

FOUR Issues from Topic 1

1. The patterns of international capital flows to developing countries have seen several significant changes in past 30 years. There is much to be learned from what went (often badly) wrong in some of the different episodes since 1970
2. There is a kind of apartheid between those countries that have passed the tests necessary to attract large PRIVATE capital flows (see Topic 4) and the other developing countries that still need to “improve their act” before they can attract such capital. The latter group (the majority) remains “aid dependent”
3. Within that latter group the 41 HIPC stand out as being unable to service even extremely concessional loans. Debt forgiveness in these countries is but the first small step to moving them towards the ability to truly “develop” their economies. Their general creditworthiness is ZERO. But individual insulated project may still attract private capital (e.g. gold mines in the Congo).
4. Aid flows and debt forgiveness are necessary supports to build the infrastructure (physical and human and institutional) that is needed to COMPLEMENT the future CAPITAL investment that will likely be needed for the stronger PRODUCTIVE base needed for true development to occur.

Financial Crises

Alan Roe with materials from
Edi Segura

Topics

1. Different Explanations of Crises
2. Main Features of Crises
3. Mexico 1994
4. Development and Poverty Consequences
5. Managing Crises – Rich v Poor Countries
6. East Asia 1996-97

Topic 1. Classes of Explanations

- Unsound fundamentals (Generation 1)
- Inconsistent policies (encouraging speculation) – (Generation 2)
- Domestic distortions causing unsustainable inflows
- Exogenous shocks (trade, finance, demand, exchange and interest rates)
- Contagion (direct and indirect)

Market failures that may aggravate problems

- Asymmetric information (credit rationing etc.)
- Agency issues (contracts, liquidity preference, moral hazard)
- Economic externalities (herding, overvaluation etc)

Topic 2 Features of Financial crises in practice

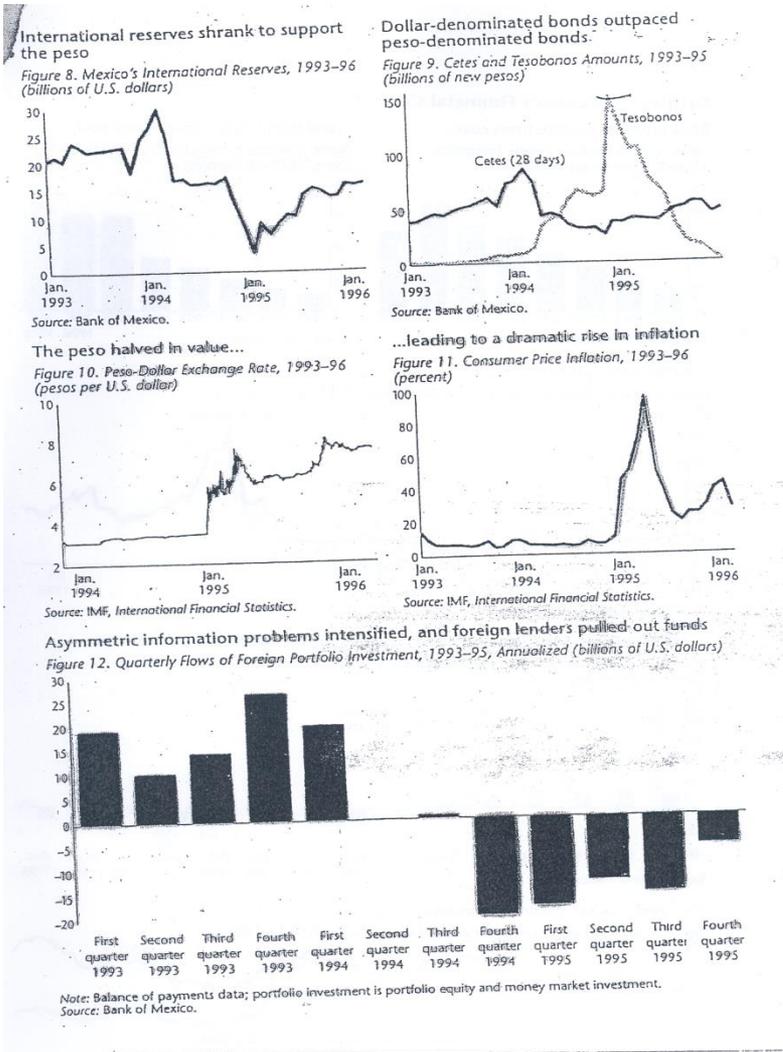
- 2.1 Excessive enthusiasm is followed by collapse
- 2.2 Origins of Emerging Market financial vulnerability has several causes (cf Mexico v East Asia)
- 2.3 Private (International) Lending is Pro-Cyclical

Boom to Bust

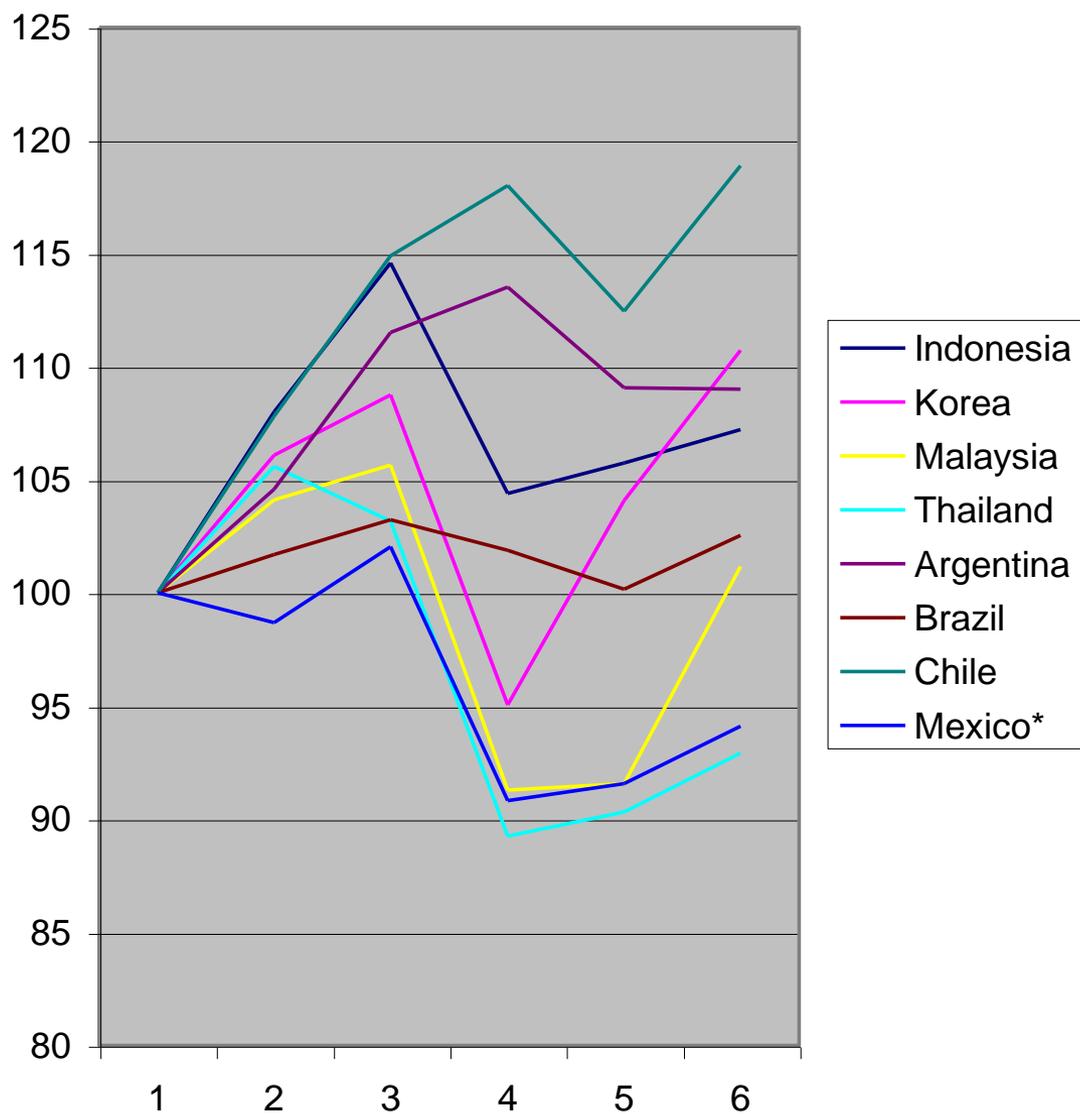
- FDI trends steady but short-term portfolio flows are highly volatile: especially bank credits (see earlier data)
- Rapid pre-crisis growth of output mainly based on consumption and non-tradable production, not investment or exports – this often leaves internal and external debt overhang

Frederick Mishkin *World Bank, Annual Conference on Development Economics,*

1996 (Bruno and Pleskovic (editors))



Per Capita Household Consumption in Crisis Countries



Sources of Emerging Market financial vulnerability

- Relative size/maturity of capital market and its openness
- inappropriate exchange rate policies and/or sequencing or liberalization
- currency mismatch and maturity mismatches in banking and corporate sectors

Private Lending is Pro-Cyclical

- Systemic herding by market participants and risk management systems; liquidity risk
- Balance sheet effects prevent smooth adjustments to capital flows
- Need for counter-cyclical lending (by whom?)

