Three Complications in Asian Economic Recovery

Manuel F. Montes*

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Latin American experiences in balance-of-payments crises have been a rich source of insight into the causes and results of such crises. Using the Latin American backdrop, certain features of the Asian crisis suggest that recovery can be more complicated in Asia, though it might not necessarily be more drawn out.

In recent memory, we can distinguish between two Latin American crises: the 1980s debt crisis and the 1994 Tequila crisis. In fact, Mexico's external payments problems served as the trigger to both. Currently the Thais are trying to avoid a similar reputation; early on, it had been suggested that Asia's crisis be called the 'Tom Yum' crisis.

The private-lending boom origin of the Latin American Southern Cone crisis of 1981–83 shares many of the features of the Tequila crisis. The 1994 Tequila crisis was characterised by a 'V-shaped' pattern: drastic economic collapse followed by rapid recovery. The 1980s debt crisis manifested an 'L-shaped' or 'extended' recovery pattern.

In the context of these two types of Latin American crises, three factors create specific complications for Asian economic recovery:

(1) Unlike the 1980's debt crisis, the locus of the Asian crisis is not overwhelmingly in the public sector, but in the private sector
(2) The Asian crisis is situated in the credit system, with its inherent problems of rehabilitation and recapitalisation plus vulnerability to currency devaluation and instability
(3) In the Asian case a greater role is played by internationalised asset markets arising from a combination of liberalised capital accounts and the impact of information-impelled movements of large international funds.

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1 Private, as Opposed to Public Sector Locus

The 1980s international debt crisis was seen mainly as a Latin American crisis, although one Asian country, the Philippines, and a few African countries were also involved. For Latin America, the 1980s debt crisis was a region-wide phenomenon and lasted at least a decade.

The common elements in the 1980s debt crisis were: large public sector investment-savings deficits were feeding into unsustainable current account deficits that were being financed by private international bank lending; imports were subsequently forced to contract in order to reconcile current account deficits to the reduced external private willingness to lend to these countries when the lending frenzy stopped, thereby inflicting on them a decade-long output contraction. Investment dried up, public sector expenditure was cut back drastically, and the bulk of savings and consumption compression went to pay interest on accumulated foreign debt. The possibility of recovery only emerged when significant chunks of the principal were in effect written off through the Brady bond discounts, beginning in 1988.

The debts that brought Latin America low for over a decade were ultimately based on public sector borrowing and when the debt crisis exploded even those debts that had been incurred by the domestic private sector were rapidly nationalised, either through the operation of the government guarantees or as an outcome of debt restructuring negotiations.

The contrast with the Asian debt – and this is ironic since the region had been reputed to be one where the public sector had a strong and successful role in development – is that the largest and most problematic debt in Asia was incurred by the domestic private sector: banks, finance, companies and corporations. In the case of Indonesia, a majority of the external liabilities were undertaken directly by corporations. The debt is in various forms: credit lines, project financing, bonds.

The prevalence of the strategy of government-guaranteed borrowing in the 1980s explains its pervasiveness; countries that did not undertake too much of this type of borrowing escaped the crisis. In the case of Asia, economies that did not participate to the same extent in the external private borrowing boom have also been affected through currency depreciations.

Because of its private nature, it is more difficult to consolidate the debt in Asia.[1] Thus, the debt workout is more complicated there. But it is not necessarily the case that the debt workout will take longer in Asia than it did in Latin America. The prolongation of the crisis in Latin America arose from the unwillingness and initial inability of Western deposit-money banks to recognise losses on developing country debt. This problem is still operating at this time, but international players have a better understanding that it is better for all involved to recognise losses earlier rather than later. The debt negotiations in Thailand, Korea and, lately, Indonesia appear to embody this piece of wisdom from 1980s.[2]

What about recovery? For both Latin America during the 1980s and Asia during the1990s the critical element is (1) the rehabilitation of the trade credit system so that exports can restart and (2) recovery of investment spending.

