

The Asia Crisis – Five Years On

Foreign Capital Less Important

Five years after the Asia crisis Indonesia, South Korea and Thailand are again reporting high economic growth rates in macroeconomic output. They have reoriented their monetary policies and are pushing forward the reform of their banking sectors, albeit to different degrees. International monitoring of cross-frontier transactions has also been increased. All in all, the investment risks have become more transparent since the crisis – although the improvement in information has not stopped the outflow of capital from the emerging economies, so that these countries now have to rely more on the supply of domestic capital.

Unrealistic monetary policy, a high level of foreign debt and domestic lending not based on criteria of risk and efficiency led to the damaging financial crisis in Asia in 1997, which soon affected the world economy.¹

Although their economies as a whole suffered a drastic downside as a result of the financial crisis, South Korea and Thailand rapidly regained powerful growth rates in their gross domestic product (cf. figure 1). In Indonesia, where the recovery process was delayed by political distortions,² gross domestic product rose by 2.5% in the first quarter of 2002. In Thailand the growth rate was 3.9%. The development in South Korea was even more dynamic, with economic growth reaching a year-on-year rate of 6.3% in the second quarter of 2002. In all these countries this development has recently been borne mainly by a recovery in exports, particularly exports of IT products. Rising real wages have also helped to expand private consumption. South Korea is currently seeing a clear expansion of investment, which had been declining markedly.

At first glance these macroeconomic figures suggest that these Asian economies are back on a similar development path to before the crisis, at least in part. In reality, much has changed. The investment ratios, however, which had been extremely high, fell dramatically during

¹ The 'Asian crisis' began when the Thai baht was floated in July 1997, and it then spread to the Philippine peso and the Malaysian ringgit. In August 1997 the Indonesian rupiah was devalued. Singapore and Taiwan were less badly affected, and their currencies only declined slightly in value in October 1997. But the South Korean won was strongly devalued in December 1997.

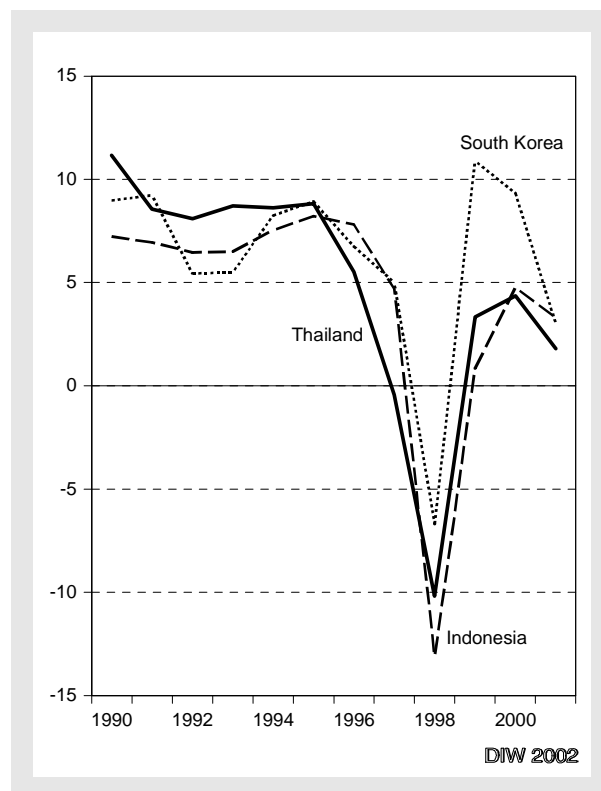
² The economic cooling in 2001 must be seen as mainly due to the downswing in the world economy, which badly affected the economies that are still heavily dependent on exports.

the crisis (cf. figure 2), and even five years later they are still about ten percentage points below the 1996 level; hence the investment ratios are now of a similar order to those in the developed industrial countries. With clearly higher savings ratios these countries are now exporting capital. So the international integration pattern of these economies has changed markedly. Five years after the crisis South Korea, Thailand and Indonesia are registering clear payments balance surpluses (cf. figure 3). All three have moved away from the strategy they were pursuing before the crisis in at least two decisive points. They have abandoned their pre-crisis strategy of, first, fuelling macroeconomic development with extremely high investment and second, financing a considerable percentage thereof with international capital inflow.

