Global Financial Systems
Chapter 6
Asian Crisis of 1997 and the IMF

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To accompany
Global Financial Systems: Stability and Risk
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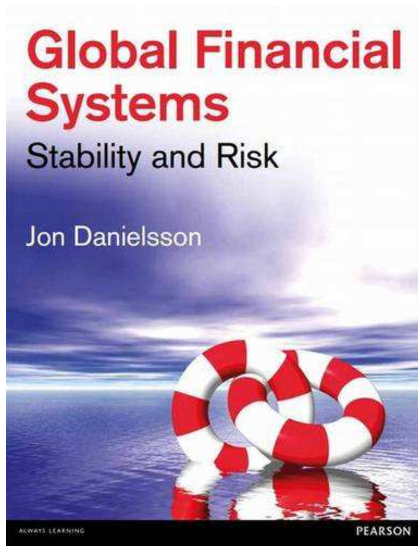
Book and slides



- The tables and graphs are the same as in the book
- See the book for references to original data sources
- Updated versions of the slides can be downloaded from the book web page

  www.globalfinancialsystems.org

Asian Miracle

Leading to a crisis

Countries

- Unaffected
  - China, India, Japan
- Avoided serious crisis
  - Hong Kong, Singapore,Taiwan
- Serious crisis without requesting outside assistance
  - Malaysia
- Serious crisis and IMF help
  - Indonesia, Korea, Thailand

Our main focus is on the last three

Washington consensus

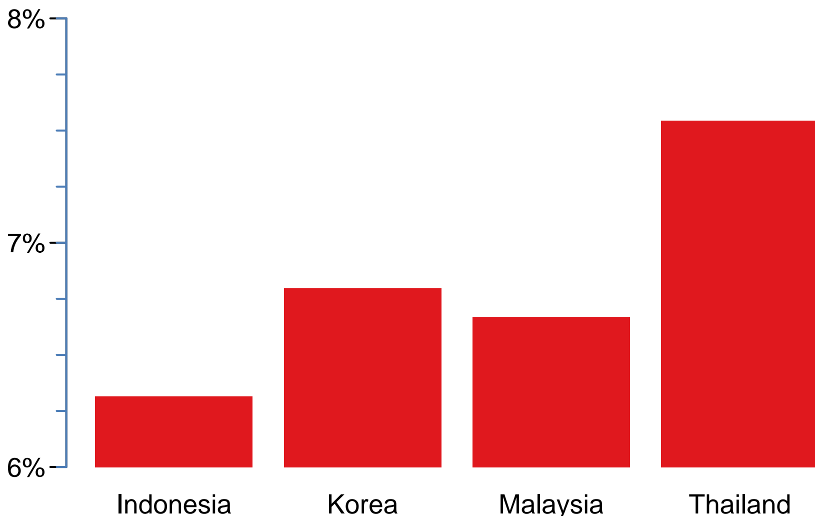
1. Fiscal discipline (eliminate deficits);
2. Broaden tax base, low taxes;
3. Market interest rates;
4. Raise spending on health and education;
5. Secure property rights;
6. Privatization;
7. Deregulation;
8. Free trade;
9. Competitive/sensible exchange rates;
10. Free capital flows (remove barriers to foreign direct investment).

The Asian miracle

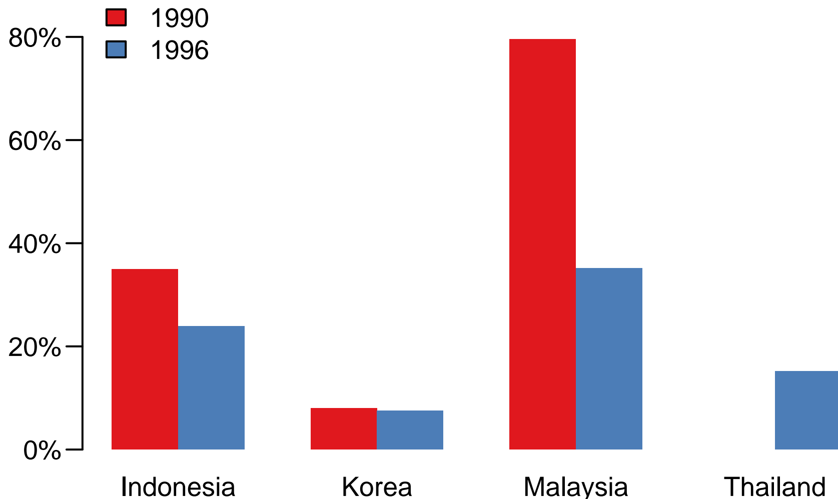
- In the early 90s, investors began looking to Asia for *higher returns*
- East Asian countries had just started to open their *capital accounts* and to *liberalize* their financial systems
- *Net capital inflows* into East Asia surged from $42 billion in 1990 to $329 billion in 1996
- Spectacular *growth rates* averaging up to 8% of GDP per year
- A *stock market boom* attracted even more capital inflows