Topic 3. Mexico's Crisis in December 1994

Origins of the Mexico Crisis

(In 10 years before 1994, Mexico had made major progress on economic reforms:

- the fiscal budget was balanced (+0.3% in '93 and -0.7% in '94),
 - inflation was reduced to 7% pa in 1994,
 - public sector debt was reduced over one-half in terms of GDP,
 - a large number of state enterprises and banks were privatized,
 - the domestic economy was de-regulated and liberalized,
 - international trade was liberalized – also NAFTA
- The strength of the program , and low interest rates in the US, encouraged capital inflows: US\$25 billion in 1992, and US\$30 billion in 1993 (about 6-7% of GDP, & 20% of all inflows to EMs).
 - These inflows permitted a large increase in international reserves, which reached US\$30 billion by February 1994.

Consequences

- But these capital inflows led to a significant appreciation of the exchange rate, which encouraged significant increases in imports, a lot of it for consumption.
- The current account deficit, financed by these capital inflows, ran at about US\$25 billion per year in 1991-93, or about 6% of GDP.
- The Government realized that this was not sustainable.
- But the Government felt that it would be possible to “soft-land”: that is, to get a gradual reduction of the deficit over a longer period of time.
- The Government felt that, with the approval of the NAFTA agreement with the US in early 1994, exports would improve, productivity would be enhanced, inflation would be reduced, and the exchange rate would be gradually depreciated.

World Bank (external) view

– also from Krugman, *Currency Crises*, 1997 – his web site. Dornbusch
Dornbusch, R. (1993) "Mexico: stabilization, reform, and no growth"
Brookings Papers on Economic Activity

- Mexico could not afford to wait for a soft landing. Why?
- Rapid productivity gains and growth were not materializing.
- Domestic savings had been reduced sharply by the cheap availability of imported consumer goods (from 22% of GDP in 1989 to 10% of GDP in 1993).
- Foreign debt was still large and Mexico was in a vulnerable position as changes in investors' sentiments could create a crisis.
- The domestic banking sector would be hard hit by a crisis – lots of FOREX borrowing.
- More flexibility in exchange rate policy including a probable devaluation was needed to reduce the current account deficit.

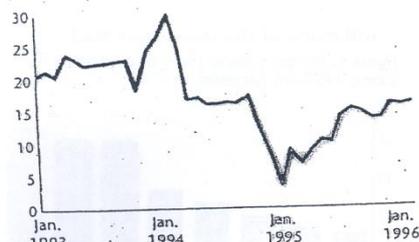
The Government counter-view:

The peso was not overvalued, because:

- (i) Mexico's exports of non-traditional goods were increasing rapidly at a rate of 10% pa.; and
- (ii) there was not under-utilization of industrial capacity.
- There were also political reasons: President Salinas did not want a devaluation during a critical 1994 Presidential election year.
- During 1994, the level of capital inflows remained significant, at US\$15 billion; but they were less than in 1993.
- These inflows were not enough to cover imports: Therefore:
 - During 1994, the level of Tesobonos (govt borrowing denominated in \$US) increased from US\$4 billion in February 1994 to US\$30 billion in December 1994.
 - At the same time, the level of International Reserves declined from US\$30 billion in February 1994 to US\$10 billion by November 1994.

International reserves shrank to support the peso

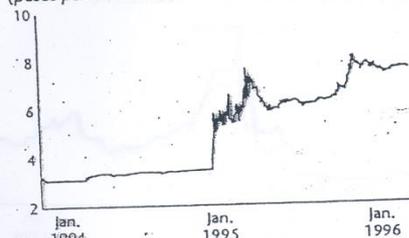
Figure 8. Mexico's International Reserves, 1993-96 (billions of U.S. dollars)



Source: Bank of Mexico.

The peso halved in value...

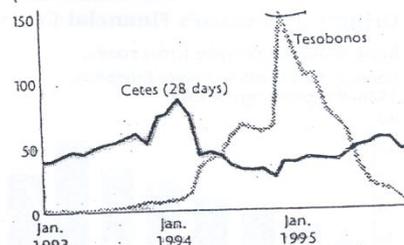
Figure 10. Peso-Dollar Exchange Rate, 1993-96 (pesos per U.S. dollar)



Source: IMF, International Financial Statistics.

Dollar-denominated bonds outpaced peso-denominated bonds.

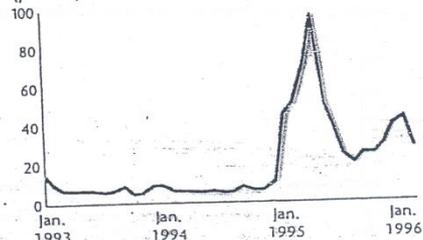
Figure 9. Cetes and Tesobonos Amounts, 1993-95 (billions of new pesos)



Source: Bank of Mexico.

...leading to a dramatic rise in inflation

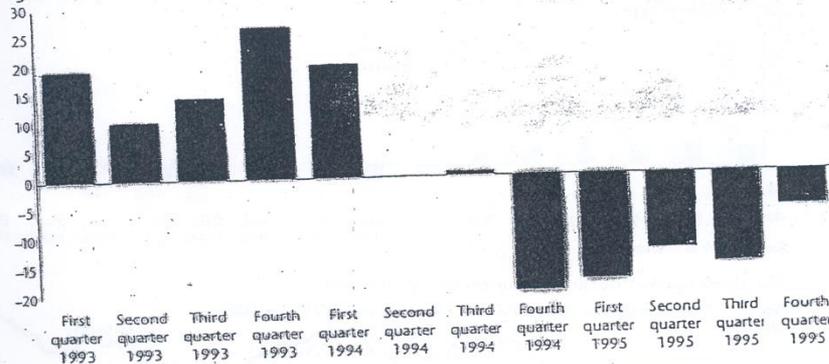
Figure 11. Consumer Price Inflation, 1993-96 (percent)



Source: IMF, International Financial Statistics.

Asymmetric information problems intensified, and foreign lenders pulled out funds

Figure 12. Quarterly Flows of Foreign Portfolio Investment, 1993-95, Annualized (billions of U.S. dollars)

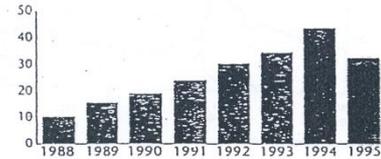


Note: Balance of payments data; portfolio investment is portfolio equity and money market investment.
Source: Bank of Mexico.

Origins of Mexico's Financial Crisis

Bank credit to private firms rose...

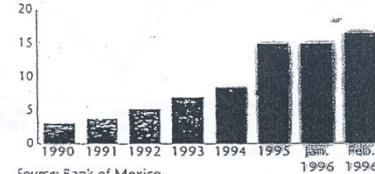
Figure 3. Bank Credit to Private Enterprises, 1988-95 (percentage of GDP)



Source: Bank of Mexico.