A change in monetary policy

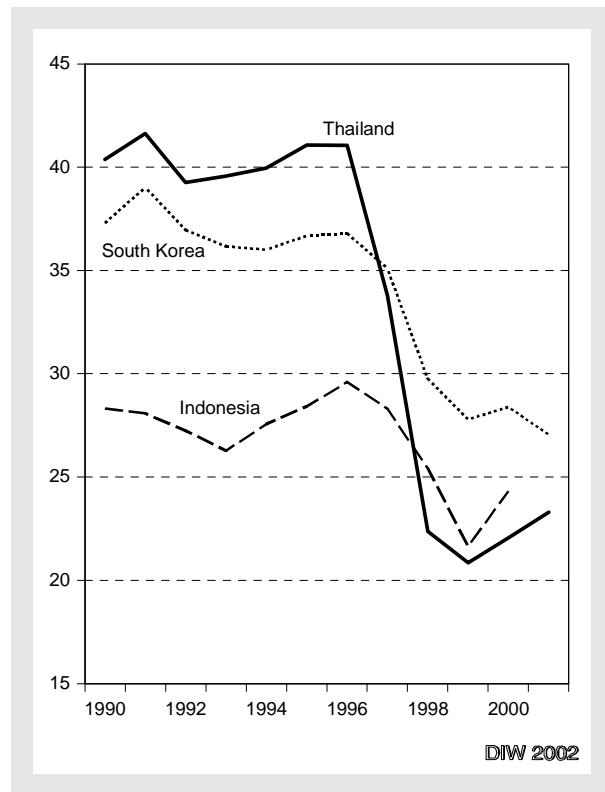
The Asian financial crisis caused the opportunities and risks of fixed exchange rate systems for the emerging

Figure 1
Gross Domestic Product 1990 to 2001
Year-on-year change in %



Sources: IMF: International Financial Statistics, August 2002; DIW Berlin calculations.

Figure 2
Gross Investment Ratio 1990 to 2001¹
 Gross investment in % of GDP



¹ Indonesia to 2000.
 Sources: IMF: International Financial Statistics, August 2002; DIW Berlin calculations.

economies to be reassessed. It became increasingly clear that successful integration in the international financial market also requires the observance of international standards in the commercial banking sector. Better information, on international transactions as well, would lead to better assessment of risks and so help to stabilise integration in the international financial market – so it was argued.

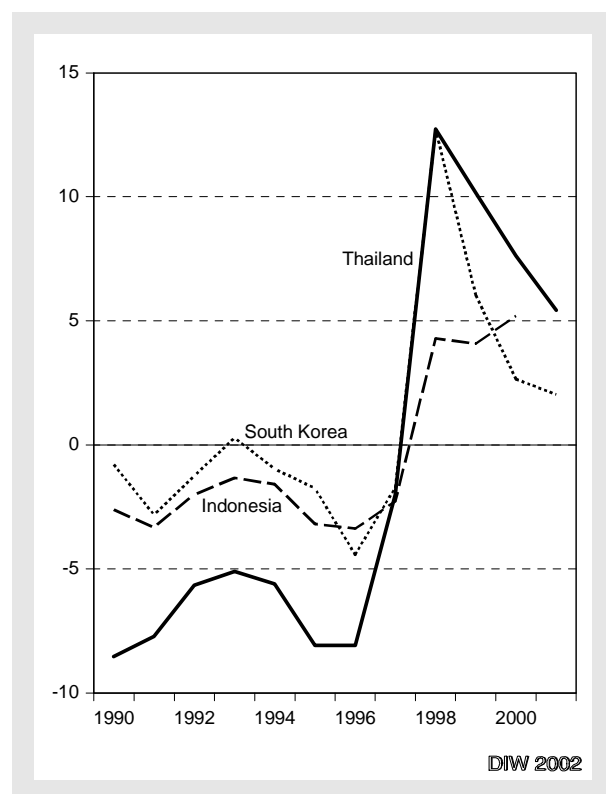
As a result of the crisis the Asian countries affected were often accused of pursuing an unrealistic exchange rate policy.³ In fact, Indonesia, South Korea and Thailand had tied their currencies more or less tightly to the US dollar (cf. figures 4a and 4b), so that their central banks were in practice bearing the costs of securing the