Virtuous cycle leading to a bubble

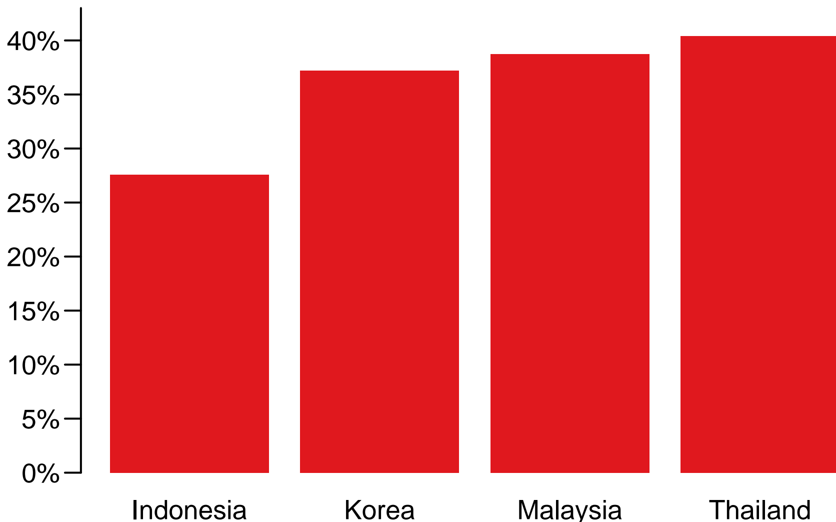
Average GDP growth 1990–1996



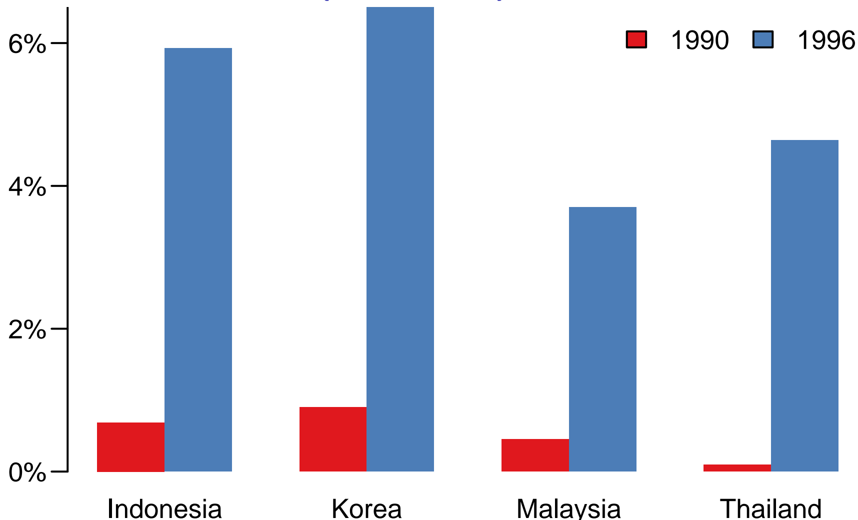
Debt to GDP



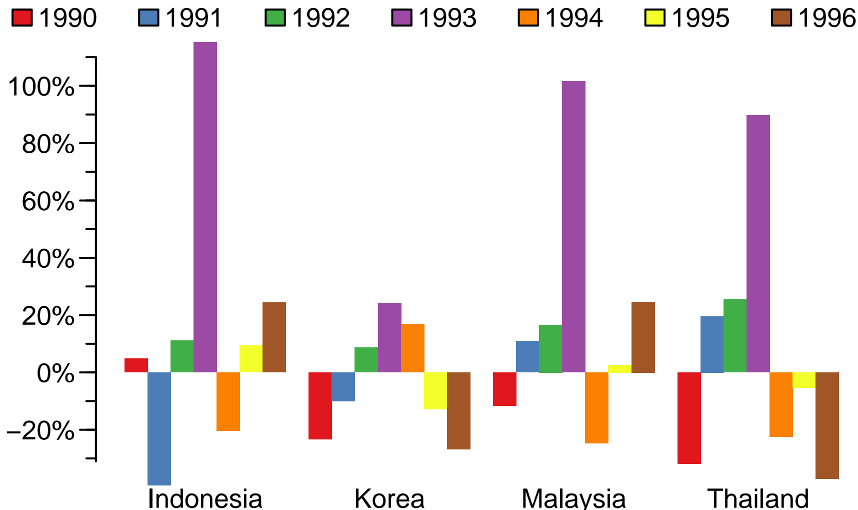
Investment rates (to GDP)



