

# The Financial Crisis in South East Asia, 1997



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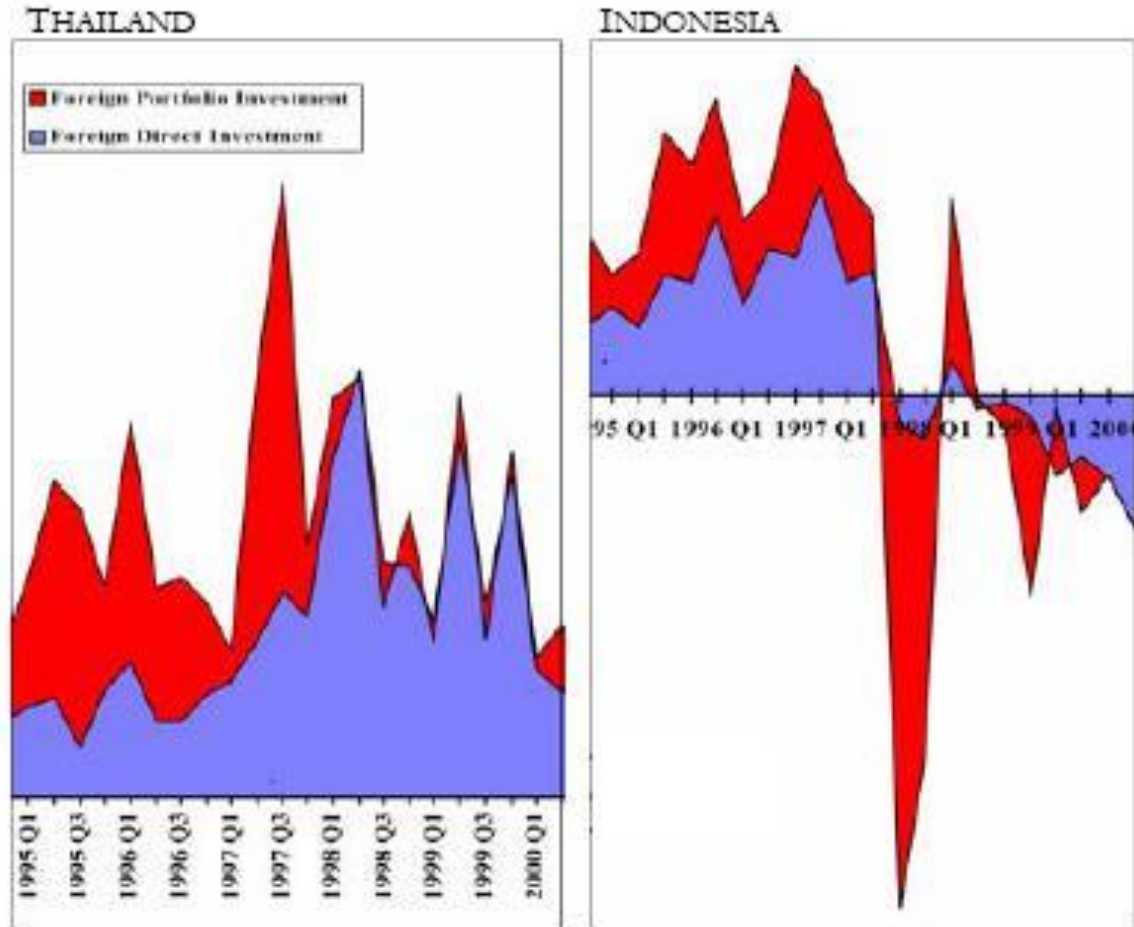
# Summary

- Started in May 1997 in Thailand with the collapse of the Thai currency –baht
- Affected Indonesia, Malaysia & South Korea (**financial contagion**).
- “Wake up call” for the foreign investors
- Potential threat to the international monetary system
- IMF’s \$110 billion program.
- Economies start to recover by 1999

# Background

- ASEAN- 4  
Thailand (baht)  
Indonesia  
Malaysia (ringgit)  
Philippines
- South Korea
- Most attractive markets for capital inflow (until 1997)
- High interest rates-  
high rate of return  
for investors

Capital Flows During the Asian Financial Crisis



# Causes of the Crisis

- Local currencies pegged to dollar
- Common elements
- Investment boom and Excess Capacity
- Debt bomb
- The Excessive role of the government
- Financial sector supervision weaknesses
- Loss of competitive advantage

# Thailand

- **Thailand was the first one**
- **Property market collapse**
  - Somprasong Land
- **Financial Institutions Collapse**
  - Finance One
  - Bangkok Bank of Commerce
- **Increase of non-performing loans**
- **Stock market decline by 45%.**

# Speculations

**“Soros’s Quantum Fund”, “J.P. Morgan & Co”,  
“Goldman, Sachs & Co”.**

## **“Soros’s Quantum Fund”**

- Accused of being the author of the financial crisis in South East Asia.
- Borrowed 100 bln Baht from the banks worldwide
- Then, changed all these Baht to dollars at the fixed rate of 24.7
- Rumors all over the world that the Baht would devalue
- The Thai started to sell Baht in big quantities.
- 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.