³ 'Finanzkrise in Asien: Realistische Währungspolitik erforderlich', by Gustav A. Horn and Mechthild Schrooten, in: *Wochenbericht des DIW Berlin*, no. 25/98. Following the financial crises of the 1990s the weaknesses of fixed exchange rates for emerging economies were discussed. On the relevant discussions see Sebastian Edwards: 'Exchange Rate Regimes, Capital Flows and Crisis Prevention', 2001, <http://www.anderson.ucla.edu/faculty/sebastian.edwards/papers.htm>.

exchange rate. As nominal interest rates were also relatively high (cf. figure 5) these countries appeared attractive to foreign investors for a long time. The combination of tied exchange rates and high nominal interest rates by international comparison also created considerable incentives for domestic investors to borrow abroad. Hence the level of indebtedness to foreign creditors rose.

After the revised assessment of the 'tiger economies', as they were called, by international lenders there was not only a rapid and drastic outflow of capital and a marked devaluation of the domestic currencies; the fixed exchange rate regimes previously practised were also abandoned.⁴ That this reorientation of macroeconomic policy was more than formal is evident first and foremost in the greater volatility of the domestic currencies against the US dollar. Inevitably the transition to a flexible exchange rate 'privatises' the exchange rate risk

Figure 3
Balances on Current Account 1990 to 2001¹
 In % of GDP

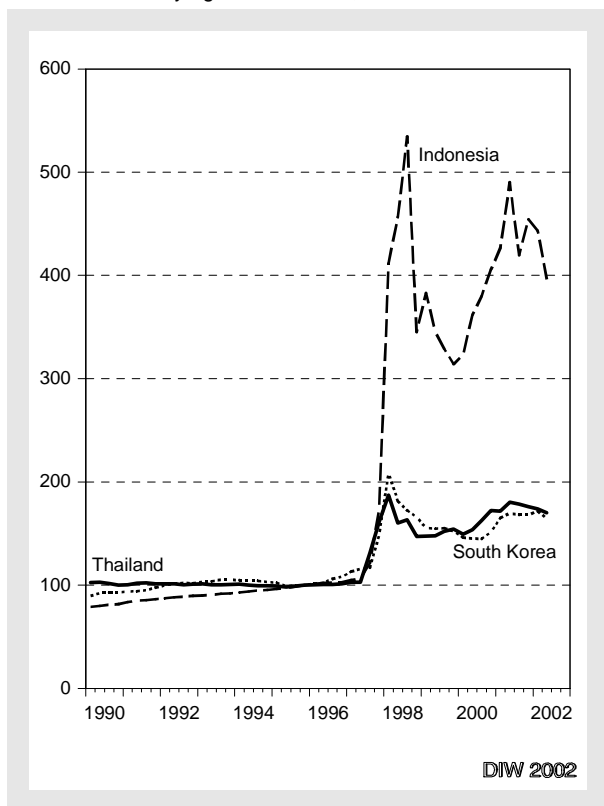


¹ Indonesia to 2000.
 Sources: IMF: International Financial Statistics, August 2002; DIW Berlin calculations.

⁴ Indonesia and Thailand introduced controlled floating on 31 December 2001; de facto since then the volatility of the exchange rate has not noticeably changed in either country.

