Analytics of the Asian Crisis


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The east Asian crisis was most unexpected. The severity of the crisis and the speed with which it spread to many countries took everyone by surprise. The economic and social consequences of the crisis have necessarily been the subject of many studies. The volume under review is a collection of articles and covers almost all aspects of the crisis including, as the title puts it, the causes, contagion and consequences. Most of the articles have more than one author. The empirical evidence is well marshalled and the analytical rigour is maintained throughout. Scholars must be grateful to the editors and publishers for bringing together such a fine collection of essays on the east Asian crisis. Several viewpoints emerge, even though one can detect an underlying unity of thought.

The volume contains four parts. Part one, which includes four chapters, presents a factual and analytical overview of what happened. The main focus is on the role of vulnerability and how it got built up. Part two contains three theoretical chapters dealing with the impact of inflation of non-traded goods, welfare effects of capital inflows and the timing of the onset of crisis. Part three presents three essays dealing with several aspects of contagion such as the channels through which contagion spreads and the regional aspects of contagion. Part four addresses policy issues including the reform of the international financial institutions and control of capital flows and international capital markets. Thus, in substance, these chapters deal with the causes both proximate and deep seated, the analytics of the spread of the crisis from one country to another and finally some answers towards crisis prevention.

Vulnerabilities

In the opening chapter Alba, Bhattacharya, Claessens, Ghosh and Hernandez, provide a detailed empirical account of the crisis including data on the magnitude and composition of capital flows, investment and savings rates, external debt indicators and domestic financial pressures. Though the chapter emphasises primarily the domestic factors, the external factors cannot be excluded from the purview, for after all, it is the withdrawal of capital flows that precipitated the crisis. However, the focus of this chapter is very much on the buildup of the financial vulnerabilities. The authors write, “While we believe that panic played a role, we also believe that the build-up of the vulnerability was very large and allowed the crisis to take hold”. The main contention of the authors is that inappropriate macroeconomic policy responses to large capital inflows, weaknesses in domestic financial intermediation and poor corporate governance resulted in the build-up of vulnerability. Banking fragility, high leverage and currency and maturity mismatches made these economies highly susceptible to reversals in capital flows. These weaknesses remained unnoticed so long as these economies were growing strongly. The authors emphasise a point which is well accepted now. Despite their strong growth, the east Asian economies suffered from several fundamental weaknesses.

In their article, Corbett and Vines raise the question: Why did ‘crisis’ turn into ‘collapse’? Their answer is that it was because of the inter-relationship between currency crisis and financial crisis. Currency depreciation led to a financial crisis because the more or less fixed exchange rate regime had led to massive unhedged borrowing in foreign currency. When devaluation became sufficiently large, those who had lent to the financial system came to the conclusion that government guarantees to them would not be honoured and this triggered the financial collapse. Quite clearly, the east Asian crisis is a typical example of the currency crisis leading to financial crisis. Pegged exchange rate and unhedged borrowings were only one part of the cause. The financial system was already vulnerable for
a variety of other reasons and the currency crisis pulled the trigger. The authors also point to the difficulty in dealing with private debts as compared with sovereign debt. This makes a difference between the Mexican crisis and the east Asian crisis. The authors express their disagreement with the IMF policy to raise the rate of interest to arrest currency depreciation. However, on a closer reading, it appears that what they are trying to emphasise is that interest rate policy should have been accompanied by a target for prices. They cite the example of UK strategy in 1992 when two instruments - interest rate and an announced target for prices - formed part of the strategy. While no price target was set during the crisis, prices did not rise too high. The UK analogy is not directly relevant. Restoration of confidence in the currency required action which had to include a rise in interest rate. In several of the affected countries the increase in the interest rate came much later in the crisis. In fact, in South Korea interest rates remained low even as late as September 1997. Since the rise in interest rates was not preemptive, when the rates were raised actually, they had to be much higher. Much of the problem arises from the failure to anticipate the crisis. As the discussant Christopher Bliss remarks “The failure of the economics profession to make those forecasts must be counted as a singular failure”.