Financing via international capital markets (to GDP)



Annual stock market performance

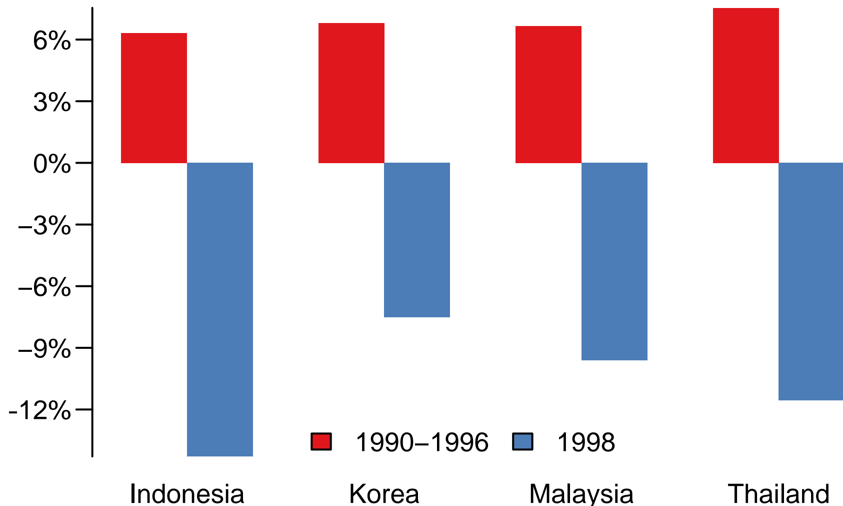


Crash and the Impact on the Main Countries

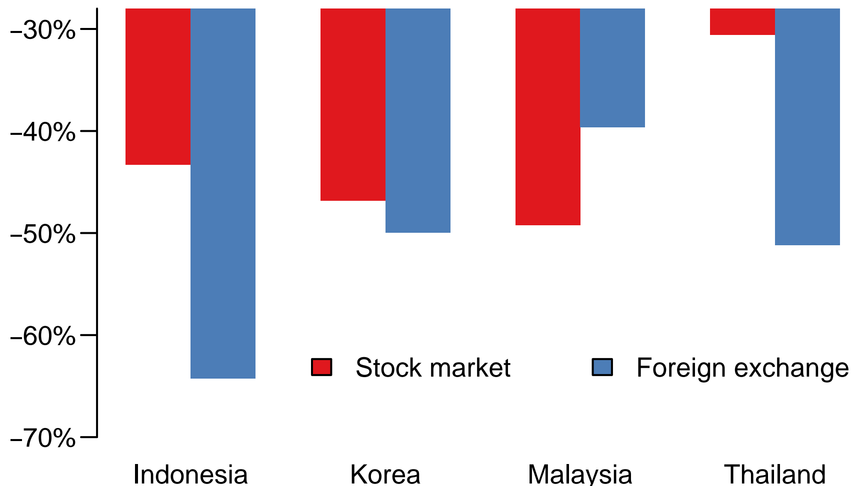
The crash

- Market sentiment started to turn in 1997 as the Thai stock market *plunged* and the baht came under attack
- Thailand *devalued* its currency triggering *attacks* on the currency of almost every other East Asian country
- South Korea, Indonesia, Malaysia and Taiwan subsequently *devalued*
- Thailand, Indonesia and South Korea faced massive *insolvencies* of financial institutions, their financial systems were on the brink of *collapse*
- They called in the IMF which pushed through an *austerity program* with raising interest rates and budget cuts
- Malaysia did not request IMF help

