THE ASIAN CRISIS, 1997

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Asian Crisis or Asian Flu

Introduction

Every crisis in the world destroys the ordinary life-being of people affected, leads to the crash of many established and seemed-to-be prosperous institutions and creates a panic in the society. While most of the stakeholders are suffering in the process, there are, however, fortunate people that use this opportunity to benefit. The challenge is, however, to try to cope with it and try to use lessons learned for the future generations to be smarter and well-prepared to future challenges.

The paper will describe the background, causes and consequences of the South Asian financial crisis 1997 with the specific attention to Thailand and Malaysia.

Summary

The Asian financial crisis started in May 1997 in Thailand with the collapse of the Thai currency -baht and affected three other Asian countries, namely Indonesia, Malaysia and South Korea (financial contagion). The currency collapse in Thailand served as a “wake up call” for the foreign investors to reassess the creditworthiness of the other three Asian countries having high degrees of debt to GDP ratios. After the crisis erupted in Thailand and as the contagion spread also to Korea-the world’s 11^{th} largest economy, the possibility of a default by Korea raised a potential threat to the international monetary system and the International Monetary Fund stepped in to stabilize the Asian financial system by initiating a $110 billion program. Only by 1999 economies of Asia were beginning to recover.

Background

Until 1997 South Eastern Asia (SEA), particularly Thailand, Malaysia, Indonesia, Singapore and South Korea, had the most attractive markets among the developing countries in the sense of capital inflow, performing the well-known “Asian economic miracle” attracting almost half of the total capital inflow from developing countries. The economies of SEA maintained high interest rates attractive to foreign investors looking for a high rate of return. Integration into world economy, high rates of economic growth and fixed local currencies pegged to dollar resulted in ASEAN-4 to be perceived as most attractive borrowers. South Korea, Malaysia, Thailand were among the group of 10 developing countries that attracted the largest amounts of net capital flows.

As there was a high level of government involvement in the financial and private sector, lenders were confident, should something happen in the private sector, the public sector will be able to intervene. Nearness of financial center, Tokyo, with low interest rates of lending resulted in huge amounts of borrowings mainly through short-term money. Most of the borrowing was in US dollars (i.e. in lower rate comparing to the domestic currency). However, in case of local currency devaluation negative impact on debt burden would occur.

Common Elements

Prior to the crisis the Asian countries were experiencing unprecedented growth. Economic growth was fostered by the export (over 1990-1996 Malaysian export had grown 18% per year, Thai export by 16%)[1].

Investment Boom and Excess Capacity

There were changes in the structure of export from basic materials to more complex increasingly high-tech products. The wealth created from export generated an investment boom in commercial and residential property, industrial assets, and infrastructure. A building boom in Thailand resulted in the excess capacity of residential and commercial property. Thus, by early 1997 it was estimated that there were 365,000 apartment units unoccupied in Bangkok. Property prices began to fall. The huge quantities of import negatively impacted the Balance of Payments (BOPs) of SEA countries: current account deficit equaled to 5.95% of GDP for Malaysia and 8.1% for Thailand. With these deficits it was becoming difficult for the governments to hold the currency peg. There was a risk of dollar denominated debt increase which would cause default of payments. Ratio of external debt to foreign reserves started to grow.

Debt Bomb

Most of the borrowing was in US dollars as lower rates were suggested compared to the domestic currency. SEA countries made tremendous investments in infrastructure, factories, and buildings by purchasing capital equipment and materials from America, Europe, and Japan. The huge quantities of import negatively impacted the Balance of Payments of SEA countries. With these deficits it was becoming difficult for the governments to hold the peg. There was a risk of dollar denominated debt increase which would cause default of payments.

The Excessive Role of the Government

Governments had very significant role in the financial sector by having an excessive ownership in the banks' capital or influencing the decision making processes. Banks became the so-called "quasi fiscal" agents for governments providing an indirect mechanism for channeling government assistance (off-budget) to ailing industries. In many cases governments stood behind huge infrastructure projects.