Michael Dooley in his essay makes the point that much of the capital inflows into emerging markets may be described as ‘arbitrage capital flows’. The capital flows into these countries were a reflection not so much of the investors’ confidence in the economic performance of the recipient countries, as of the ability of the governments to guarantee abnormal rates of rates of return. The chain of guarantees included the commitment to a nominal exchange rate target as well as the implicit guarantee of deposits and solvency of the domestic banking system. The crisis erupted, when the perception regarding states’ capacity to honour the guarantees changed. To maintain a pegged exchange rate in order to attract capital flows is a wrong stance of economic policy. It has, however, to be noted that nearly half of the capital inflows into the Asian economies was in the form of direct investment even though it was somewhat lower in the case of the five countries. A fact that has not been sufficiently highlighted in the discussions has been that the major factor responsible for the outflow of capital was the action of banks. And credit to the crisis affected five Asian countries which showed a net inflow of $41 billion in 1996 showed an outflow of $32 billion, thus, registering a turn around of $73 billion. While arbitrage was a factor influencing capital flows, it will be incorrect to treat a major part of the capital inflows as having been influenced just by this factor.

The last article in the first part contributed by Corsetti, Pesenti and Roubini goes back to the question of the fundamental weaknesses in the crisis-hit economies. They argue that beneath strong economic performances of these countries lay institutional weaknesses, policy inconsistencies and severe structural distortions. The authors provide a framework to understand why these weaknesses made the Asian countries vulnerable to a currency crisis. They construct a number of indices such as the crisis index, index of financial fragility and index of current account unbalances and show through a regression analysis that speculative pressure on a country’s currency is adequately explained by indices of financial fragility and external imbalances. They also note that the efficiency of the investment in east Asia was falling in the four years prior to the crisis. They come to the conclusion that their empirical analysis covering several episodes provides adequate support to the thesis that crises are systematically related to the fundamental weaknesses in the real and financial sectors of the economies. On the issue of raising the rate of interest at the time of crisis, they support the need for such an action on the ground that loose monetary policy in the early stages of currency crisis can contribute to further depreciation, increasing the burden of foreign currency denominated liabilities issued by banks and corporates. They further argue that high interest rates maintained beyond the ‘emergency scenario’ can have destabilising consequences. They recognise that a comprehensive approach to bank and corporate restructuring will require an active role on the part of governments as a market-based work-out of external and internal debts may not achieve speedy results.

Instability and Welfare Costs

Aghion, Bacchetta and Banerjee in chapter 5 argue that financial liberalisation can have destabilising effects on the econo-
mies at intermediate levels of financial development. Their analysis focuses on the role of prices of non-traded goods. With low non-traded goods prices, the profit rate becomes high, generating an investment boom and attracting capital inflows. But as the boom develops, the demand for the non-tradable input which is assumed to be not very elastic, rises fast and the resultant price increase relative to the tradable goods leads to lower profits, reduced credit worthiness, less borrowing and less investment. The squeeze in profitability leads to a slump. The authors argue that the boom and bust cycle of the Asian crisis was not an aberration. However, this phenomenon is ascribed by the authors only to countries at intermediate levels of financial development. A crucial assumption in the model relates to the elasticity of substitution between tradable and non-tradable goods. Also, if the supply of non-tradable inputs becomes more elastic, the ‘price-effect’ gets weakened. The model emphasises one aspect of the implication of the surge of capital inflows into countries with weak financial foundations and inelastic supplies.

Agenor and Aizenman deal with the welfare costs of financial market integration. While international financial market integration brings significant long-term benefits, they argue, that a high degree of financial openness may entail significant short-term costs. The major conclusion is that financial integration lowers welfare, if the foreign interest rate facing the economy under openness is more volatile relative to the degree of volatility of interest rates under financial autarky. Under these circumstances, it becomes necessary to balance the short-term costs with long term benefits.