In the case of Latin America, the slowness to recognise losses by foreign creditors was an important factor in delaying recovery. The restoration of

[1] In the case of the Mexican 1994 crisis, the debt had been consolidated in the dollar denominated government treasury bills, called *tesobonos*. Somehow, before the crisis, the Asian private sector elicited more credibility from international financiers than the Latin one and a significant proportion of the lending was made directly to private parties; many individual Asian companies also floated bonds in developed country markets. As it turns out, but as everyone who lent to Asia should have known, bankruptcy procedures, even where the laws are in place, do not operate at all in many instances. The fact that international bankruptcy procedures are not in place either raises the question of whether domestic bankruptcy procedures would be sufficient anyway.

[2] However, the Asia debt adjustment is not necessarily secure with the restructuring packages or systems now in place. Further falls in the currency, further widespread bankruptcies – which can be also caused by further currency depreciations – and political upheavals could cause an unravelling of these packages.

investment confidence in Latin America was dependent also on the completion of the privatisation and liberalisation efforts that were put in place through the accompanying structural adjustment packages.

For Asia, the natural sluggishness in private-sector debt workouts will be an important factor that will slow down adjustment. This is not a problem only of the Asian private sector; it is a problem of the private sector everywhere. Private companies, especially their shareholders, tend to be slow in recognising losses. This delays the sale of these companies to other investors, who face the danger of having to increase provisioning for unknown or unforeseen liabilities in the assets they have purchased.

Domestic banks are sitting on chunks of doubtful claims. These losses have to be recognised as rapidly as possible and could be either liquidated by securitising them or consolidated into an asset restructuring agency and securitised. Governments are involved in this process (through the imposition of provisioning rules and by the setting up of asset-restructuring agencies), but the resistance of domestic shareholders to recognise losses could delay the liquidation. In the 1980s case when Latin American countries were involved, it was usually the government that was the shareholder of the borrowing company.

Will the Asian crisis last a decade? I sincerely hope not, and it is critical that the Asian *private sectors* recognise their losses early.

A complicating Asian factor is that a lot of potential private sector losers are well-connected to the government. This is especially true in those countries which the World Bank (1993) designated as being in the group of 'miracle economies' because of good governance,[3] a key part of which was effective business–government coordination. This suggests that addressing the financial sector problem will at the very least generate much political controversy and recrimination. The use of taxpayers resources to bail out favoured businessmen will in turn appeal to governments that are likely to encourage the undertaking of risky projects as the rationale for a bail-out. At worst, these adjustments can lead to the collapse of governments, even though such collapses would more likely be the result of macroeconomic events rather than bank restructuring policies.

Even in Indonesia, where there is a new president, credit restructuring will be problematic. The new president is not directly politically connected with failing projects, but in the process of forcing write-offs he will have to follow due process which will entail investigations into parties associated with the previous regime and awaiting the outcome of legal proceedings. In the case of Japan, the intricate system of determining primacy of claim from the proceeds of land sales is complicated by the possible claims of criminal groups on loan proceeds. Examples like this abound in the region.

2 The Credit System as Locus of the Asian Problem

I use 'credit system' instead of 'financial system', since direct borrowing by corporations, not just financial institutions, constitutes a significant element in the Asian crisis. Regulatory oversight of the banking system and the finance companies (the latter proving to be the Achilles heel of the system in Thailand and Korea) was certainly not adequate. With liberalised capital accounts, regulatory oversight was practically non-existent in regard to the enormous direct external borrowing by corporations, which was a key ingredient in the Indonesian crisis.

The Southern Cone (Chile, Argentina, Uruguay) crisis experience of 1981–83 has many of the elements of the Asian situation. In this experience, as in Asia, a lending boom fuelled by external private borrowing followed upon the rapid liberalisation of the domestic financial system and the opening of the capital account. The same elements were observed in Norway, Sweden and Finland between 1988 and 1992, and before 1994 in Mexico.

Rehabilitating and recapitalising the credit system is a more critical aspect of the Asian than the Latin American case, where the locus of the domestic credit aspect of the crisis was government corporations or government-owned banks. As pointed out

[3] The Philippines was pointedly excluded from this group.

earlier, where there were domestic private parties involved in the Latin American case, the credit problems were rapidly socialised, with the government taking over the liabilities. Closures and privatisation of indebted government corporations and banks were carried out in Latin America. To do this, public sector labour unions had to be appeased (or undermined) but when the corporate adjustments were eventually carried out, normal credit operations could theoretically restart. The real constraint to the restart of investment was the slow reflow of capital from external sources and slow restoration of private investment confidence in the light of the controversial structural reforms that the countries were undertaking. Latin American countries were having to put their public finances on a sounder footing and liberalise their trade sectors.