...and many of the loans were bad

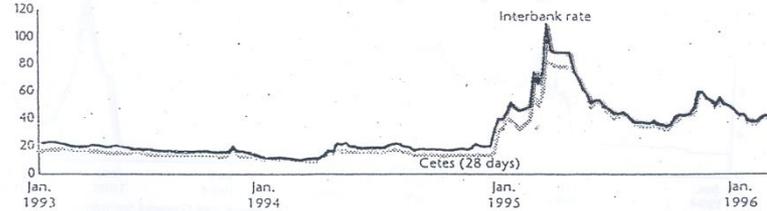
Figure 4. Nonperforming Loans as a Share of Total Loans, 1990-96 (percent)



Source: Bank of Mexico.

Interest rates spiked...

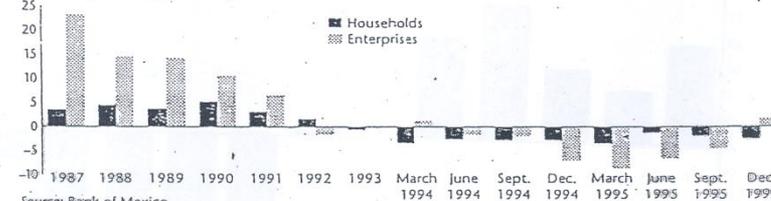
Figure 5. Interest Rates on Cetes and Interbank Loans, 1993-96 (percent)



Source: Bank of Mexico; IMF, International Financial Statistics.

...contributing to the deterioration of household and enterprise balance sheets

Figure 6. Net Creditor or Debtor Position with the Domestic Financial System, 1987-95 (stocks as percentage of GDP)



Source: Bank of Mexico.

The stock market declined as uncertainty increased

Figure 7. Stock Market Prices on the Bolsa, 1993-96, index (1993 = 100)



The build up to the Crisis

- This information, however, was not made public, particularly the rapid increase in Tesobonos.
- During 1994, the Government could have taken other possible contractionary economic measures -- to deal with the large current account deficit and insufficient foreign financing of it.
- These measures could have included fiscal contraction (moving to a fiscal surplus), tight money and higher interest rates.
 - But these contractionary measures were not attractive during the 1994 election year.
 - New York mutual fund managers, threatened to reduce Mexican exposure if peso interest rates were to increase (reducing the price of their holdings).

The trigger for Crisis

- Unfortunately, during 1994, many non-economic political events eroded private sector confidence:
 - The Chiapas up-rising by local indigenous peoples.
 - The assassinations of political leaders, Messrs. Colossio and Ruiz Massieu.
 - The uncertainties in the results of the presidential elections of 1994.
- “Insiders” detected the imminence of a devaluation and, during the first half of December, massively sold pesos for US dollars, thus reducing the level of reserves from US\$10 billion in early December to about US\$5 billion by December 20, 1994.

Crisis December 22nd

- **When Finance Secretary Jaime Serra Puche announced a 15% devaluation on December 20, the level of international reserves were not enough to support the new exchange rate.**
- **Furthermore, the Government did not announced any major economic program to demonstrate that it could serve its large Tesobonos debt, given low reserve levels. Tesobonos auction at end December failed to raise the money to roll over debt**
- **The lack of a credible adjustment and credit program to deal with this fundamental debt service issue is regarded as a key mistake of the December 20 announcement by Serra Puche.**
- **On December 22, the peso could not be supported and was left to float freely.**
- **International financiers and mutual fund managers reacted with disbelief, anger, panic.**
- **Two days later, after a visit to New York, Serra Puche resigned.**

Consequences

- In the next few weeks, capital outflows continued and the exchange rate moved from 3.3 pesos /dollar in December 1994 to 7 pesos/dollar in early March 1995.
- It was only on March 9, 1995 that the markets started to calm down, when the Government announced a strict fiscal and adjustment program linked to a US\$50 billion support program.
- The support program was provided by:
 - the US Treasury's Exchange Stabilization Fund (US\$20 billion),
 - the IMF (US\$17 billion),
 - the Bank of International Settlements (US\$10 billion),
 - the World Bank (US\$3 billion).
- In 1995, the Government produced a "primary" fiscal surplus of 5% of GDP, to enable it to serve its debt. Because of large interest payments, in 1995 the overall fiscal deficit 0.8% of GDP, compared to a deficit of 0.7% of GDP in 1994 and to a fiscal surpluses of 0.3% of GDP in 1993.

Lessons from Mexico

- 1. The Current Account Deficit is a key variable that should not be allowed to get out of line, even if this deficit is due to overspending by the private sector and the Government has a balanced fiscal budget.**
- 2. The composition of large capital inflows into a country -- short-term versus direct investments or long term -- is very important for the vulnerability of the country in a crisis.**
- 3. The use of proceeds of foreign investments is important for its sustainability: consumption (as in Mexico) versus investments (which could generate growth/exports).**
- 4. There is an inherent danger in using fixed or quasi-fixed exchange rates as a stabilization device. It is hard to have a “soft-landing”.**

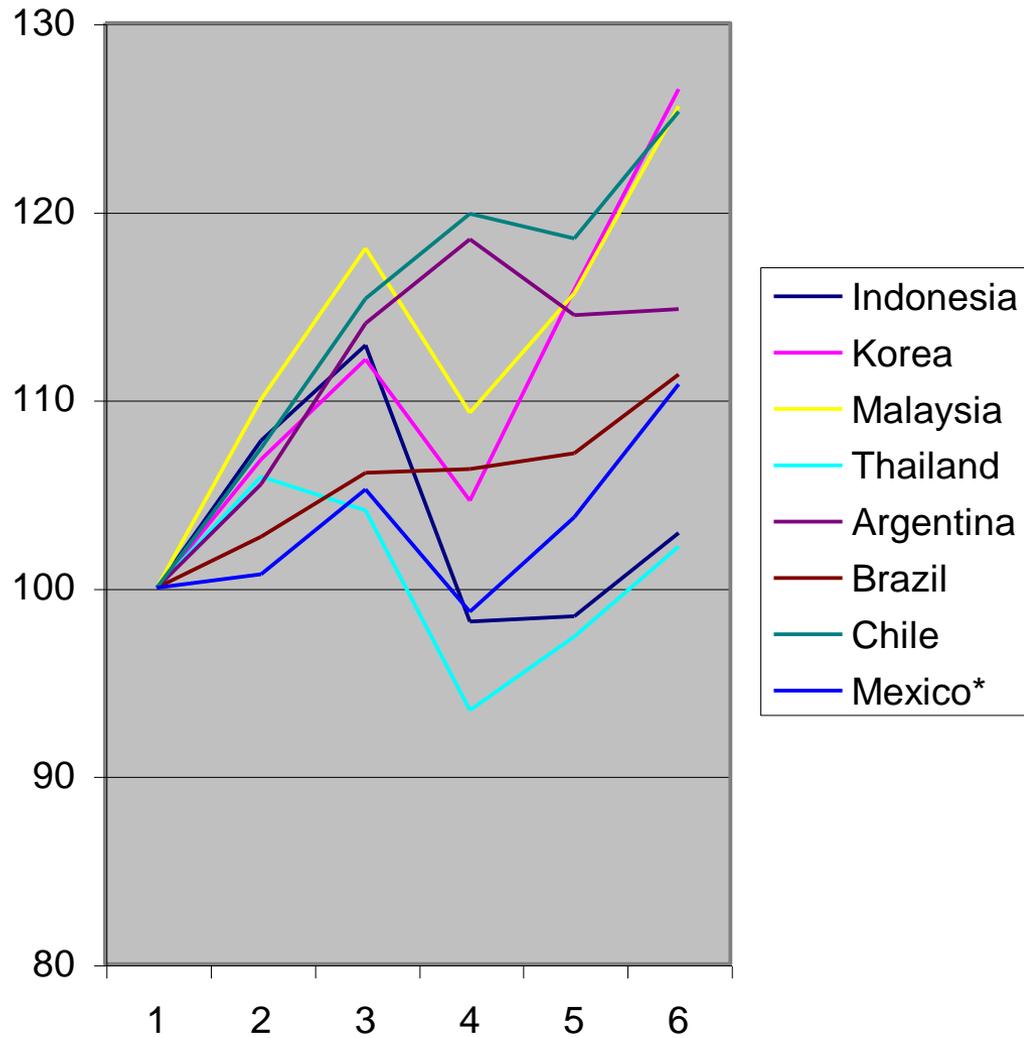
Lessons continued

5. The structure and maturity of public foreign debt is very important in periods of crisis.
6. The exchange rate must be adequate to bring equilibrium both the goods markets as well as in the financial markets.
7. The possibility of a financial crisis can be foreseen based on major imbalances in economic fundamentals. But what is difficult to predict is the timing of the crises, the depth of it, and its spillover effects (the so called Tequila Effect) in other EMs.
8. If a country enters in a financial crisis, the only way to bring back confidence is with a very strong fiscal and economic adjustment program, backed up by significant financial resources from abroad.