Financial Sector Supervision Weaknesses

The ASEAN 4 countries would not have suffered so much from the buildup of credit booms and currency/liquidity mismatches if sound banking and financial sector supervision had been in place. Like in many of the emerging countries, loan classification and provisioning practices were too lax. There was too much "connected lending" (lending to bank directors, managers and their related businesses), as well as "evergreening" [2] which became the reason for credit concentration risk and lack of arm's-length credit decisions ("crony capitalism"). In most of the Asian countries bank capital was inadequate relative to the riskiness of banks' operating environment. Based on the past behavior there was an expectation that should banks get into trouble depositors and creditors would get bailed out and bank supervisors could not resist strong political pressures for regulatory forbearance. On top of all this, the quality of public disclosure and transparency was poor. (*e.g. see Attachment 1*)

Loss of Competitive Advantage

Increasing wages (1990-1997) and the rise of dollar against (1995-1997) (CRS Report for Congress) the Yen decreased export competitive advantages of the ASEAN products.

[1] *Hill, Charles W.L. "The Asian Financial Crisis", http://www.wright.edu/~tdung/asiancrisis-hill.htm*

[2] *Evergreening is the provision of troubled borrower of a new loan for repayment an old one.*

Crisis

Thailand

One of the first ones affected was Thailand where the depreciation of Thai baht was approximately 19% by July 1997, and it was continuing to depreciate up to 50% by the end of 1997 leading Thailand's banking and industrial institutions to bankruptcy. Many of those institutions had sizable foreign debts required to be repaid in US dollars. These meant increasing amounts to be repaid as the baht was decreasing.

The unbelievable development of Thai economy started to face its first failures by mid 1996 when the rise of interest rates and the default of property developers resulted stock market decline by 45%. This in turn ended in the collapse of financial institutions. Though the policy of local banks was not as aggressive as of the non bank financial institutions, the overall loans to private borrowers in 4 years had increased by $ 115 billion ($ 204 billion in 1996).

The crisis started with the failure of one of the largest property developer in Thailand. On the February 5th 1997 a Thai property developer, Somprasong Land, announced that it had failed to make a scheduled $3.1 mln. interest payment on an $80 bln. eurobond loan. Somprasong Land was the first victim of speculative overbuilding in the Bangkok property market. Due to expectations that many property companies might go bankrupt, the stock market reacted by declined of 45% (compared to 1996).

One of the shocking news that Thai economy faced in mid 1996 was the case of Bangkok Bank of Commerce, one of the largest banks run by a *former central bank official*. Though using its connections the bank had managed not to disclose the information about his insider dealings and financial speculations in real estate and corporate takeovers since 1993, in 1997 the bank itself was forced into a takeover.

Some interesting events were happening in Thai financial markets, which as we'll see later had their direct impact on Thai economic crisis. One of those was the performance of "Finance One", a non-bank financial organization which was providing almost 20 percent of overall lending of the country-being specialized in law interest rate easy lending to Thai consumers and businesses. "Finance One" the pioneer in issuing Eurobonds denominated in US dollars and profiting from the differences between the interests of dollar denominated and Thai debt started to have problems at the time of property market bust. Because of doubling of non-performing loans its shares lost their value by 70 % and "Finance One" eventually went bankrupt.

Another and probably most important omission or ***"secret"*** of the Thai government was the fact that of more than 30 billion US dollars that the Bank of Thailand publicly claimed to hold in reserves only a few billion were available, because of forward transactions that Bank of Thailand had conducted and had never announced anything about those transactions. Those transactions were used by the Bank of Thailand to defend the fixed rate of baht. While by the beginning of 1997 the Bank of Thailand had hard currency reserves of about $38 billion by May 1997 $23 billion was engaged in forward transaction in order to defense the currency from speculators like "Soros's Quantum Fund", "J.P. Morgan & Co", "Goldman, Sachs & Co".