GDP growth



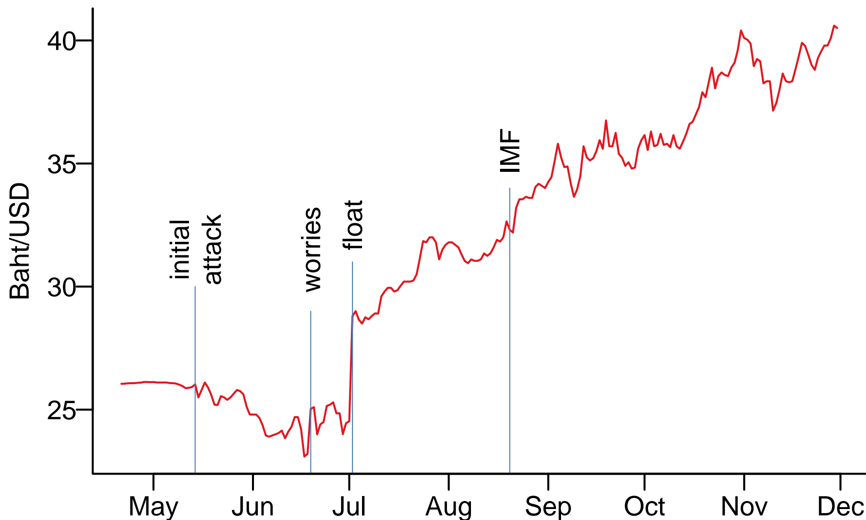
Drop in stock markets and exchange rates in the second part of 1997



Thailand

- It had a budget surplus but trade deficit due to strong dollar
- Finance companies had *short–term* foreign currency debts, lent to consumers and businesses on easy terms
- Increases in non–performing loans lead the Central Bank to secretly lend $20 billion to prop up insolvent institution
- Baht lost more than half its value

Thai baht in 1997



IMF in Thailand

- August 20, 1997, package $17.2 billion
- Markets not impressed, nor by disclosure of $23.4 billion in forward commitments by the Bank of Thailand
- IMF recommended the closure of weaker financial institutions
- Problems in distinguishing between liquidity problems and solvency problems
- Demands fiscal and monetary tightening
- The fiscal tightening was ineffective and economic activity slowed down

Indonesia

- Economic reform agenda early 1980s, restraining government spending, opening the economy and easing regulation
- Rapid growth, a current account surplus, FX reserves growing
- Corporations were increasingly using short–term dollar–denominated debt
- *Virtuous feedback* loop between currency inflows, reduced cost of debt service and currency appreciation
- "KKN", corruption, collusion and nepotism
- By the mid 1990s non–performing loans exceeded 25% of total loans made
- Rupiah under pressure after the Baht floated. Devastating effect on corporations with unhedged dollar liabilities

IMF in Indonesia

- October 1998. IMF General Manager, Michel Camdessus

> "The IMF strongly supports the approach that has been followed by Indonesia, which sees this as an occasion to strengthen its economic policies even if fundamentals are basically sound."

- Package of $40 billion
- Conditions, such as the demand that the worst 16 bank be closed immediately, with limited protection to depositors
- Particular 16 banks chosen arbitrarily
- Result was a run on the banking system and the country
- Within a few weeks the son of the president reopened his bank under a different name
- Indonesia unable to maintain the required monetary tightening and high interest rates

South Korea

- One of the poorest countries in the world in the 1950s
- Series of military regimes dictated lending decisions
- "Chaebol" financed with extremely high levels of debt, exceeding 400% of shareholder equity in some cases — too big to fail, money not always well used
- Second most industrialized economy in Asia
- The currency depreciated in the beginning of the 1997
- Difficulties for the corporate sector
- Little fear about the solvency of the Korean state
- Central bank running out of reserves,
- Foreign investors stopped rolling over loans
- A self–fulfilling crisis was created with a *vicious feedback* between solvency problems, the currency falling and currency reserves depleting

IMF and Korea

- $57 billion package
- Conditions, including its standard fiscal and monetary policies, along with trade and capital account liberalization, labor market and financial sector reforms
- Package was not effective, currency continued falling
- IMF had lost credibility as neither the Thai nor the Indonesian packages effective, and Korean package was insufficient
- IMF accelerated the payout of funds and along with the G7 applied what was known as "*jawboning*", strongly leaning on the creditor banks to roll over Korean exposures
- This succeeded in halting the currency decline and prevented more corporate defaults

Reasons for the Crisis

Phases of explanations

- Moral hazard — corruption
- Market panic and contagion
- FX crisis
- Liquidity crisis
- Or back to fundamentals

The current account position and the nature of capital inflows

- Throughout the 1990s, the East Asian countries had a consistently *negative* current account position
- Which was financed by capital inflows that were mainly *short–term* and denominated in *foreign currency*
- Capital inflows fueled a domestic *lending boom*
- Domestic financial institutions had an *incentive* to actively seek foreign funds to finance massive lending operations
- Short–term nature of capital inflows made countries vulnerable to *roll–over* and *liquidity risk*

Poor regulation, bank lending and moral hazard

- Rapid financial liberalization was not followed by a *coherent* regulatory and supervisory framework
- On the contrary, governments usually supported *reckless domestic lending*
- Governments implicitly *guaranteed* investments, giving *subsidies* and heavily *favoring* specific firms or industries
- This created a whole set of wrong incentives for financial institutions and *moral hazard* problems

Panic and contagion?