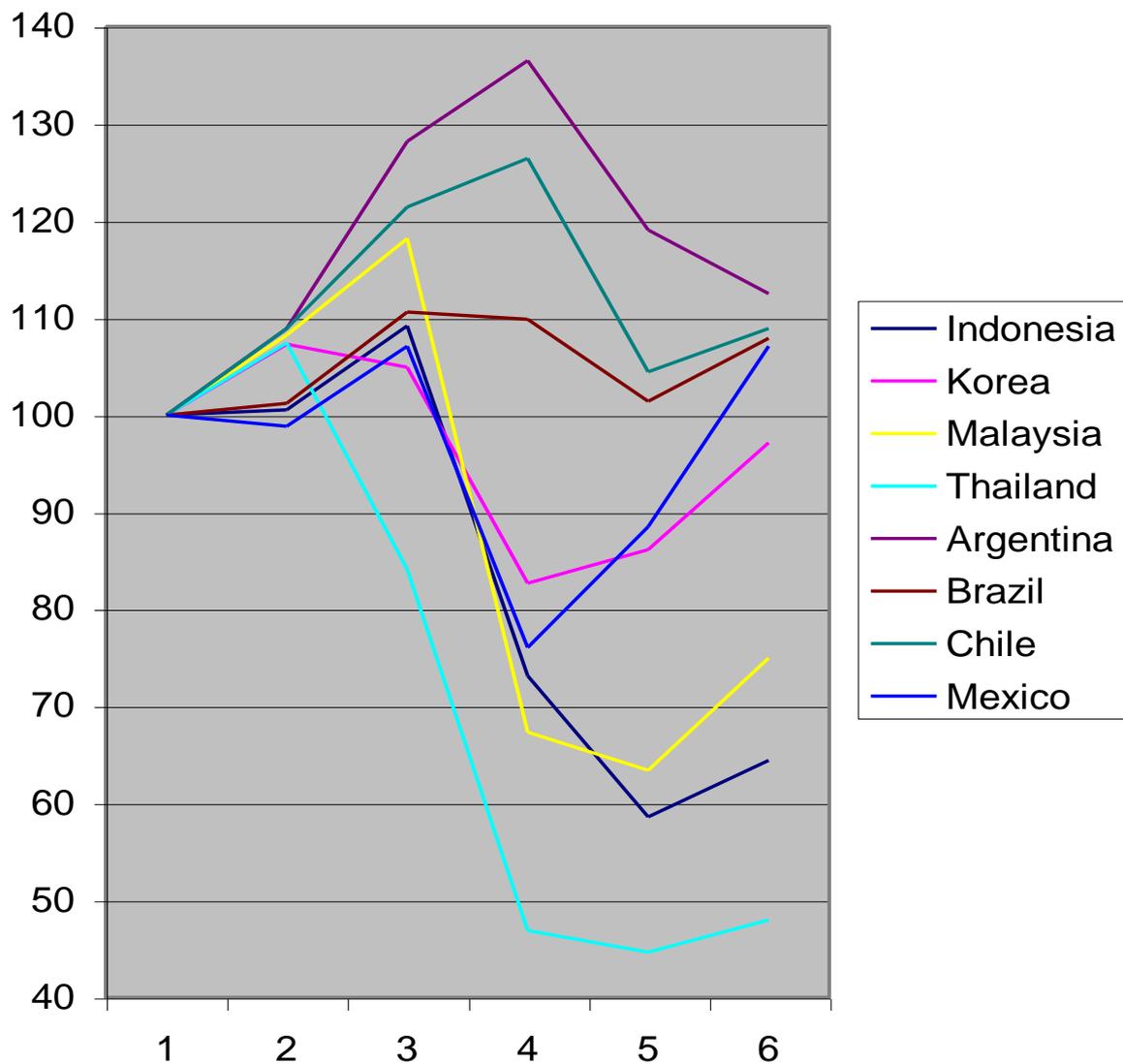
3. Development & Poverty consequences

- Immediate unemployment, large fiscal retrenchment
- distributional effects depends on policy, labour markets etc
- investment, growth loss more likely than greater efficiency
- Long-term consequences for income levels, deadweight loss etc