Figure 4a
Development in Exchange Rates
1990 to 2002¹

Domestic currency against US dollar, 1995 = 100

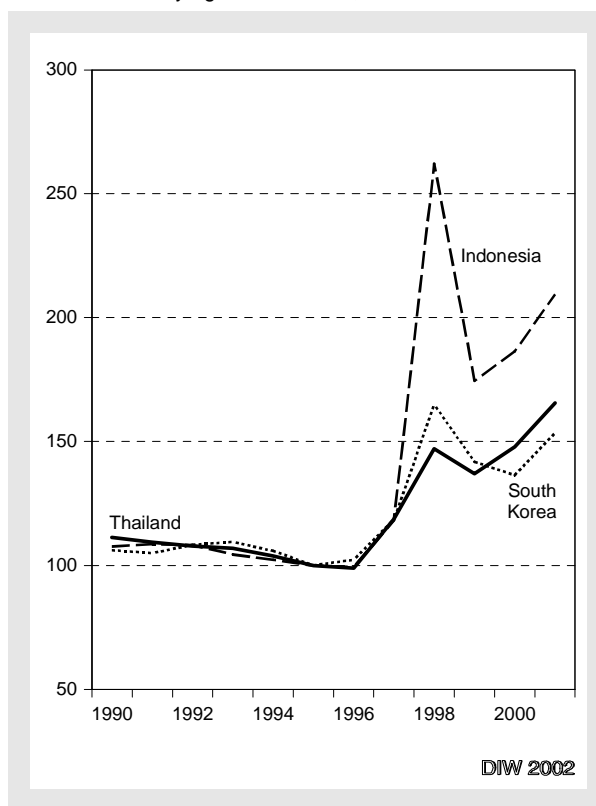


¹ Second quarter of 2002.

Sources: IMF: International Financial Statistics, August 2002; DIW Berlin calculations.

Figure 4b
Development in Real¹ Exchange Rates
1990 to 2002²

Domestic currency against US dollar, 1995 = 100



¹ Calculated on the basis of consumer prices. — ² Second quarter of 2002.

Sources: IMF: International Financial Statistics, August 2002; DIW Berlin calculations.

which is borne by the central bank when exchange rates are fixed.

The exchange rate regime that is de facto chosen is of crucial importance for monetary policy. With a flexible system the exchange rate cannot be used as an 'anchor' to brake or limit inflationary expectations, for the central bank has to take full responsibility for maintaining monetary stability. When inflation accelerated immediately after the crisis, the central banks of the economies considered here embarked on a restrictive monetary policy and strongly increased nominal interest rates. The strategy quickly proved effective in combating inflation (cf. figure 6). Now nominal interest rates have been markedly reduced although real interest rates are still relatively high by international comparison – and this is necessarily hampering investment (cf. figure 7).

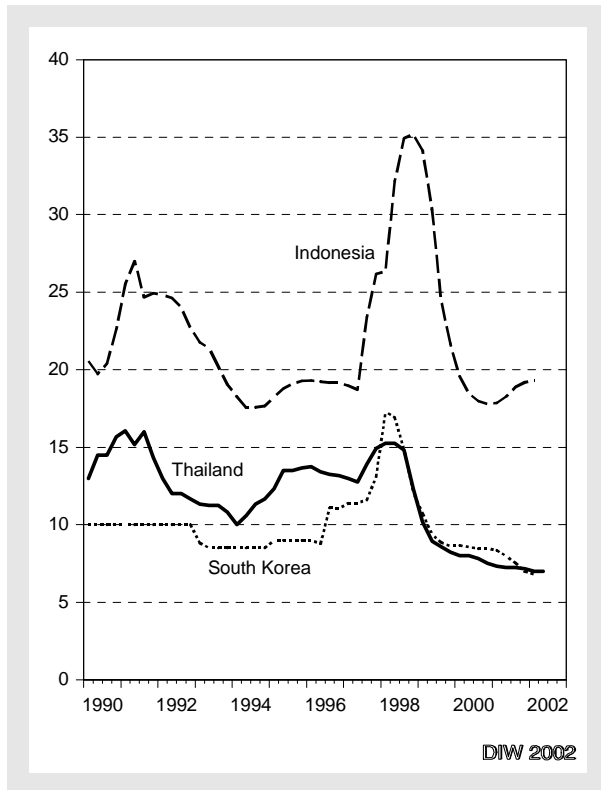
The direction of monetary and exchange rate policy also has important implications for international investors. With a fixed exchange rate system the nominal

interest rate offered abroad is the decisive factor in investment decisions, but with a flexible exchange rate system other risk premiums have to be taken into account. Against that background foreign investors may feel it appropriate to exercise restraint in lending even if there is a considerable differential between the nominal interest rate offered and those in their own country. For the potential borrowers this is like 'rationing' international lending. In fact, the risks are now being borne entirely by investors and borrowers in the financial markets and no longer by the central bank. If only for that reason the inflows of finance to the emerging economies have fallen dramatically in recent years (cf. table 1).