In the case of the 1994 crisis, Mexico's bad debt problem was quickly consolidated by an asset-restructuring agency. The extent of the resulting reflow of capital into Mexico was so strong (something I discuss in the next section) that the matter of financing the clean-up of this problem has been postponed. This is now an issue for Mexico.

For Asia, the rehabilitation of the credit system and how it is done is critical. I have already pointed out above the problems inherent in the private sector nature of the Asian crisis. Here I would like to focus on the credit-centredness of the crisis. Credit rehabilitation and recovery require the recognition of losses, their liquidation, and the recapitalisation of credit institutions. For example, in Thailand, there is an estimated recapitalisation requirement of $7.5 to $10 billion in the next three years.

In the Asian case, domestic savings rates are high and, unlike in Latin America, the reflow of capital from external sources is not a necessary ingredient in credit rehabilitation and recovery for all countries. What is needed for credit rehabilitation and recovery is a credible plan for adjustment and the stabilisation of exchange rates.

The current Malaysian case is a good illustration of the kind of credit sector problems that did not have to be faced in a significant way in Latin America. It could be argued that Malaysia, as a nation, has sufficient domestic resources to absorb the bad loan write-offs. The proposal, not subsequently implemented, for addressing the loan problems of the controlling shareholder of the Malaysian Airways System raised fears that Malaysia would undertake a write-off process, thereby undermining business confidence. If bad loans are transformed from being liabilities of individuals to liabilities of corporations, this would weaken the financial condition of the corporate sector, potentially undermining equity prices, and causing further banking weaknesses, considering that a large proportion of bank collateral is in shares.

Credit sector problems are appallingly widespread in Asia and it is clear that this has had a large impact on exchange rates. Japan, which is the most recent contributor to the Asian crisis, has a credit sector problem that undermines confidence in Japanese savings being invested in yen assets. Addressing this credit sector problem through a leisurely approach to writing off losses has also required Japan to maintain low domestic interest rates, which sustains the incentive for Japanese savers to move out of yen-denominated financial assets. If Japanese savers cannot be converted into Japanese consumers[4] overnight it is imperative all the more that Japanese financial restructuring be completed quickly.

Historically, a combination of a raid on taxpayers' money and money creation has proved the most forthright way to get out of a credit sector problem. Normally, the size of the debt overhang cannot be absorbed through private write-offs, even though private write-offs are required to reduce the cost of the operation, to increase the speed at which specific loan instruments are liquidated, and to restore creditor confidence.[5]

In a democracy, raiding taxpayers' money, as Japan and the Scandinavian countries found out, is not

[4] In the Latin debt crisis of the 1980s, the US economy was most of the time in the doldrums and could not play the role of an engine of growth. The international, mainly US, banks that had lent to Latin America were in no position to absorb the write-offs implied by the crisis when it began in 1982.

[5] There will be a period, unavoidably, in which the government and government agencies will be holding equity and participating in the management of financial and industrial enterprises.

straightforward since it requires that sufficient pain be inflicted on those who made hay during the lending boom. Taxpayers have to be mollified with the assurance that culprits in the lending boom are contributing their share in accepting the losses and being punished for their violations of the law. Arrests, bankruptcies, and in the case especially of Japan, tragically, suicides are part of this process.[6]

Japan's experience since 1990 of reluctance and inability to use the resources from these two sources to resolve its financial instabilities is illustrative of the kinds of controversies that are being replayed in the other Asian economies. Add to this the IMF's obsession (perhaps due to the IMF's informational advantage in understanding how private currency markets operate, a rather doubtful claim) with liquidity restriction and high interest rates, and one could argue that the process will be more complicated in the other Asian countries.

With regard to money creation, a contrast with regard to the stance of foreign cooperators to the recovery program can be made. The Argentines actually carried out significant money emission (to use a Latin phraseology) to rescue the banking system in response to the Tequila crisis. This is normally a 'no no' when running a currency board and the Argentineans did claim that they were determined to maintain their system in the face of the crisis. Argentina's friends in the international community, including the IMF and the private market, apparently permitted Argentina the liquidity leeway during the crisis, something that has proven very difficult for the Thais and the Koreans to obtain from the IMF.