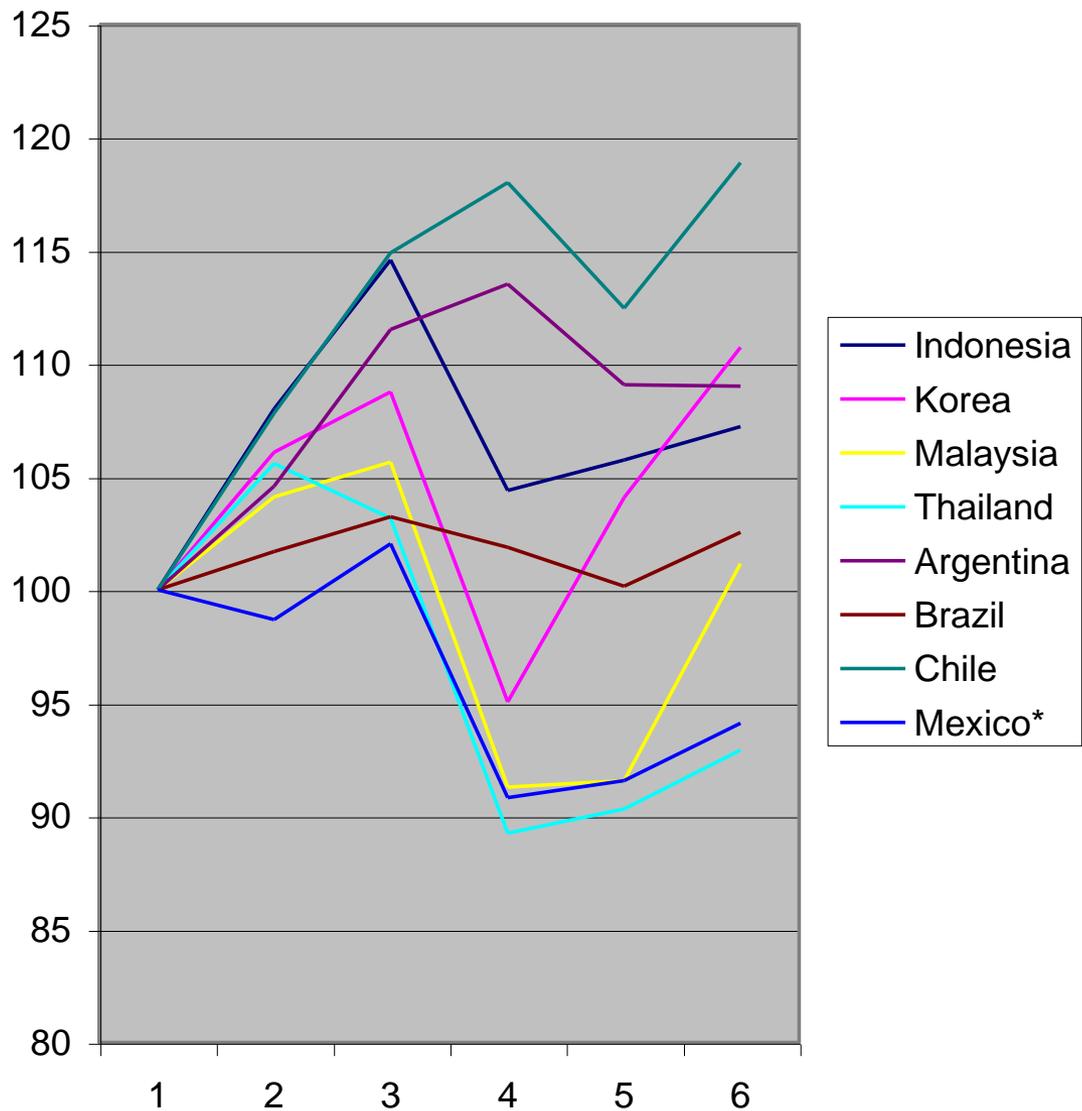
GDP in Crisis Countries



Gross Fixed Investment in Crisis Countries

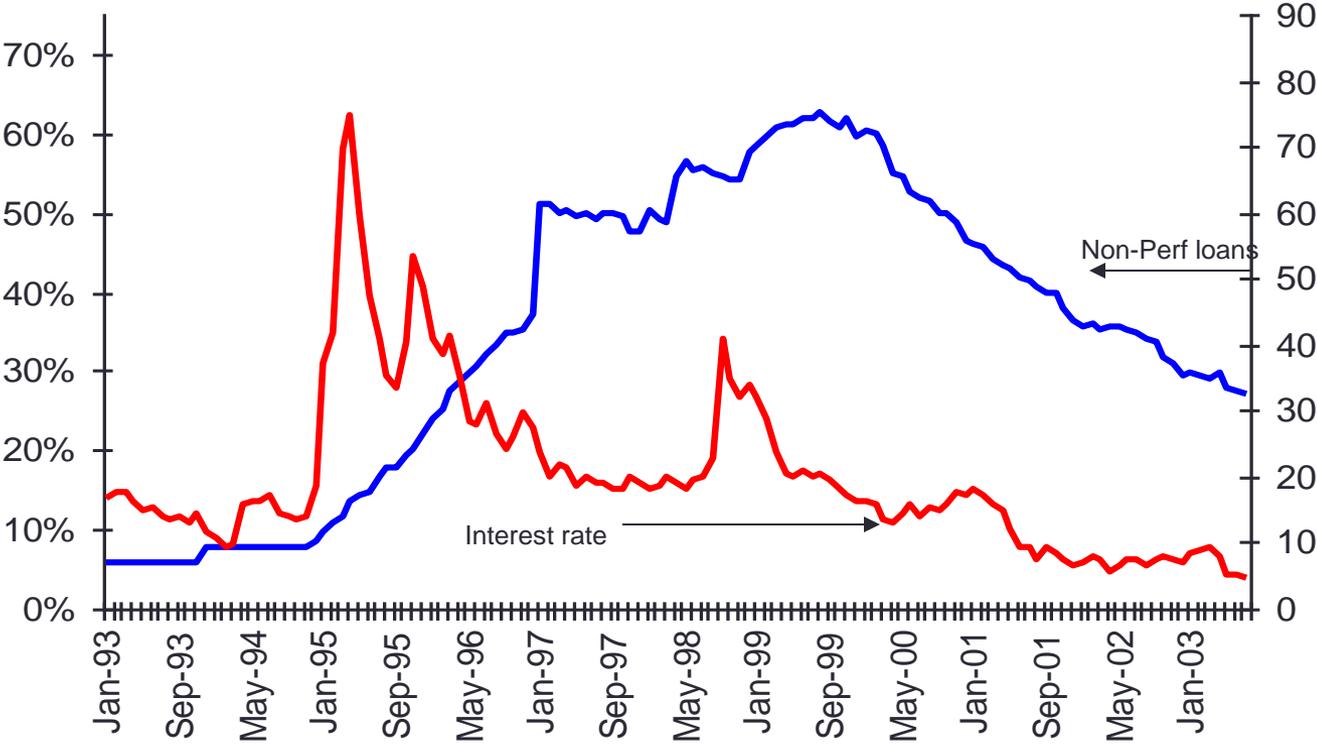


Per Capita Household Consumption in Crisis Countries



Example: Mexico Post 1994-Crisis

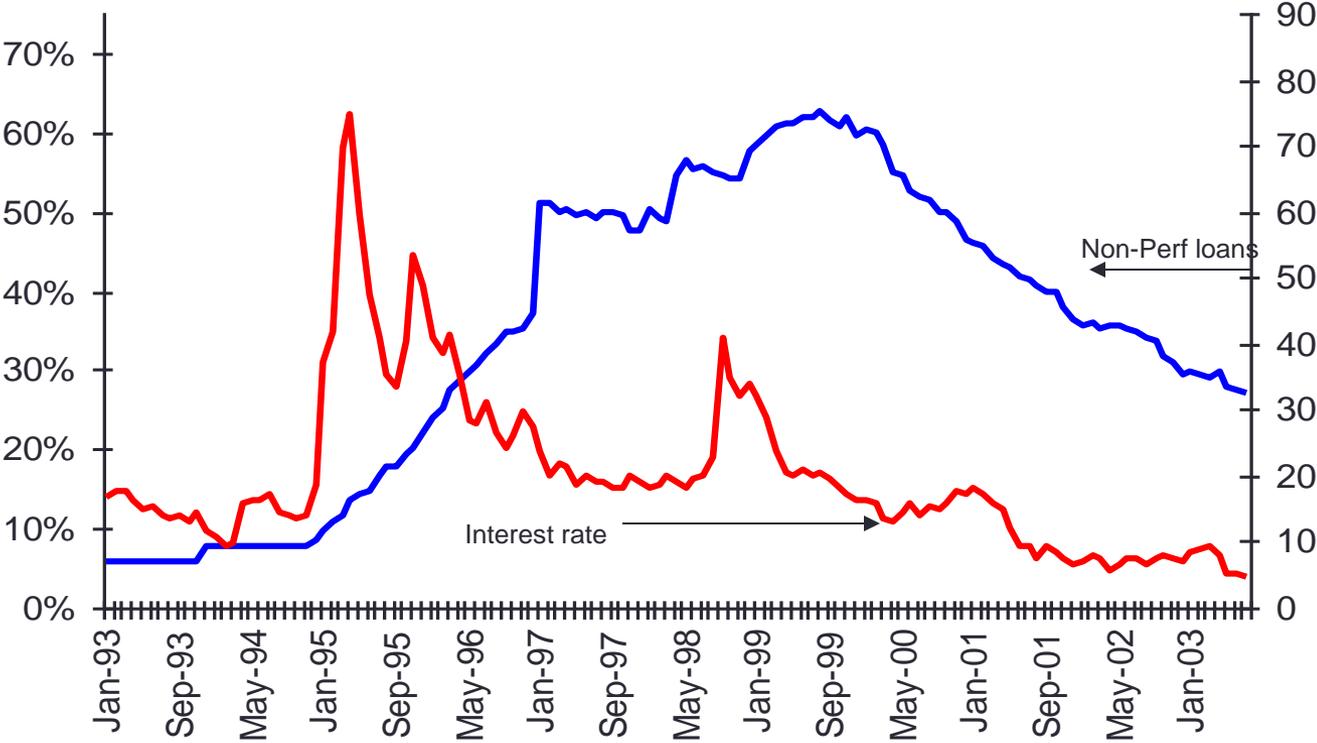
NON-PERFORMING LOANS & INTEREST RATE
(% of the total bank loans)



Source: Inegi

Example: Mexico Post 1994-Crisis

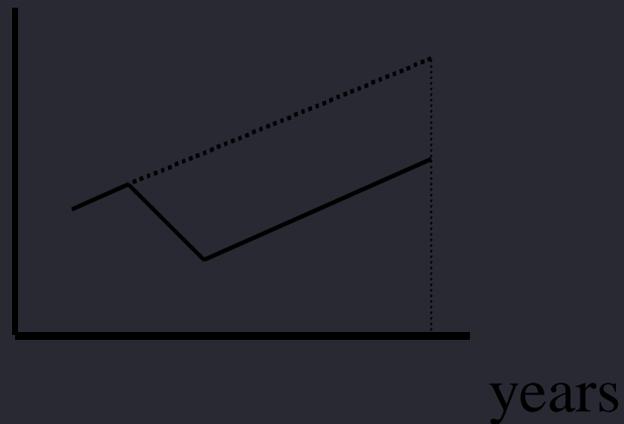
NON-PERFORMING LOANS & INTEREST RATE
(% of the total bank loans)