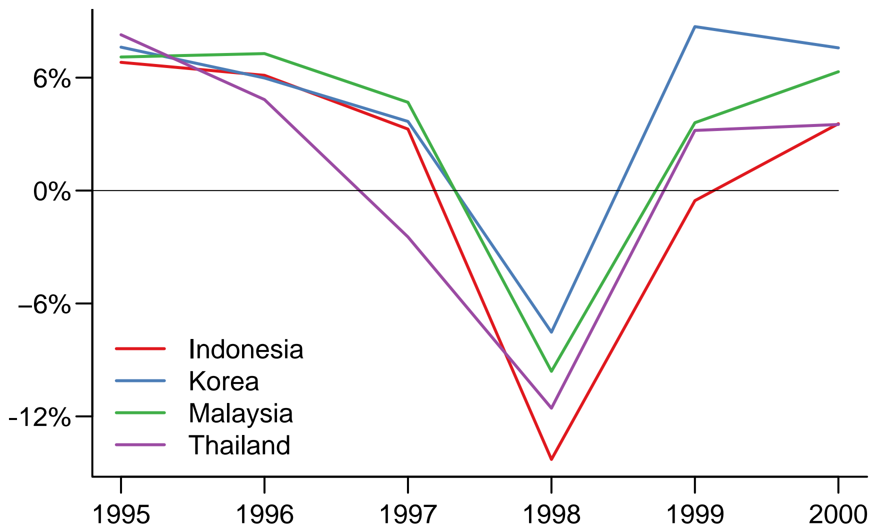
- Initial Thai baht devaluation caused a market panic that spread to other countries in the region
- Asian economies quite interrelated
- Focus of many statistical studies
- Problem is that any such analysis is conditional on an actual crisis happening and simply provides a statistical description of how a crisis moves from one country to the next
- Hard to interpret such results. A panic does not happen by itself, there must be an underlying reason.
- Statistical descriptions help in mapping but not much in understanding

Performance before and after the crisis (to 2007)

Benefit of hindsight

- If fundamental weaknesses, it would have taken many years to recover
- Even if the strong reform programs demanded by the IMF at the height of the crisis had been successfully implemented, they would also have needed a few years to take effect
- But it was *V shaped*

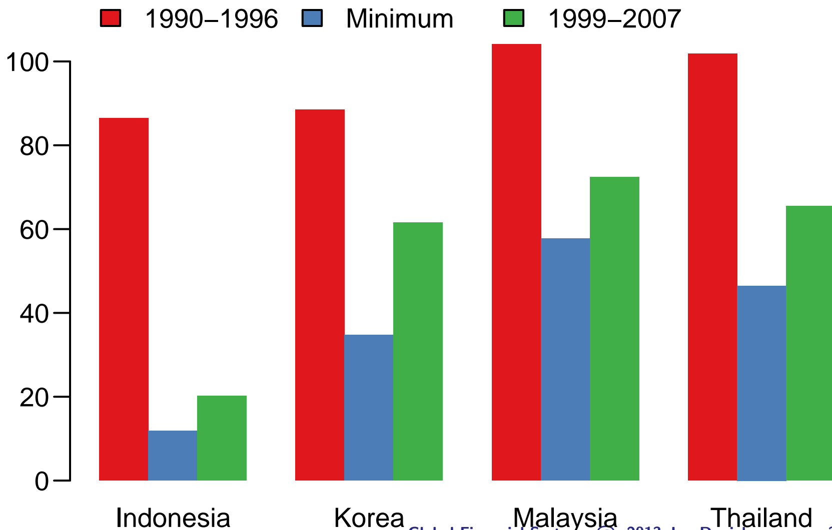
GDP per capita growth



Average GDP per capita growth

Annual average	Indonesia	Korea	Malaysia	Thailand
1990–1996	6.3%	6.8%	6.7%	7.5
1998	-14.3%	-7.5%	-9.6%	-11.6
1999–2007	3.8%	4.7%	3.4%	4.0