Moreover, exchange rate stability is indispensable for the recapitalisation of the domestic credit system; otherwise, it would be wise for residents to hold their assets in foreign currencies. The processes can feed into each other and at this juncture it is critical for Japan to get its financial house in order as quickly as possible.

What does the credit locus of the Asian problem bode for the future? One would hope that Japan's long-running experience will not become the norm in the other Asian economies.

3 Role of Internationalised Asset Markets

The contrasting role of nationals, both resident and non-resident, against those of non-nationals provided some analytical edge to understanding Latin currency attacks. Before the 1994 Mexican crisis, it appeared, for example, that non-nationals continued to be optimistic about Mexico's medium-term prospects while the nationals were quietly increasing their assets outside of Mexico. The role of this so-called 'heterogeneity of expectations' will undoubtedly be the subject of formal study of the Asian cases in the future.

During the 1980s Latin American crisis, capital accounts had not been liberalised; however, that crisis abounded with stories, economic models, and estimates of capital flight and how wealthy Latin Americans had moved their assets abroad and profited from the so-called maxi-devaluations. The Asian economies have also carried out maxi-devaluations, but for the most part their capital accounts are now widely open. In the case of Korea, its capital account has been drastically opened as part of its IMF reform package. Since the crisis began in July 1997, attempts in Asia to make residents' purchases of foreign assets illegal have only resulted in further currency attacks, that is, capital flight.

Internationalised asset markets have played a key role in the Asian crisis, as the currency crisis hopscotched its way through all the celebrated East Asian economies. The 1994–95 Latin American crisis had all the elements of these internationalised asset markets. Argentina became the immediate victim of Mexican devaluation, in spite of the currency board in place. Multinational banks cut their domestic credit lines and Argentina experienced colossal interest rates.

However, the contrast in the international response to the Tequila crisis as opposed to the Tom Yum crisis are quite stark. When the Mexican crisis began,

[6] Raiding taxpayers' money was a politically possible strategy in Latin America since government companies had been involved and democracy was only a gleam in the Latin eye when the debt crisis began. However, the Latin Americans had limited taxpayers' resources to raid just at the point when the crisis struck.

there was an immediate recognition of the contagion problem and the possibility of an international meltdown of financial markets. The US support for Mexico was swift, practically unconditional, and large. Two memorable events of 1995 are worth noting. First, the whole outstanding stock of ***tesobonos*** (short-term Mexican treasury bills denominated in US dollars) had been wound down by April 1995, using the funds provided from the rescue package. Second, European executive directors of the IMF were seen to have complained about how the US had strong-armed the IMF into providing a rescue package that bent the IMF rules beyond recognition. European directors actually abstained in the vote on the IMF package.

The swift, large, and mostly unconditional international response to the Tequila crisis in 1995 prevented that crisis from creating widespread banking crises in the countries subjected to currency attack. Currencies devalued and stopped falling further. For Argentina, interest rates soared and credit disappeared. For the affected economies, there was a large drop in output, rapid nationalisation of financial losses (at relatively stable exchange rates), and a normalisation after about one year.

The contrast with Asia is quite stark. The US did not participate in the Thai package. In the Indonesian case, successive, highly conditional, but ultimately unsuccessful rescue programmes saw the precipitous decline of the rupiah and undermined banking and corporate solvency. The Korean programme is also highly conditional.

For all the economies, as we have described above, the private sector nature and the credit-centredness of the crisis complicate recovery, but it is also the case that the continued uncertainty in exchange rates complicates attempts to provide a basis for the return of resident assets and to recapitalise the financial system. The currency instability has lasted quite a long time in Asia. For the length of time since the crises began, the Thai baht standard deviation is 55 per cent more than that of the Mexican peso. The fall of the Japanese yen since November 1997 has added its own volatility to the Asian currencies.