Source: Inegi

Figure 1: Deadweight Income Loss from Crisis

Income per capita



Topic 4. The Puzzle: Policy Response to Recent Crises in Rich v Poor Countries (based on Alan Roe *Economic Systems Research* June 2003)

Rich Countries

- Actions to strengthen Balance-Sheets
- Injection of Liquidity
- Looser Monetary and Fiscal Policies
- Lower Interest Rates

Developing/Emerging Countries

- Tightening of Liquidity
- Tighter Monetary and Fiscal Policies
- Very High Nominal and Real Interest Rates
- Most Actions weaken Balance-Sheets

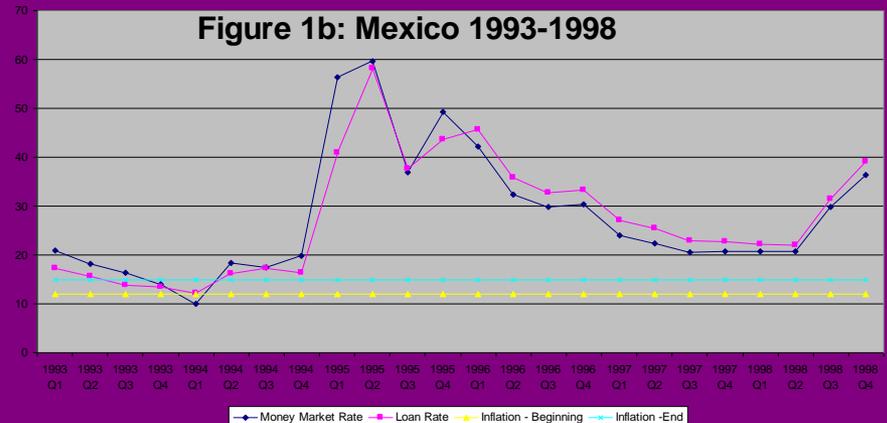
Emerging Market Economies: An Example

Example of Mexico-1994

Money Market Rates (18% to 60%)
Bank Lending Rate (15% - 58%)

Both Rates still > 30% 2 Years after Crisis

Bank Lending Rates still > 22% - 3 Years after crisis

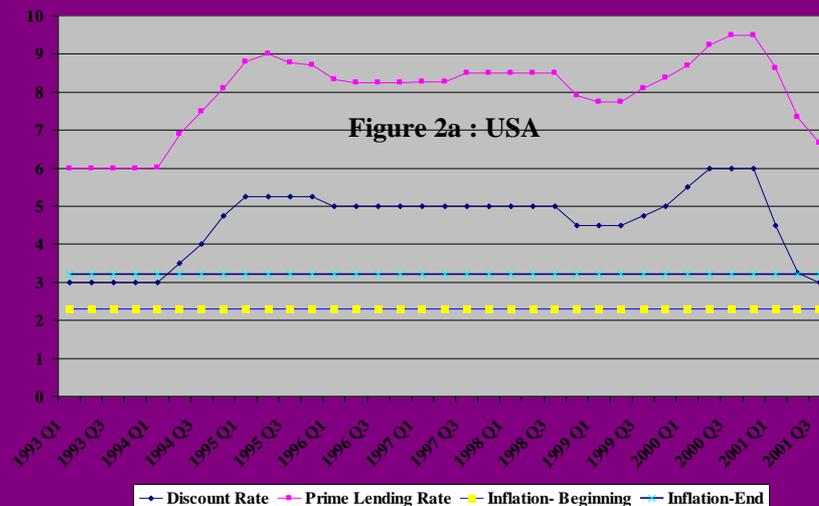


Rich Economy Example

United States

Note:

- Sustained Modest Rates
- Significant Drop in Rates at time of LTCM Crisis in Autumn 1998
- Similar Moderation of Rates after Sept 11th 2001
- Ditto at time of Mini Bond Crisis in 1994



Standard Explanations of Differences

1. Financial Structures of Poorer Countries

- More Forex Denominated Debt
- More Short Terms Debt

2. Macroeconomic Tendencies of Poorer Countries

- Greater Tendency to use Inflationary Policies
- Generally Weaker Policies and Fundamentals

Underlying Logic (IMF Model)

Diagnosis

Excessive Borrowing (e.g. Tesobonos -Mexico, hedged TBs - Ukraine, domestic bank loans, East Asia) has resulted in *unsustainable* upward pressures on:

- Assets Prices
- Commodity Prices (General Inflation)
- Cost of Funds (Interest Rates ?)
- Nominal and Real Exchange Rates

It is the reversal of these movements that constitutes the crisis

Medicine

Assume that the Excessive Borrowing is attributable to Monetary (bank) Credit

TARGET just TWO of the FOUR Variables namely Commodity Prices (Inflation) and the Nominal Exchange Rate

Tighten Monetary Policy to redress the excessive borrowing and to hit the two targets

Treat Interest Rates as an INSTRUMENT in this process

What's Wrong with That?

Answer 1. Interest Rate Feedback Effects on Fiscal

- These feed-backs can theoretically be counterproductive in relation to the announced targets (Sargent and Wallace, *Some Unpleasant Monetarist Arithmetic*, in T Sargent, *Rational Expectations and Inflation*, 1986)
- Where govt. domestic debt is large relative to Forex debt, they may be as large a source of fiscal vulnerability as exchange rate movements
- Where interest charges are already a large share of budget, i.e interest rate might be seen as a possible *target* not just an *instrument* of policy
- In some cases debt write-down has to be a part of the package if you are serious about allowing high interest rates

Large inter-country variability NOT reflected in policy package differences

Continued

Answer 2. Feedback Effects via Corporate Balance-Sheets

- There are theoretical reasons to expect very high R to damage corporate balance-sheets (G. Calvo, in Simon Commander, *Managing Inflation in Socialist Economies in Transition*, World Bank, 1991)
- The actual numbers for East Asia confirm the near CERTAINTY of serious deflationary effects from the 1997 hikes in rates

Corporate Characteristics in Asia -pre Crisis

(M.Pomerleano, E Asia Crises and Corporate Finances, Wbank 1998)

	Leverage	Debt Raised	Altman's Fragility	ROCE-Lending Rate
	1992-96	(% of Investment)	Index 1995/96	1995/96
	(Average	1992-96 Average		
Crisis Countries				
Indonesia	92%	67%	2.6	-9%
Korea	132%	69%	1.55	-2%
Thailand	155%	78%	1.5	-8%
Malaysia	62%	45%	3.9	3%
Philippines	69%	25%	3.4	-9%
Comparator Countries				
Hong Kong	39%	45%	6.9	12%
Latin America	31%	19%	1.9	na
Germany	58%	6%	na	-8%
USA	90%	8%	na	4%

A Typical Asian Corporation

Table 4: Interest Rate Impacts on a Typical Company									
Combined Operating and P&L Account									
	Year 1	Year 2 (A)	Year 2 (B)	Year 2(C)		Year 1	Year 2 (A)	Year 2 (B)	Year 2 (C)
Costs					Revenues				
Wages	150	165	165	165	Sales	490	539	539	539
Materials	50	55	55	55					
Interest Charges	80	88	176	220					
Depreciation	130	143	143	143					
Balance-Profit	80	88	0	-44					
Totals	490	539	539	539	Totals	490	539	539	539
Balance-Sheet									
	Year 1	Year 2 (A)	Year 2 (B)	Year 2(C)		Year 1	Year 2 (A)	Year 2 (B)	Year 2 (C)
Fixed Assets	1300	1287	1287	1287	Loans	800	880	880	880
Cash	80	231	143	99	Shareholder Funds	500	500	500	500
					Revaluations	0	50	50	50
					Retained Profits	80	88	0	-44
Totals	1380	1518	1430	1386	Totals	1380	1518	1430	1386
ROC						5.80%	6.38%	0.00%	-3.19%
Revaluation Profit									
Fixed Assets		130							
Loans		-80							