Morris and Shin in a technical essay discuss the timing of the crisis. A satisfactory theory of the onset of crisis must explain when and why a shift in sentiments occurs. They focus on the role of differential information among the participants in causing currency attacks. Participants in the market are aware that the authorities become progressively less willing to support the currency as fundamentals deteriorate. The authors argue that speculators so determine a unique level of fundamentals at which the resistance of the authorities will be overwhelmed. The currency attack happens when the fundamentals evolve to the break point.

**Contagion**

Part III begins with an essay by Masson which provides new insights into the concept of contagion. He distinguishes several situations in which crisis may occur simultaneously in a number of countries. First, it may be due to a common cause or causes. The debt crisis of Latin America in the early eighties is a good example of this type. Second, a crisis in one country may affect the economic fundamentals of a group of countries to which it is closely associated through trade and financial links. For example, depreciation in the value of the currency of one country can affect the price competitiveness of other countries. These effects are better described, according to the author, as ‘spillovers’. The third situation is one in which the crisis in one country triggers a crisis in another country because of the shift in market sentiment. The author prefers to call this situation a case of contagion. Pure contagion, in his view, involves changes in expectations that are not related to changes in a country’s macroeconomic fundamentals. However, contagion can be caused by a reinterpretation of the fundamentals of a country in the context of the events in another country. The author’s empirical analysis leads him to the conclusion that pure contagion effects were an important factor in the Asian crisis. However, it can be argued that the strength of the contagion effects depends on the weight of trade and other links.

Glick and Rose in their article raise the question: Why are currency crises regional? The natural answer is that this is so because countries are linked by trade and trade tends to be regional. The authors agree with this. They argue that empirical evidence relating to the five recent waves of speculative attacks in 1971, 1973, 1992, 1994-95 and 1997 show that trade is an important channel for contagion. According to the authors, trade links help explain the intensity as well as the incidence of currency crises. As a matter of policy, the authors argue for enhanced international monitoring on a regional basis. Trade and other linkages indeed constitute an important conduit through which the disease spreads. One interesting question that arises is whether the crisis affects all countries with which there are trade linkages. In this context, the discussant of the paper points to the example of Australia which was immune from the attack de-
spite its strong trade linkage with Thailand. Perhaps the more important example will be Taiwan which suffered the least despite being very much within the regional block.

Diwan and Hoekman in their article go beyond trade linkages and argue that the contagion must be seen in the context of “a complex set of real side links between the various countries of the region”. The important point stressed in the chapter is that one should look at competition and complementarities as both are likely to operate simultaneously. Complementary in general must have a positive effect while competition will have a negative effect. The same country such as Japan can have both kinds of effects on other countries in the region. The difficulty lies in determining which effect is more dominant. Obviously ‘trade shocks’ are an important component of a crisis. But they by themselves do not fully explain why the situation turns into a full-fledged crisis.

Policy Response

Part IV of the book deals with policy prescriptions. Bhattacharya and Miller examine various suggestions that have been made in the context of both crisis prevention and crisis management. They discuss several issues such as more transparency and disclosure, creation of an international lender of last resort, facilitation of debt workout and standstill and capital controls. There is a greater convergence of views on the need for action on all these fronts.