Progress in banking reform

Under these conditions the domestic banking sector in Indonesia, South Korea and Thailand has acquired

Figure 5
Nominal Interest Rates 1990 to 2002¹
In %



1 Average interest rate on loans; Thailand to 2nd quarter of 2002, South Korea and Indonesia to 1st quarter of 2002.
Sources: IMF: International Financial Statistics, August 2002; DIW Berlin calculations.

greater importance in financing investment. But this is where the Asian economies were known to have structural problems in the past. In many cases the commercial banks did not orient their lending to criteria of risk and efficiency, while they themselves refinanced largely in the international financial market. The Asian crisis clearly showed that the interest rate only serves as a meaningful instrument to allocate international lending, particularly in cross-frontier transactions, if the financial sector is subject to internationally binding regulations that will reduce the problems of asymmetrical information and increase transparency.⁵

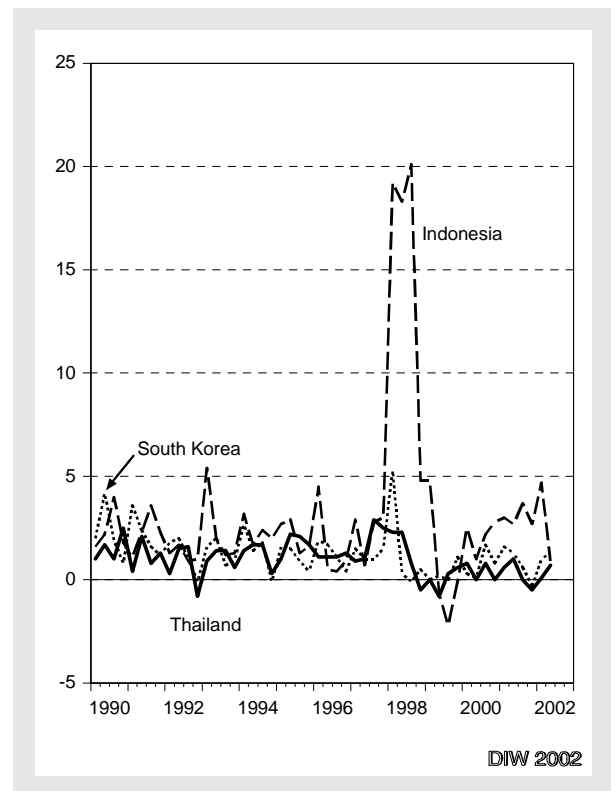
A central point of application in coping with the Asia crisis was therefore to reform the banking sector and its regulation. International pressure to improve national banking supervision and efficiency was also increased. The aim was not only to consolidate and

⁵ Cf. Barry Eichengreen: 'Toward a New International Financial Architecture. A Practical Post-Asia Agenda', Washington D.C., 1999.

update the commercial banking sector in each country, but also to create efficient national control authorities and impose international standards for future lending. The implementation of the regulations in the Basle Accord for a ratio of 8% for commercial banks' risk-weighted equity capital was and still is important here.⁶ All the three economies considered have undertaken to implement these criteria. However, in practice this entails considerable problems, most of which are due to the lack of international standards in corporate accounting. This makes the assessment of the risk of default on lending more difficult, and as a result the orientation of lending to meaningful criteria of efficiency and risk is still hampered.

To deal with the bad loans problem all three countries have set up agencies, although they have different competences.⁷ The differing degrees of determination to