Rich Countries -The Current Consensus

Crisis -Responses can be Supportive because

- After years of erratic progress, fiscal discipline is now high- fiscal deficits rarely exceed 1-2% of GDP
- Low inflation also sustained by formal commitments (e.g. Maastricht) and intensive global competition
- Small interest rate cuts do little either to re-fuel inflation or to damage confidence in financial markets

Rich and Poor Countries - Parallels

Poorer Countries

- Money-Phobic view suggests need to tighten liquidity as a response to crisis.
- But ignores the *non-monetary* flow of funds and how these get impacted
- Central Bankers/IMF neglect of non-monetary financing achieves short term semblance of stability at the risk of intensified problems longer term

Richer Countries

- Money-Phobic view interprets low inflation as reward of moderate borrowing via banks
- But ignores the huge *non-monetary* borrowing that has resulted in far riskier balance-sheets
- Central Bankers neglect of non-monetary financing achieves short term semblance of stability at the risk of intensified problems longer term

Rich and Poor Country - Differences

Poorer Countries

- Thin Capital-Markets mean that indirect effects of high interest rates on **financial asset values** can reasonably be ignored
- Inflation cost of borrowing is high because borrowing gets swiftly reflected in monetary/liquid assets
- Portfolio inflows from rich countries have relatively low risk-adjusted returns because they do not benefit from the hidden guarantee.

Richer Countries

- Huge pyramids of Capital-Market Credit means that large interest rate hikes need to be avoided (this fact provides a hidden guarantee for bond holders)
- Inflation cost of borrowing gets suppressed because of strong (but risky) portfolio preferences for capital market assets
- Portfolio outflows (to poorer countries) are immediately more risky even when economic management in those countries is very sound.

Financial Adjustment in the Poorer Economies

IF Bankruptcy Institutions Exist

- a. Limited Insolvency
 - EFFICIENT rationalisation
- b. Systemic Insolvency
 - Bankruptcy Neutralised as an institution (insufficient capacity)
 - Chronic Information problems for allocating any new Credit
 - ➤ Cumulative growth of “Messy” Credit (Arrears etc.) as the major source of new Credit

Bankruptcy Institutions do NOT Exist or do NOT Function

- Confused Information about how to allocate any new Credit on offer
- Cumulative growth of “Messy” Credit (Arrears etc.) as the major source of new Credit - especially if Insolvency is systemic

Topic 5: The East Asian Crises -1997

- **In spite of the success of East Asian economies in many areas of economic reform, the 1997 Asian Crisis was caused by an unsustainable deterioration in key macroeconomic fundamentals -- resulting from poor economic policies, poor banking practices that led to poor investments, and contagion effects.**
- **In a number of economic areas, East Asian countries were doing well:**
 - **Their Fiscal Budgets were balanced (if fact, most countries had small fiscal budget surpluses of 1% of GDP).**
 - **Inflation was also under control. For all countries inflation rates ranged form 5% to 10% pa.**
 - **Domestic savings rates were quite high, over 30% of GDP, except for Philippines (18% of GDP).**
 - **GDP growth was high for all countries in the region.**

Consequences

- On the strength of these economic results, and low interest rates in Japan, significant capital inflows came into the region, growing from US\$10 billion per year in 1984-89, to US\$108 billion in 1996, of which US\$30 billion were in the form of bank loans.
- These capital inflows led to accumulation of large foreign exchange liabilities. For the five most affected countries, short-term bank foreign debt increased from US\$93 billion in 1993 to US\$152 billion in 1996.
- The ratios of short-term foreign debt to international reserves were above 1.0 in Thailand, Indonesia and Korea.
- These capital inflows led to appreciation of local currencies during the 1990's.
- Many countries (Thailand, Malaysia, Philippines) tacitly **pegged their currencies to the US dollar**, to facilitate borrowings and reduce borrowing costs.

Continued

- From 1990 to 1997, real exchange rates appreciated by 19% in Malaysia, 23% in Philippines, 12% in Thailand, 8% in Indonesia, and 30% in Hong Kong. (Korea and Taiwan had depreciations.)
- The appreciation of the domestic currencies, and the easy availability of foreign short term loans, led to significant current account deficits in Thailand, Malaysia and Philippines, and Korea in 1996, as shown below (based on national income):

(%GDP)	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>
Korea	-1.7	-0.2	-1.5	-1.9	-4.9
Indonesia	-2.5	-0.8	-1.5	-4.5	-3.4
Malaysia	-4.1	-10.1	-11.5	-13.5	-6.0
Philippines	-3.2	-6.7	-3.7	-5.1	-5.9
Singapore	12.3	8.5	18.2	17.9	16.3
Thailand	-6.3	-6.5	-7.2	-9.0	-9.2
Hong Kong	5.3	8.1	2.0	-2.1	0.6
China	1.1	-2.1	1.2	1.0	-0.3
Taiwan	3.8	3.0	2.6	1.9	5.2

Imbalances

- Several factors contributed to these CA imbalances:
 - (1) The long stagnation in Japan led to a slow down in the growth of exports of Asian economies.
 - (2) The sharp appreciation of the US dollar relative to the yen in 1995 led to a worsening of cost-competitiveness of those Asian countries that had pegged to the dollar.
 - (3) In 1996, there were sector specific shocks, such as a major reduction in demand for semiconductors and adverse terms of trade for many countries in the region.
- For a number of years, foreign financial institutions were aware of the large current account deficits in the region and of the increases in external debt.
- But the rationale for continuing lending was that *these capital inflows were used for investment purposes, which is consistent with high growth and increased capacity to sustain exports and debt service.*

Problem Areas

- **Capital inflows were not used for current consumption, as was the case in Mexico.**
- **However, there are THREE main reasons why investments in Asia should have been seen with caution:**
 - **A substantial portion of new investments went to the non-traded good sector, particularly real estate, whose prices increased rapidly. These projects do not contribute directly to improve future exports and debt service capacity.**
 - **The profitability of new investments was low. The incremental capital output ratios (investment rate to GDP growth rate) increased sharply during 1993-1996.**
 - **Another evidence of low profitability was that, before the crisis, the rate of non-performing loans were increasing rapidly in most commercial banks in the region, reaching over 15% in Thailand, Indonesia, Malaysia and Korea.**

The main reasons for over-investment

- Political pressure, favoritism, and patronage coupled to poor banking practices.
- Poor banking practices were widespread and induced by moral hazards: the understanding that their investments were “insured” by the Government which was encouraging them.
- Bad banking practices were also facilitated by lack of transparency, poor banking regulations and supervision, inadequate bank capital requirements, and inadequate bankruptcy procedures.
- Through the 1990’s excessive bank lending is shown by the ratios of bank lending to GDP of more than 50% in Thailand, and Philippines, 27% in Malaysia, and about 15% in Korea, Indonesia, Hong Kong and Singapore (cf Mexico)
- As a result of excessive bank borrowings, many enterprises had very large debt to equity ratios (see earlier slides).

Thailand

- For two years, Thailand had a Current Account Deficit of over 9% of GDP, financed by foreign bank loans.
- A significant portion of the local currency counterpart of the foreign bank loans went to real estate with large over-investments.
- After 1996, these real estate investments suffered losses, due to large vacancies. This led to a deflation in real estate prices in late 1996.
- But since mid-1996, equity investors had already perceived difficulties, which led to a decline in stock market prices as noted in the chart.

THAILAND in US Dollar
Price Index (official) Daily 29-Mar-1996 to 26-Apr-2001



Source: MSCI, RIMES

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Foreigners were less Perceptive

- **However, many foreign banks disregarded these signals, perhaps because the experience of Mexico also suggested that large countries will not be allowed to fail: the multilaterals will bail them out eventually.**
- **But in early 1997, the asset bubble started to burst with the emergence of wide losses & outright defaults in the financial and corporate sector, starting in Thailand (with Somprasong Land's default of an Eurodollar and the collapse of Finance One, one of the largest finance companies).**
- **The widespread perception of a real misalignment and unsustainable external imbalances undermined the credibility of the commitment to fixed exchange rates in Thailand and also in many countries in the region.**

The lead-up to Crisis

- This led to a change in lending sentiments. Without the possibility of roll-over, many firms with large short-term foreign debt could not easily repay them. More defaults followed.
- The Thai Central Bank had promised to bail out these companies.
- But this promise could not be met when the new Minister of Finance discovered that the level of international reserves were not the official US\$30 billion; but only US\$1 billion
- This was because reserves had been committed in early 1997 to defend the Bath through forward contracts.
- A few days later, on July 2, 1997, Thailand was forced to let the Bath float.
- The Bath depreciated by 35% in a few **weeks**.
- By that time, the stock exchange index had already collapsed from about 600 in mid-1995 to 200.
- In a new months, by December 1997, it went down to 50.