The step that the Bank of Thailand could and decided to take was de liberalization of financial market enforcing all local banks not to lend baht outside the country. But those measures were not able to stop the crisis, because at that time local banks and corporations were to pay back short-term debts, as not a single foreign institution in those circumstances would agree to extend the loans further. So they had to acquire huge amounts of dollars in order to fulfill their obligations.

> *"By selling the Thai baht in January 1997, the Quantum Funds managed by my investment company sent a signal that it may be overvalued. Had the authorities responded, the adjustment would have occurred sooner and it would have been less painful. As it is, the authorities resisted and when the break came it was catastrophic".*
> *George Soros*
> *The Crisis of Global Capitalism, 1997*

At this point currency traders began a concerted attack on the Thai currency-the baht pegged to the US dollar at an exchange rate of \$1=Bt25. Taking into account Thailand's growing current account deficit the speculators sold Baht short in order to profit from a future decline in the value of the Baht against the dollar. George Soros who was then accused of the causes of crisis in Asia believed that the price level in Thailand, \$1=Bt24.7 was low thus he borrowed 100 bln Baht from the banks worldwide. Then he changed all these Baht to dollars at the fixed rate of 24.7. After all the Baht were sold out, he began to scatter the rumors all over the world that the Baht would devaluate, which made the Thai sell their Baht in big quantities to the Thai government thus reducing the foreign exchange reserve of Thai government. As a result the exchange rate was increased to one Dollar for 29.45 Baht. At this time, Mr. Soros changed one portion of his Dollars back to Baht at the new rate of 29.45 and paid back the principal and interest to the banks. When he borrowed the Baht, he changed them to Dollars at the rate of 24.70. After the Thai Government gave up the fixed exchange rate, he changed back one portion of his Dollars at the rate of 29.45. In such a deal, he made a very considerable profit.

Contagion or Domino effect

> *Contagion is usually greater during the periods of turbulence, it operates more on a regional basis, rather than on global, and it runs from big countries to the smaller ones.*
> *Calvo and Reinhart, 1996*

Unlike the other crises Asian currency crisis started from Thailand and spread to a large-scale economies. The countries, which are in heavy trade with each other, face the problem of replication the same currency problems. Following the devaluation of Thai Baht, the speculation wave hit also the rest of the Asian countries (except for Singapore and Hong Kong). In a period of weeks the Malaysian ringgit, Indonesian rupiah and the Singapore dollar were all marked sharply lower. In addressing the issue of what was driving the contagion it seems unlikely that the main reasons were bilateral trade or investment shares with Thailand. Thailand's quite small size makes it less probable for bilateral relationships to be so disastrous for other countries. If, however, these relationships counted so much, than Taiwan, Malaysia and Singapore were supposed to be more affected, than South Korea and Indonesia, which was not the case.

The 2 main hypothesis that try to somehow explain the contagion are: *"Wake up call effect"* and *Competitive dynamics of devaluation.* The first suggests that Thailand acted as a wake-up call for international investors to reassess the creditworthiness of the Asian borrowers. On the other hand, competitive dynamics of devaluation suggests that as one country after another in a region undergoes a depreciation of its currency, the countries that have *not* devalued experience, are becoming more susceptible to speculative attacks.

Malaysia

Following the devaluation of Thai Baht, the speculation wave hit also the rest of the Asian countries, namely Malaysia. With its foreign exchange reserves down to $28 billion, its currency, the ringgit, was let float on July 14th, 1997. Prior to the devaluation, the ringgit was trading at $1=2.525 ringgit. Six months later it had declined to $1=4.15 ringgit. In early September the government deferred spending on several high profile infra-structure projects including its prestigious Bakun dam project followed in December 1997 by the release of plans to cut state spending by 18%. The government also stated that it would not bail out any corporations that become insolvent as a result of excess borrowing. Then in January 1998, IMF managing director Michel Camdessus, stated that Malaysia was correct in asserting that it did not need an IMF rescue package to get it through the regional financial crisis. On the other hand, he did state that the government needed to raise interest rates to slow credit growth, moderate inflationary pressures and support the weakening currency.