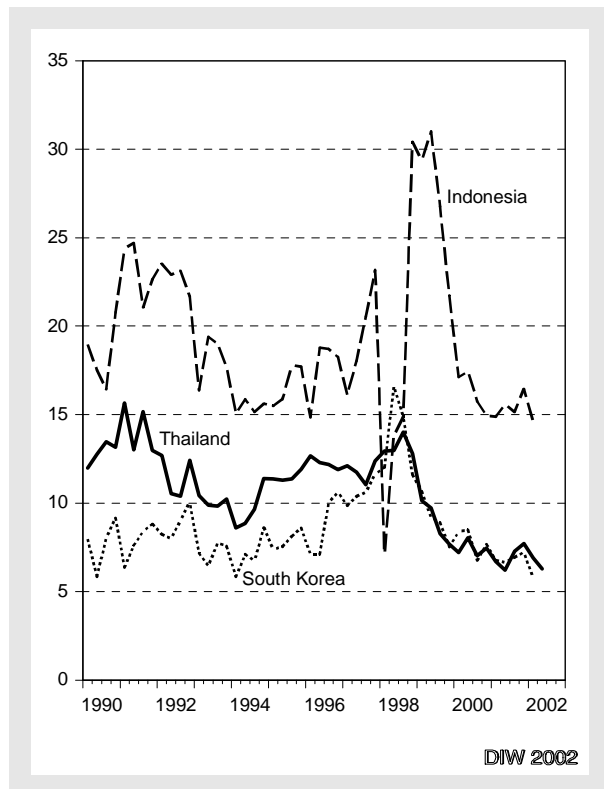
Figure 6
Consumer Price Index 1990 to 2001
Year-on-year change in %



1 Second quarter of 2002.
Sources: IMF: International Financial Statistics, August 2002; DIW Berlin calculations.

⁶ The Basle Committee for Banking Supervision: Basle Accord, Basle 1988. A new weighting of risks that are reflected in the draft Basle Accord II is now under discussion.

Figure 7
Real Interest Rates 1990 to 2002¹
 In %



¹ Thailand to 2nd quarter of 2002, South Korea and Indonesia to 1st quarter of 2002.
 Sources: IMF: International Financial Statistics, August 2002; DIW Berlin calculations.

carry out reforms are still reflected in the share of non-performing loans. In summer 2002 more than 10% of all loans in Indonesia and Thailand were regarded as non-performing, while the share was about 2.5% in South Korea.

The differences in the efficiency of the commercial banks are also evident in lending to the private sector, which is generally regarded as an important determi-

⁷ Different institutional arrangements have been chosen. Indonesia set up the Indonesian Restructuring Agency in January 1999, which was not only to solve the debt problems of banks and companies but also to perform monitoring and supervision functions over the banks most badly affected by the crisis. In South Korea a Financial Supervisory Commission was created in April 1998 to solve the financial crisis; its chairman was a member of the Korean Deposit Insurance Corporation, which in turn is controlled by the Ministry of Finance and Economics. In Thailand the central bank was primarily responsible for coping with the crisis. Cf. David Scott: A Practical Guide to Managing Systemic Financial Crises. A Review of Approaches Taken in Indonesia, the Republic of Korea and Thailand, The World Bank, Washington D.C., 2002.

nant of macroeconomic growth. In Thailand and Indonesia it has not recovered so far (cf. figure 8), although monetary policy is now much more relaxed and interest rates have been lowered. The development in South Korea is different, and lending to the private sector has increased. The dominant factor here is generous lending to private households. Many of these loans are mortgages, which are regarded as relatively well secured.

Another indicator of the efficiency of the commercial banks is the difference between interest rates on lending and deposits. This can be seen as an indicator of the transaction costs in the financial sector. In turn it is evident that this spread is much wider in Indonesia and Thailand than in South Korea (cf. figure 9). All in all, there is much to suggest that there is a mutual relation between the differing tempos of banking reform and the differences in development of the economy as a whole. Favourable economic development in itself reduces the share of non-performing loans and so supports the banking sector. At the same time the reform of the banking sector through a better allocation of loans helps an economic upswing. In South Korea a relatively rapidly advanced reform of the banking sector was combined with a relatively rapid and marked recovery, while Thailand and Indonesia had much greater problems.

Lessons learned?

After the Asia crisis, Indonesia, South Korea and Thailand made their exchange rates more flexible and implemented banking reforms. At the same time, discussion on the international level intensified on the appropriate exchange rate regime for economies that are facing the problem of a backlog in development. The disadvantages of a fixed exchange rate system are often seen as the lack of a successful exit strategy. The collapse of the relatively fixed exchange rate systems in Asian countries caused many other economies elsewhere in the world to make their exchange rates more flexible, at least formally (cf. table 2). De jure they reduced the role of the central bank in largely securing the exchange rate and increased the 'privatisation' of risk.