Korea

- The attack on the won and its devaluation in October 1997 was induced, not by the Thai devaluation, nor by large current account deficits, but by the large number of bankruptcies of conglomerates, due to excessive bank borrowings.
- The debt to equity ratio for the 30 top conglomerates (Chaebols) in Korea was 333% in mid-1996 (compared to 100% for the US).
- These bankruptcies started in mid-1996, when investors realized that Korea was already in clear trouble.
- This sentiment led to a rapid decline in stock prices, as seen in the chart, from an index of 180 in mid-1996 to 110 in December 1996.
- The crisis deepened in early 1997, with the collapses of Hanbo Steel and Sammi Steel and the defaults of the Jingo and Kia Groups.
- By mid-1997, investors were in panic, and the devaluations in Thailand, Indonesia and Korea were the triggers that led to the Korea devaluation of October 1997.
- By December 1997, the stock exchange index had declined to 30.

KOREA in US Dollar
Price Index (official) Daily 29-Mar-1996 to 26-Apr-2001



Source: MSCI, RIMES

www.rimes.com

Malaysia

- the deterioration of fundamentals had also occurred before the Thai devaluation of July 1997.
 - From 1993 to 1995, with large capital inflows, it had current account deficits in excess of 10% of GDP.
 - Capital inflows were driving real estate and equity prices to unsustainable levels.
 - Concerned about real estate price increases in the capital, in March 1997, the Central Bank announced ceilings in lending for real estate and also for purchase of stocks.
 - The impact on the stock exchange was immediate, with foreign investors liquidating their holdings and moving capital out.
 - Stock prices collapsed from March 1997 on, with the stock index dropping from 450 in March 1997 to 100 in December 1997.
 - By August 1997, the currency was devalued.
 - Subsequently, the Government introduced capital flow controls.

MALAYSIA in US Dollar
Price Index (official) Daily 29-Mar-1996 to 26-Apr-2001



Indonesia

- the crisis was also originated by fundamental economic weaknesses, with many firms in difficulties.
 - But investors refused to perceive these difficulties, with the stock exchange firm up to mid-1997 (comment by a banker: “Indonesia is too big and important to collapse”).
 - Following the Thai devaluation, Indonesia’s currency was attacked and devalued in August 1997.
 - This led to a quick collapse of the stock exchange from an index of 680 in mid-1997 to 70 by December 1997.
 - The crisis in Indonesia became even deeper and more prolonged with the announcement in December 1997 that the level of foreign debt had been underestimated/misreported.
 - Foreign debt was close to US\$200 billion, rather than the official figure of the Government of US\$117 billion.
 - Private foreign borrowings were also higher than previously estimated.

Summary- E Asian Crises

- Causes:
 - Large external imbalances caused by poor economic policies, particularly pegged exchange rates and excessive bank foreign borrowings due to implicit government guarantees.
 - Excessive and low-profitability investments, caused by bad banking practices and undue political patronage.
 - A contagion effect made more pronounced by a series of competitive devaluations.
- The crisis was made deeper and more widespread by bad banking practices throughout the region that led to poor investments (the main cause of the crisis, according to Paul Krugman).
- A Paper by Oxford's Jenny Corbett and David Vines says:
 - Vulnerability was created *both* by capital liberalisation in the presence of a bank-based financial regime (which contained implicit promises of bail-out), and by capital liberalisation under pegged exchange rates (which led to boom and bust).

Continued

- These vulnerabilities were interconnected.
- Negative shocks precipitated *both* a financial crisis and a currency devaluation.
- The financial crisis created obligations for the government to bail out the financial sector.
- The critical extra feature which then led to collapse was that the fixed exchange rate regime had induced massive unhedged borrowing in foreign currency.
- When the currency depreciated this raised the burden of that borrowing and led to a worsening of the financial crisis.
- Financial collapse resulted when currency devaluation was large enough that those who had lent to the financial system came to believe that government guarantees might not be honoured.
- This then triggered fears of sovereign insolvency, and that in turn pushed currency depreciation into currency collapse.

Lessons from East Asia

- **The lessons from the Mexico 1994 crisis are relevant too from the crisis in Asia, particularly regarding fixed exchange rates and foreign borrowings.**
- **In addition, the Asia crises has highlighted the need for:**
 - **Improved Bank Regulation and Supervision.**
 - **Development of capital markets to improve financial intermediation.**
 - **Improved Governance to deal with political favoritism.**
 - **Avoiding moral hazards from implied Government guarantees.**
 - **Improved bankruptcy procedures.**
- **The Asia Crisis has also highlighted the need to review the role of Multilateral and other international agencies in the international financial system.**

Lessons re External Support

- The role of the International Community in addressing the Asia Crises was as follows:
- For two years before the crises, the IMF/World Bank had highlighted the issues and risks, particularly to Thailand.
- After the crisis, they worked with the three countries most affected -- Thailand, Korea and Indonesia -- in arranging programs of economic reforms that could restore confidence.
- A financial support package of \$112 billion was arranged, with financing provided as follows (US\$billion):

Country	IMF	World Bank and ADB	Bilateral	Total
Korea	21	14	23	58
Thailand	4	3	10	17
Indonesia	10	8	19	37
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Total	35	25	52	112

BUT! –see also Topic 4 above

- As regards the adequacy of the **economic program** imposed by the IMF, some analysts believe that the application of tight monetary policies to Asia reduced, rather than improved, the creditworthiness of indebted firms and exaggerated the financial collapse.
- They also believe that fiscal contraction, by exacerbating the downturn, caused firms' revenues to fall and also worsened the collapse.
- And they believe that different policies were needed:
 - Interest rates should **not** have been increased, given the size of foreign debt (monetary policy was too tight). Currency depreciation should have been controlled by inflation anchors.
 - The IMF delayed assistance since the fiscal deficits that Governments were prepared to accept were **larger** (sensibly so) than the IMF demanded. This delays/uncertainty deepened the crises.

What happened next?

- The main economic disequilibrium in the Asian region before the crisis was the large size of the Current Account deficits.
- After the crisis the Current Account deficits were eliminated and became large surpluses, as follows:

	<u>Current Account to GDP (%)</u>					<u>Fiscal Deficit 2000(%GDP)</u>
	<u>1996</u>	<u>1997</u>	<u>1998</u>	<u>1999</u>	<u>2000</u>	
Korea	-4.9	-1.8	12.3	5.9	2.4	1.1
Indonesia	-3.4	-2.4	4.2	3.4	5.1	-4.7
Malaysia	-6.0	-5.7	13.6	16.2	9.2	-4.8
Philippines	-5.9	-5.4	2.0	9.4	11.9	-4.2
Thailand	-9.2	-2.1	12.7	9.1	7.1	-2.2
Hong Kong	0.6	-3.6	1.4	5.2	5.4	na
China	-0.3	3.3	3.0	1.0	1.2	-2.8

- However, large public expenditures to bail out banks and carry out corporate restructuring is now putting fiscal pressures, with several countries showing large fiscal deficits in year 2000.

Last words

The Mexico and Asia Crises have shown that:

1. The IMF and World Bank should develop different policy responses for different situations. “Blueprints” do not work well in all circumstances.
2. Under the current international financial system, the leverage of multilateral institutions, such as the IMF and the World Bank, is substantial only when the country is in crisis, in its knees. But it is not important when the country is doing “reasonably well”.
2. The current debate on the new International Financial Structure is quite relevant to prevent crisis: the recent approval of an IMF’s Contingent Credit Line (CCL) will give leverage to the IMF/World Bank to seek sound macro policies in anticipation of crises; rather than just provide bail-out interventions after the crisis.