# Government Strategy

- Most of Thailand's reserves in forward contracts. (\$23 bln out of announced \$34 bln)
- Exchange rate of US Dollars increased to one dollar for 29.45 Baht (previously \$1=B25).
- Thailand only had \$1.14 bln (instead of 33 bln because of the forwards) available foreign exchange reserves to defend dollar peg, which was impossible
- Thai government short of foreign currency reserves.

## Action

- On July 2 1997, Thai government announced that they would allow baht to float freely against the dollar.
- Baht depreciated against the dollar by 50%, which caused lots of bankruptcies of financial institutions (liabilities expressed in dollar).



# Contagion or Domino Effect

- Following the devaluation of Thai Baht, the speculation wave hit also the rest of the Asian countries (except for Singapore and Hong Kong).
- Malaysian ringgit, Indonesian rupiah and the Singapore dollar were all marked sharply lower.
- 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.

## Implications of Contagion

- “***Wake up call effect***” Thailand acted as a wake-up call for international investors to reassess the creditworthiness of the Asian borrowers
- ***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

- More strong in terms of macroeconomic fundamentals
- The financial system appeared robust with non performing loans declining from 20% to 4% percents in total loans.
- Capital adequacy ratios in banking sector appeared strong accompanied with strong supervisory and regulatory framework.
- Little dependence on foreign capital, esp. short-term flows
- Panic was spread and as a result foreign exchange reserves down to \$28 billion
- Malaysian currency, the ringgit was let float on July 14th, 1997. (\$1=2.525 ringgit in 6 months declined to \$1=4.15 ringgit.)
- Government deferred spending by 18%.

*"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*

# Consequences of the Crisis & IMF's Role

- On July 28<sup>th</sup> the Thai government called in the IMF.
- Thailand lacked the foreign currency
- 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.

**IMF's main function is safeguarding the stability of international monetary system.**

- After the crisis erupted in Thailand and also to Korea-the world's 11<sup>th</sup> largest economy, the possibility of a default by Korea raised a potential threat to the international monetary system.
- IMF helped the infected economies by *providing loans with tight conditions*
- 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, including structural economic, financial reforms and also addressed government issues.

# IMF Reforms

- **From the economic perspective**
  - IMF required the Thai government to tighten monetary policy by increasing taxes, cutting public spending raising interest rates.
  - Also several state owned businesses privatized.
  - All these steps were designed to cool Thailand's overheated economy.
- **From the 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.
- **Government issues**
  - Break the close links between business and governments
  - Ensure integration of the national economy with international financial markets is properly segmented.

*Although politicians in each country initially resisted these conditions, they ultimately accepted them and so far at least, seem to be pursuing them*

# Further Steps and Remedies

- The cooperation of IMF with World Bank and Asian Development Bank to support economic reforms.
- SRF (Supplemental Reserve Facility) created for problems with BOP-s
- The IMF's continuous dialogue with the countries' press, public and labor groups.
- IMF programs associated with coordinated efforts between international creditor banks and debtors in the affected countries (e.g. Thailand negotiated a debt rollover with key Japanese creditor banks in August 1997)

# Early Results and Outlook

- The magnitude of the recession exceeded all initial expectations.
- Very sensitive to other shocks from other economies (weakening of the Japanese economy, Russian crisis in 1998, Brazil ).
- Notable progress evidenced in some countries, in particular:
  - the strengthening of exchange rates,
  - the decrease in interests rates to pre-crisis level in Thailand and Korea,
  - macroeconomic stabilization in Thailand and Korea,
  - the turnarounds in current account positions from deficits to surpluses in Korea, Thailand and Indonesia,
  - the rise of equity prices,
  - strengthening of the reserves in Thailand and Korea.

# Lessons Learned

1. More effective surveillance over countries' economic policies and practices, facilitated by fuller disclosure of all relevant economic and financial data.
2. Financial system reform, 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.
3. Ensure that the integration of international financial markets is orderly sequenced.
4. Promoting regional surveillance.
5. More effective structures for orderly debt workouts, including better bankruptcy laws at the national level
6. A worldwide effort to promote good governance and fight against corruption.



**THANK YOU**