The last article in the book is the reproduction of a lecture by Stiglitz. He goes over a terrain familiar by him. It is couched in less combative style. Stiglitz makes four major points. First, financial markets must be subject to control because the traditional theory of market clearing does not apply. We are essentially dealing with markets with imperfect information. But in one sense, he is labouring the obvious. Financial markets and more particularly the banking segment have always been subject to a number of controls. The Bank for International Settlements recognised the need for prudential norms in the eighties in the context of the rapid development of banking across borders and the swift and large movement of funds in the wake of the removal of exchange controls. Most industrialised and developing countries have adopted these standards and the attempts to improve the standards are continuing. In fact, some of the earlier instruments such as deposit insurance which were considered to be relevant for reducing risk have become themselves sources of generating risk. Uniform prudential standards with some adjustments for country and institution specific characteristics coupled with cooperation among supervisory authorities should be in a position to reduce risk associated with lending and investment across borders. Even in terms of financial regulations, a balance has to be struck between promoting innovations and avoiding too high risks. There should be no attempt to impose a straitjacket because that could also lead to distortions. The second point made is that while improved information and better financial regulation are necessary, they may not be adequate to prevent the crises. However, it is obvious that if the east Asian countries had a better regulatory system and if the exchange rate system had been better managed, the severity of the crisis, even if the crisis could not have been avoided, would have been much less. As many articles in the book have shown, there were serious fundamental weaknesses both in the real and financial sectors. There was virtually a credit spree. Financial and corporate restructuring had become necessary in the aftermath of the crisis. Misconceived policies such as the anxiety to maintain pegged exchange rates have also contributed to the onset of the crisis. Even the need for preventing maturity mismatches was not clearly recognised. There was a failure all-around to recognise the importance of some of the norms. The third point stressed by Stiglitz is that control over capital inflows should complement prudential regulations. He pleads for policies which should influence both the pattern and timing of the capital flows. There is a growing realisation that imposition of restrictions on the movement of short-term ‘hot money’ is desirable. Several countries including India have attempted to regulate some of the flows. The basic issue is how to evolve price-based controls which while restraining volatile capital inflows will not cut at the root of capital flows themselves. Fourth, any programme of crisis management must ensure that indiscreet lenders bear a part of the cost of the adjustment. This involves the extension of some of the rules relating to bankruptcy that are currently in force in the
domestic systems to the international level.

The east Asian crisis hit five countries hard - South Korea, Malaysia, Thailand, Indonesia and the Philippines - even though its reverberations were felt by many others, including India. The currencies of these five countries came under severe pressure from the middle of 1997 resulting in heavy depreciation in relation to the US dollar. The currency crisis in turn led to a severe domestic financial crisis and the two taken together plunged these countries into a severe economic depression. These Asian economies which for several decades had experienced strong growth rates exceeding 7 per cent per annum, saw a decline of output in 1998. It is easier to write about east Asian crisis now than in 1995 or even early 1999. These countries, were groping in the dark till the middle of 1999. Fortunately these countries, with the exception probably of Indonesia, are talking about ‘return of growth’. South Korea particularly experienced a very strong growth in 1999. Exchange rates have stabilised except in Indonesia and inflation has declined to very low levels. Interest rates have come down below the pre-crisis levels. Not all share the optimism that these countries are on the road to recovery. But all indicators do point to a substantial improvement. Nevertheless, there are important lessons to be learnt from the crisis by developing countries, developed industrial countries and international financial institutions.’ While ‘panic’, ‘sentiment’, ‘herd instinct’ and ‘predators have played a role, it has to be recognised that there were serious weaknesses in several segments of these economies and more particularly in the financial system. A weak financial system, it has been shown, can derail the engine of economic growth. The crisis-hit economies were important beneficiaries of capital flows. If these economies recover fully and resume the growth path, they would still have done well in the long haul. The proximate cause of the crisis was the withdrawal of capital flows. The turn-around was $ 105 billion - from a net inflow of $ 93 billion in 1996 to a net outflow of $ 12 billion in 1997. However, given the weaknesses in the financial and real sectors and the political uncertainties in some of the countries, the crisis could have been triggered by other factors as well. Instead of capital outflows becoming the trigger, they would have been the consequence.

Capital flows cut both ways. When they flow in, they augment investible resources and accelerate growth. When they move out, particularly suddenly and massively, they cause havoc. The east Asian crisis has lessons both for crisis prevention and crisis management. ‘there is a general consensus on the need to contain and restrict flows that are volatile and short-term debt falls primarily in this category. Also when there are massive inflows, they need to be managed well and hence the need for strengthening the domestic financial system through which the flows are mediated. While stringent capital controls may be adopted as a temporary shield as part of crisis management, they cannot be a permanent solution. Controls should not substitute for appropriate economic policies.

A collection of essays like the volume under review does not tell the story as it evolved. It is assumed that the readers know about it. What each article seeks to do is to probe deeply into one or two aspects and come up with conclusions that are theoretically and empirically sound. This is a volume full of deep insights.

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