At the same time steps were taken by international financial organisations to improve transparency in international capital transactions. Meantime the OECD, the Bank for International Settlements and the International Monetary Fund have published joint data on the debt situation of individual emerging economies. In addition, the costs of obtaining information on international financial transactions have been markedly reduced, not least by the Internet. However, greater transparency, better quality information and lower information costs

Table 1
Net Capital Imports by Developing Countries¹

Annual average in US-\$ billion

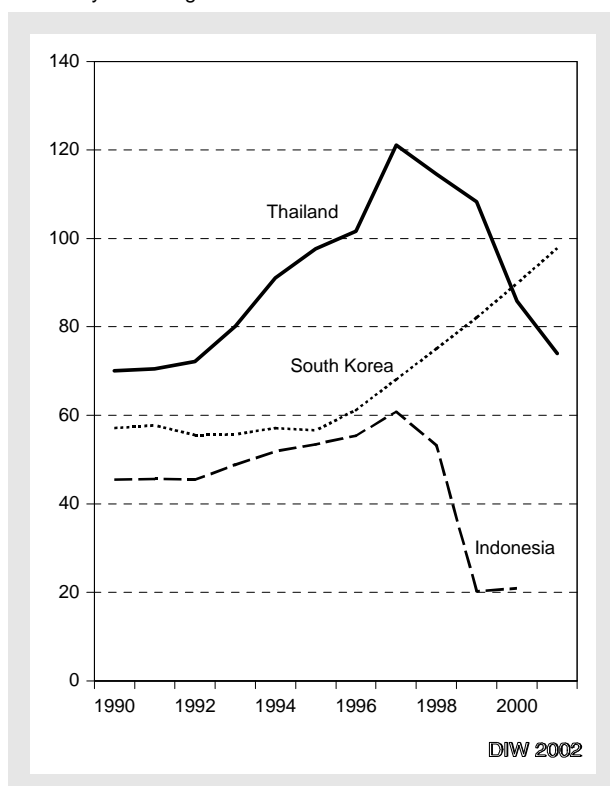
Position	1971 to 1979	1980 to 1989	1990 to 1999	2000 to 2001	Memo item:	
					1990 to 1997	1998 to 2001
Total	25.5	45.3	154.3	41.0	166.8	72.7
Breakdown by recipient region						
Latin America	14.8	17.1	57.7	49.1	54.8	59.1
East Asian crisis countries ²	5.6	8.7	27.4	-12.4	38.1	-13.9
Other Asian countries ³	3.7	11.1	17.9	15.8	21.5	9.6
Europe and former Soviet Union ⁴	.	.	18.2	3.4	16.2	14.8
Africa and the Middle East ⁵	1.4	8.4	33.2	-14.9	36.1	3.3

1 Including emerging economies and transition countries and Israel, South Korea, Singapore and Taiwan. — 2 Indonesia, South Korea, Malaysia, the Philippines and Thailand. — 3 Without the Middle East and the successor states to the former Soviet Union. — 4 Including central, eastern and southern Europe and the successor states to the former Soviet Union. — 5 Including Turkey, Israel and Malta.

