there can also be far greater transparency in the markets as movements of capital can be more easily traced.

At national level, in the North countries, which are the major sources of international capital flows and speculation, national regulations can be imposed to reduce the power and leverage of funds.

For example, banking regulations can be introduced to limit the amount and scope of credit to hedge funds. Proposals can be made for this and other similar objectives.

At national level, in the South, countries should explore options of regulating and discouraging inflows of short-term

speculative capital. The well-known case of Chile where 30% of all incoming foreign capital (other than foreign direct investment) had to be deposited with the Central Bank interest-free for up to one year, can be emulated by other countries.

This device was introduced after an episode of excessive inflows of funds. It helped to reduce short-term speculative inflows and outflows whilst at the same time it was not a disincentive for the inflow of long-term foreign investment.

Another measure worth emulating is the requirement that local companies seek Central Bank permission before securing foreign-currency loans, and permission should be given only if or to the extent that the project being financed is shown to be able to yield foreign exchange earnings sufficient to service the loan.

As already mentioned, this is a requirement established by the Central Bank in Malaysia, and it helped to prevent the country from being saddled with the large and excessive short-term foreign-exchange private corporate loans that flooded other countries like Thailand, Indonesia and South Korea.

Further, countries that face a possible danger of sudden and large outflows of funds can consider some limited restrictions (at least for a limited time when the danger is imminent) on the freedom of residents and resident companies to transfer funds abroad.

Such limitations had in the past been in place in countries that now practise financial liberalisation. Indeed restrictions on capital outflows still exist in many developing countries (such as China and India) and have helped to stabilise their financial situation.

Whilst the institution of regulations on inflows and outflows of short-term capital makes eminent sense, countries that have

already liberalised and are dependent on the "goodwill" of the financial markets are afraid that reintroducing them could generate a backlash from the market and from the G7 countries.

Thus, it is crucial that the G7 countries themselves review their own anti-regulation position, and give the stamp of approval and legitimacy for developing countries to have these measures. Otherwise countries may not be able to institute measures that are good or necessary for their financial stability and their economic recovery for fear of being labelled as "financial outcasts."

Once again, the ball is at the feet of the G7 countries to take the lead in both international-level and national-level reforms.

5. SOME POLICY LESSONS FROM THE ASIAN CRISIS

Whilst the debate on the causes and processes of the Asian crisis goes on, it is time to draw at least some preliminary policy lessons. Developing countries should rethink the benefits and risks of financial liberalisation. In particular, they have to take great care to limit their external debt (especially short-term debt), improve the balance of payments and build up their foreign reserves.

(a) Need for Great Caution About Financial Liberalisation and Globalisation

One of the great lessons of the Asian crisis is the critical importance for developing countries to properly manage the interface between global developments and national policies, especially in planning a nation's financial system and policy.

In a rapidly globalising world, developing countries face tremendous pressures (coming from developed countries, international agencies and transnational companies) to totally open up their economies.

In some cases and under certain conditions, liberalisation can play and has played a positive role in development. However, the Asian crisis has shown up that in other circumstances, liberalisation can wreak havoc, especially on small and dependent economies.

This is especially so in the field of financial liberalisation, where the lifting of controls over capital flows can lead to such alarming results as a country accumulating a mountain of foreign debts within a few years, the sudden sharp depreciation of its currency, and a stampede of foreign-owned and local-owned funds out of the country in a few months.

Surely then a clear conclusion from the Asian crisis is that it is prudent and necessary for a developing country to have measures that reduce its exposure to the risks of globalisation and thus place limits on its degree of financial liberalisation.

Countries should not open up and deregulate their external finances and foreign exchange operations so rapidly when they are unprepared for the risks and negative consequences. Measures should be adopted to prevent speculative inflows and outflows of funds, and to prevent opportunities for speculation on their currencies.

At the least, the process of opening up to capital flows should be done at a very gradual pace, in line with the growth of knowledge and capacity locally on how to adequately handle the new processes and challenges that come with the different aspects of liberalisation.

This will require policy makers (including in the Central Bank, Finance Ministry, Securities Commission and Planning Unit) to have a proper understanding of the processes at work, the

policy instruments to deal with them, adequate regulatory, policy and legal frameworks and the enforcement capability.

Moreover, the private sector players (including banks and other financial institutions, and private corporations) will also have to understand, master and control processes such as inflows of funds through loans and portfolio investment, the recycling of these to the right sectors and institutions for efficient use, and the handling of risks of changes in foreign currency rates.

The whole process of learning and training and putting the required infrastructure in place will take time. Some European countries, which started with already sophisticated financial systems, took more than a decade to prepare for liberalisation, and yet failed to prevent financial failures.

(b) Manage External Debt Well and Avoid Large Debts

At the macro-policy level, a very critical lesson from the Asia crisis is that governments have to pay great attention to external debt management.