Undoubtedly charges that the US moved too quickly in early 1995 to bail-out its own pension funds explain part of the US hesitation in dealing with the Asian crisis; US exposure to Asia was also less than that of Japan and Europe.[7] Only in December, after a tour of the countries by US officials, did it appear that the US was taking the crisis seriously. As explained earlier, the private sector nature of the crisis might have also precluded a quick Mexican style bail-out of private claims in the region. But perhaps this would have been a conjuncture in which currency support and intervention might have been appropriate.[8]

By October/November 1998, the Asian crisis could be interpreted as a liquidity crisis, akin to a bank-run in domestic contexts where most of the banking system is still thought to be solvent, brought about by the sudden demand of Asian residents for US dollars in the face of uncertainty over how low currency values would fall. There was a dollar shortage in the region that was forcing currency values to fall quite out of line with what would have been required to restore external balance. Exchange rates, having fallen so much, had been transformed for most Asian economies from being a 'symptom' to being a cause of further domestic financial instability.

What appears to be called for to stabilise the situation is (1) for the G7 countries, especially the US, to prevent any further depreciation of the yen and (2) for the Asian countries, using funds mostly raised from Japanese guarantees and applying American conditionality, to implement an exchange rate stabilisation arrangement. With regard to the first, private markets have been waiting for this move since before the G7 finance ministers' meeting in Birmingham in late February. Almost everyone knew Japan was about to go into recession, almost everyone knew the constraints of the Japanese political cycle, and that Japan had scheduled its Big Bang for 1 April 1998.

The impact of the US intervention at the end of June highlights the prickly and information-driven

[7] European banks had been playing catch-up with US banks to increase their operations in the region, while many US banks had been reducing their exposure.

[8] Some of these arguments are also made by McKinnon (1998) in a paper presented at the annual meetings of the American Economic Society.

nature of exchange markets[9] and the importance of a steady stance in exchange stabilisation, at least until the crisis subsides. After the intervention, the yen fell, ahead of an emergency meeting of G7 deputy finance ministers and their Asian counterparts in Tokyo on 20 June 1998. This contrasts with the situation immediately preceding the three previous G7-related meetings. One could ask whether, after three experiences, currency markets associated these meetings with a 'no intervention' strategy. Efforts by the US Treasury Secretary in a public interview to dampen expectations from the Tokyo meeting were a key element; that these efforts had to be made to avert an over-strengthening of the yen followed by an over-correction which would have required more intervention indicates the hair-trigger nature of the problem.

With regard to the second element, there had been a $100 billion proposal in September 1997 to help stabilise Asian currencies, but this had been slapped down by the US and the IMF out of feelings of insecurity and because they had not particpated in the proposal. Currency markets in the developing countries in Asia are quite thin and susceptible to intervention. It remains for the US to agree on the conditionalities under which this fund, which can be raised through Japan, would be used.

The question remains as to why the US might find it in its interest, as it seems to have done in the Tequila crisis, to play a more active and sympathetic role. Here I borrow the arguments from McKinnon (1998). The US has virtually unlimited access to the international credit markets, as governments and central banks flock to US bonds and financial assets. But as it is also the prime issuer of international liquidity, it might find it in its interest to make sure that the liquidity crises do not cause the world payments to seize up and, ultimately, that the meltdown in the Asian economies does not affect its own economic performance. US politicians can be told that the US is already borrowing hugely from abroad and extracting significant seignorage. Its support for the yen would constitute a partial return of the international liquidity that its economy is now withdrawing from the rest of the world. McKinnon (1998, p.7) actually says that 'the US has a moral imperative – as well as its own economic interests – at stake in acting effectively as the lender of last resort.'

Without exchange stabilisation, financial market rehabilitation will be problematic in Asia. Without financial market recovery there can be little economic growth. Without reasonable prospects for economic growth, financial companies will remain weak and investment cannot recover. In the 1980s' Latin American crisis, it was the excruciating recovery of investment that caused the so-called 'L-shaped' recovery. In order to get out of the slump, strong public interventions were required – notably the Brady bond write-offs and the set of structural adjustment programmes. Without strong public interventions, but of a different sort as I have pointed out above, Asia faces the prospect of a slow and reversal-prone recovery.

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[9] Montes (1998a) describes some of the institutional factors in the markets, as observed from Singapore which is the fourth largest foreign exchange market in the world, trading about $100 billion everyday.