Sources: IMF; German Bundesbank, Monthly Report June 2002

Figure 8
**Consumer Price Index
 1990 to 2002¹**

Year-on-year change in %

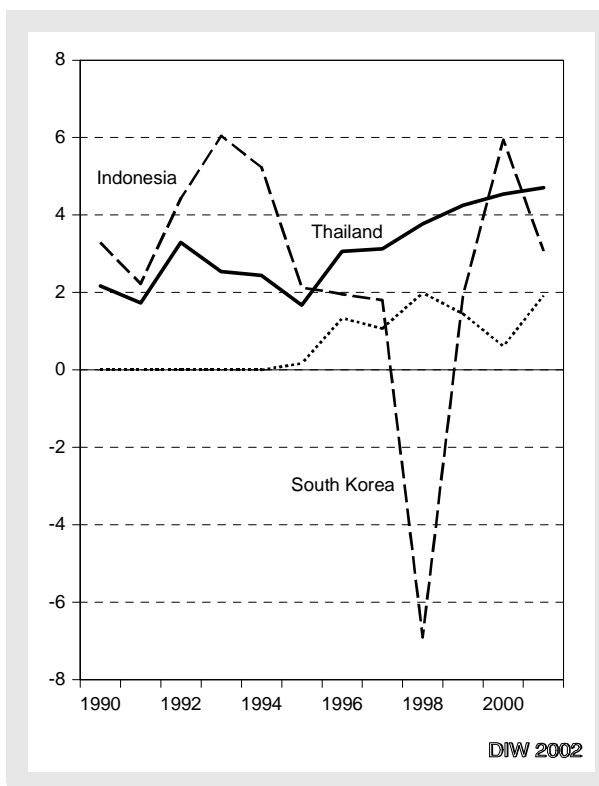


¹ Second quarter of 2002.

Sources: IMF: International Financial Statistics, August 2002; DIW Berlin calculations.

Figure 9
**Interest Rates Spread (Rates on Loans Minus
 Rates on Deposits) 1990 to 2001**

In %



Sources: IMF: International Financial Statistics, August 2002; DIW Berlin calculations.

Table 2

Frequency of Changes in Exchange Rate Systems in Emerging Economies¹

Exchange rate system ²	Number of countries			Structure (%)		
	December 1990	December 1995	May 2002	December 1990	December 1995	May 2002
'Hard' fixed exchange rates	2	5	6	5	12	15
Use of a foreign currency as legal tender	1	1	2	2	2	5
Currency Board	1	4	4	2	10	10
'Soft' fixed exchange rate	26	23	11	63	56	27
Fixed exchange rate, pegged to a key currency	7	7	7	17	17	17
Gradual adjustments of rate ³ against a key currency	4	4	1	10	10	2
Exchange rate pegged to a basket of currencies and other regulations	15	12	3	37	29	7
Flexible exchange rate	13	13	24	32	32	59
Managed floating	7	6	14	17	15	34
Independent floating	6	7	10	15	17	24
All countries	41	41	41	100	100	100

¹ The countries covered are those with access to the international financial markets in the mid-1990s (according to their inclusion in the Emerging Market Bond Index Plus by JP Morgan or the MSCI Index for Emerging Market Economies by Morgan Stanley Capital International). The countries are: Argentina, Brazil, Bulgaria, Chile, China, Colombia, Cyprus, the Czech Republic, Ecuador, Egypt, Estonia, Hong Kong, Hungary, India, Indonesia, Israel, Jordan, Latvia, Lithuania, Malaysia, Malta, Mexico, Morocco, Nigeria, Pakistan, Panama, Peru, the Philippines, Poland, Romania, Russia, Saudi Arabia, Singapore, Slovakia, Slovenia, South Africa, South Korea, Taiwan, Thailand, Turkey and Venezuela. — ² The classification of the individual countries according to the type of exchange system chosen follows the classification by the IMF. — ³ Crawling pegs, crawling bands.

Sources: IMF; German Bundesbank, Monthly Report June 2002.

do not necessarily lead to greater international integration, particularly if the change in the information situation makes the existing risks more evident to both borrowers and lenders.

In fact, as a result of the Asia crisis – and with the improvement in the information situation – international financial flows to the emerging economies have fallen markedly, and the Asian crisis countries are now actually facing a massive outflow of capital. However, Indonesia, South Korea and Thailand have been able to achieve positive macroeconomic growth rates without again registering deficits in their current accounts. This is mainly due to the traditionally high domestic savings ratio in the Asian economies. In this they differ markedly from other developing countries and emerging

economies, many of which can hardly rely on a permanently high domestic savings ratio to finance investment. As a result they are much more dependent than the Asian tiger economies on borrowing in the international financial market.

Particularly in view of the fact that financial crises – like the one in Latin America now – are increasingly crises in the domestic banking sector, it is not surprising when international lenders make their willingness to fund dependent on the efficiency of commercial banks in the economy concerned. In this field clear efforts still need to be made by the emerging economies if they are to appear as attractive locations for international capital investors in a world of lower information costs. If they do not succeed in this, considerable parts of the potential

gains in efficiency that can in principle be generated by international financial flows and integration in the financial market will not be realisable – and that would be a considerable disadvantage for the development of the world economy.

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