They have to take great care to limit the extent of their countries' foreign debt. It was the rapid build-up of external debt that more than anything else led to the crisis in Thailand, Indonesia and South Korea, and to a smaller extent, Malaysia.

Developing countries should not build up a large foreign debt (whether public or private debt) even if they have relatively large export earnings.

The East Asian countries are big exporters, including of manufactured goods, and perhaps this led them to the complacent belief that the export earnings would comfortably provide the cover for a rapid build-up of external debt. However, a bitter lesson of the crisis is that high current export earnings alone are insufficient to guarantee that debts can be serviced.

For a start, future export growth can slow down (as happened). Then, there can also be a high growth in imports and a large outflow of funds due to repatriation of foreign-owned profits or due to the withdrawal of short-term speculative funds.

In good years these factors can be offset by large inflows of foreign long-term investment. However if the negative factors outweigh the inflows, the balance of payments will register a deficit. Such deficits mean that the country's foreign reserves are being run down.

When the point is reached when the reserves are not large enough to adequately pay for the interest and principal of the external debt that is due, the country will have reached the brink of default and will thus have to declare a state of crisis requiring international assistance.

That flashpoint was reached in 1997 by Thailand, Indonesia and

South Korea, necessitating their seeking rescue packages from the IMF. Their problems had been compounded greatly by the sharp depreciation of their currencies, thus raising equally sharply the burden of debt servicing in terms of each country's local currency, and making the situation impossible to sustain.

Thus, having a large foreign debt puts a country in a situation of considerable risk, especially when that country has liberalised and its currency is fully convertible and thus subject to speculation.

In particular, having too much short-term debt can be dangerous as it has to be repaid within a short period of months or a year, thus requiring the country to have large enough reserves at that period to be able to service the debts. The structure of debt maturity should also be spread out, keeping in mind the dangers of "bunching", or too much debt coming due at the same time.

It is thus important to watch the relation of levels of debt and debt servicing not only to export earnings but also to the level of foreign reserves. Reserves should be built up to a comfortable level, sufficient to service debt, especially short-term debt.

(c) Manage and Build Up Foreign Reserves

The careful management of foreign reserves has thus emerged as a high-priority policy objective in the wake of the Asian crisis.

Maintaining and increasing foreign reserves is, unfortunately, a most difficult and complex task. There are so many factors involved, such as the movements in merchandise trade (exports and imports), the payment for trade services, the servicing of debt and repatriation of profits, the inflows and outflows of short-term funds, the level of foreign direct investment and the inflows of new foreign loans.

All these items are components of the balance of payments, whose "bottom line" (or overall balance, either as surplus or deficit) determines whether there is an increase or run-down of a country's foreign reserves.

As can be noted, these items are determined by factors such as the trends in merchandise trade, the external debt situation (in

terms of loan servicing and new loans), and the "confidence factor" (which affects the volatile movements of short-term capital as well as foreign direct investment).

To these must now be added the state of the local currency which in the past could be assumed to be stable but which recently has become a major independent factor that both influences the other factors and is itself influenced by them.

To guard and build up the foreign reserves, the country has thus to take measures in the short and longer term to strengthen its balance of payments, in particular the two main aspects, the current account and the capital account.

The first aspect is to ensure the current account (which measures movements of funds related to trade and services) is not running a high deficit.

It was the fear that East Asian countries' wide deficits in recent years were unsustainable that gave cause for speculators to trigger a run on their currencies.

One of the only positive results of the recession is that the current account is now swinging strongly into surplus.

The second aspect is to build up conditions so that the capital account (which measures flows of long- and short-term capital not directly related to trade) is also manageable and well behaved.

This can be very tricky, especially in the present volatile circumstances.

On one hand, the country may now need inflows of long-term investment and long-term loans in order to provide liquidity and build reserves. But these must be carefully managed so as not to cause large future outflows on account of profit repatriation and debt repayment.

But on the other hand, there is the difficult problem of how to manage short-term capital flows. In some past years there were excessive inflows, especially of foreign portfolio investment.

In the past year there has been the reverse problem of large outflows of short-term funds caused by the withdrawal of foreign and local funds abroad.

It is important that these outflows be reduced so that the overall balance of payments can be in surplus, and the foreign reserves be built up.

Since the flow of these short-term funds is influenced by intangible factors such as "confidence", reducing the net outflows is one of the great challenges of the recovery process.

(d) The Market Can Make Big Mistakes and Needs Regulation

Another lesson of the Asian crisis is that the market can make mistakes too, and large or mega mistakes at that.

In recent years, it had become fashionable to think that mistakes are only made by governments, whilst the market knows best.

The debt crises of the 1980s were said to be caused by over-borrowing by the public sector which, being inefficient, had

used the loans for unproductive projects, thus plunging their countries into a financial mess.

This led to the conclusion that economic resources and leadership should be passed on to the private sector, which was assumed to be much more efficient since corporations operated on the profit motive.

It was assumed that financial liberalisation and private sector borrowing would not pose problems as banks, investors and companies would have calculated accurately their credit, loan and investment decisions.