> *"Malaysia is not facing a crisis in the same way as some of the other countries in the region,…noting the authorities have taken measures to deal with the difficulties, particularly on the fiscal side"*
> *Michel Camdessus, 1998*

The Consequences of the Crisis and IMF's Role

On July 28th the Thai government called in the IMF. With its foreign exchange depleted, Thailand lacked the foreign currency needed to finance its international trade and service debt commitments and was in desperate need of the capital. Moreover, it desperately needed to restore international confidence in its currency and credibility associated with gaining access to IMF funds. Without IMF loans, it was likely that the baht would increase its free-fall against the US dollar and the whole country might go into default. As from IMF's perspective its main function is safeguarding the stability of international monetary system in order to decrease the contagion spread to Korea-the world's 11th largest economy as well as the potential threat to the international monetary system it eventually stepped in.

IMF helped the infected economies by providing loans which however came with tight strings attached. In 1997 IMF approved some 26 bln of SDR (35 bln $) of financial support for reform programs in Indonesia, Korea and Thailand. IMF also organized some $77 bln additional financing from multilateral and bilateral sources. The Thai government received $17.2 bln in loans, but the conditions were restrictive. They included structural economic, financial reforms and also addressed government issues.

Economic perspective: IMF required the Thai government to tighten monetary policy by increasing taxes (VAT from 7 to 10 percent), cutting public spending (as a precondition for the loan of $17 billion, a US credit line of $20 billion and another loan of $10 billion from Tokyo and other Asian nations) raising interest rates. Also several state owned businesses privatized.

Financial perspective: Thailand was required to close illiquid financial institutions, recapitalize undercapitalized institutions, closely supervise weak institutions and increase potential for foreign participation in domestic financial system, laying off 16,000 people in the process and further deepening the recession that gripped the economy.

IMF and World Bank (WB) established cooperation with Asian Development Bank (ADB) to support economic reforms. Supplemental Reserve Facility (SRF) was created for problems with BOP-s. The reforms were also directed to improve the efficiency of markets, break the close links between business and governments and ensure that the integration of the national economy with international financial markets is properly segmented.

Early Results

The magnitude of the recession exceeded all initial expectations. All the players in the financial markets became very sensitive to other shocks from other economies (weakening of the Japanese economy, Russian crisis in 1998, Brazil 1998-1999). Despite the setbacks, also notable progress evidenced in some countries, in particular: strengthening of exchange rates, decrease in interests rates to pre-crisis level in Thailand and Korea, macroeconomic stabilization in Thailand and Korea, turnarounds in current account positions from deficits to surpluses in Korea, Thailand and Indonesia, the rise of equity prices, and strengthening of the reserves in Thailand and Korea. The taken measures resulted in a current account surplus of 12.7 percent of GDP in1998.

Lessons Learned

As was stated in the beginning, the important outcomes of any crisis are lessons learned. Asian financial crisis resulted, first of all, in understanding how to strengthen the architecture of the international financial system to lessen the frequency and severity of future disturbances. It was obvious that more effective surveillance over countries' economic policies and practices, facilitated by fuller disclosure of all relevant economic and financial data are needed from International financial institutions, such as WB and IMF. Financial system reform was introduced, including better prudential regulation and supervision, working with the Basle Committee on banking supervision and the World Bank to disseminate a set of "best practices" in the banking area. Integration of international financial markets needs to be ensured and orderly sequenced. Regional surveillance should be promoted. More effective structures for orderly debt workouts, including better bankruptcy laws at the national level need to be elaborated. And last, but not the least a worldwide effort to promote good governance and fight against corruption is necessary to diminish the potential occurrence of financial crises.

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