There was thus the complacent acceptance of the build-up of private sector external debt since it was believed the businesses would make the profits to repay their loans.

The Asian crisis has shattered the myth of the perfectly working market and its efficient use of resources. It shows that markets and the private sector are imperfect, as seen by the huge inflows then sudden outflow of foreign funds, and by the imprudent large external loans taken by the local companies and banks which they are now unable to repay.

When the private sector makes mistakes it can be as costly as (or even more so than) when governments make mistakes. Most top-level companies and many banks in the affected East Asian countries are in trouble or insolvent as a result of having loans and projects gone sour.

Most serious are the loans contracted in foreign currency, for a default in these can bring down the country's financial standing.

In the case of the unrepayable foreign loans in Thailand, Indonesia and South Korea, the "market failure" was caused not only by their local banks and companies. The blame has to be shared by foreign banks and investors that also erred in assessing the credit-worthiness of the loans.

Thus, the financial deregulation measures taken in recent years by governments on the assumption that markets, companies and banks would behave rationally and efficiently, should be reviewed.

There should be a re-balancing of the roles of the state and the markets. The governments have to at least consider having stronger regulations to prevent private banks, financial institutions and companies from making mistakes, especially in relation to foreign-currency loans.

The Malaysian Bank Negara's regulation, that private companies have to seek its permission before taking foreign loans, which

will be given only if it can be shown that the projects can earn foreign exchange to finance debt servicing, should be maintained in Malaysia and emulated by other countries.

Indeed, the enforcement of this ruling can be tightened, since many of the companies that obtained permission and borrowed heavily now face difficulties.

(e) Other Issues

The key challenge at present is to adopt the appropriate policy options to steer towards a recovery as soon as possible, whilst recognising the negative and even hostile external environment.

To a significant extent, regional and global developments will continue to provide the backdrop to and a critical influence over future developments in the country. For example, developments like Japan not recovering quickly enough, devaluation of the Chinese yuan, the spread of the currency crisis to Russia, Latin America and Eastern Europe, or a sudden decline in the New York stock market will have a significant externally generated negative effect on recovery prospects.

Affected countries can however attempt to take measures that reduce the risks generated from external factors and at the same time improve the domestic conditions for recovery.

In minimising external risks, it would be wise to retain and strengthen the kind of policies and financial regulations that prevented the country from falling deeper into external indebtedness such as not allowing companies to obtain foreign-exchange loans unless they can show evidence that these will generate the foreign exchange earnings to service the loans.

Other regulations to discourage inflows of speculative short-term funds (such as the Chile example, of requiring a percentage of funds from abroad to be deposited interest-free for a year with the Central Bank) should be studied.

A study could also be made on the optimum extent of reliance on foreign participation in the stock market, so as to discourage excessive volatility or excessive surges of inflows and outflows of portfolio capital.

The financial authorities should also not make it too easy for local funds to exit; for example, there could be conditions placed on local people for opening bank accounts abroad; limits on the amount of currency taken out of the country; and conditions on repatriation of funds (at least by local people) abroad.

In a period of increased possibility of reduced external demand, measures should be strengthened to increase domestic linkages in the economy, for example between domestic demand and supply.

There should be increased local production (especially through small and medium-sized enterprises) to meet local consumer needs,

in all sectors (food, other agriculture, manufacturing and services and inputs in all these sectors). This should be

backed up by a sustained "buy local" campaign.

There should be reduced dependence on foreign savings (loans or capital) in order to strengthen the balance of payments and reduce exposure to foreign debt or volatile foreign capital flows.

East Asian countries normally have a very high domestic savings rate. For example, in Malaysia, gross national savings was 40% of GNP in 1997. The current account was in deficit by 5% of GNP, thus necessitating inflows of foreign funds by that amount in order to maintain balance in the balance of payments.

Since 40% is already one of the highest national savings rates in the world, Malaysia should direct its efforts towards using the national savings in as efficient and productive a way as possible, and reduce or eliminate the need to augment this with a net foreign savings inflow. This would reduce future exposure of the country to foreign loans or short-term and speculative inflows. The same principle can be adopted in other East Asian countries.

On the domestic front, the urgent needs include the resolution of the bad financial situation of private sector companies, and an improvement of the position of the banking system and of banks in relation to non-performing loans. In the process of doing this, fair and proper criteria and procedures should be adopted.

Appropriate fiscal and monetary policies will also be required, balancing the need to revive the economy with the need to have an appropriate exchange rate.

The trade-offs involved in choosing a set of policies will require a delicate and difficult balancing act, made even more problematic by the unpredictability of reactions of "market forces" and by external factors such as regional and global developments that are largely beyond the nation's control.

For countries that are under IMF conditions, the difficulty of choosing correct policies becomes much more complicated as the policies are mainly chosen by the IMF, and the governments have to bargain intensely with the IMF for any changes to be made.

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