Average and minimum exchange rates. USD/local currency, 1990=100



Relative GDP per capita ranking

Year	Indonesia	Korea	Malaysia	Thailand
1960	88%	36%	48%	71%
1990	74%	26%	44%	58%
1996	66%	23%	37%	47%
1999	70%	23%	39%	51%
2007	72%	20%	39%	49%

The closer a country gets to the top the harder it is to progress. Therefore, Korea's performance is the most impressive. Indonesia initially moves up because of the newly independent African countries. Since then it's in the same place. Thailand has fallen from 96 and Malaysia is essentially in same place

Liquidity crisis — Sudden stop

- A liquidity crisis not fundamental weaknesses, moral hazard or market panic
- Immediate cause of the crisis was a sudden stop, and reversal of capital flows
- Strongest for Korea
- In other three more muddled — Also underlying fundamental weaknesses
- But a sudden stop does not happen out of the blue, it's a consequence of fundamental problems

Policy Options

International LOLR

- If a liquidity crisis
- Optimal real time response is *massive liquidity injections*
- The IMF packages were *too small and too late*
- An international lender of last resort (*ILOLR*) called for
- IMF is not a suitable provider of ILOLR
- But the IMF does represent member governments and does have considerable power for persuasion beyond simply providing funds, like encouraging lenders to roll over short term loans and lengthening maturities

Fighting a crisis

From the point of view of a country under attack
Attackers go short local currency, long USD

- First response: Say the country will never devalue. The speculators will not believe that
- Next, raise interest rates, pushing up the cost of attack
  - Attackers may give up
  - Works if high rates don't damage economy
  - If speculators perceive that the government is not prepared to take the pain for as long as they are, they will wait the government out
  - Sweden did this successfully in the 1990s, UK unsuccessfully
  - The IMF made the Asian countries do this but it did not work

If that does not work, the country is in deep trouble

- Can buy time by closing off speculators' access to currency, but eventually the speculators will do a deal with a local entity
- Only way to plug all the holes would be to implement such draconian measures that all foreign trade grinds to a halt
- Call the IMF?

Soft benefits of calling IMF

- Humiliating set of anti–corruption and austerity measures ratchet up credibility
- Popular with lenders, and reduces local currency borrowing rates by reducing credit risk and inflation expectations
- If successful is less damaging to the economy than the rise in rates
- Relies critically on the steps being credible
- Even if the government is entirely behind the process, plenty of potential for disputes ranging from mass riots to votes of no confidence
- If these suggest that the government *cannot take the pain* then the overall effect will be *negative*

Hard benefits of calling the IMF

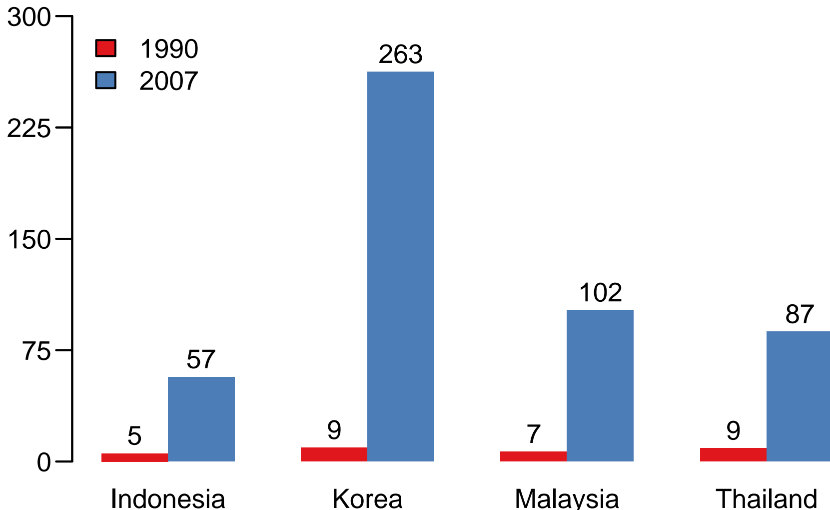
- The country takes delivery of a large loan in dollars that has to be repaid in dollars, with interest
- This signals strong commitment because if the country devalues, it loses money on the deal
- This is still problematic because if the excess foreign borrowings were part of the problem to begin with, that problem just became worse, and might offset all other benefits

Response of the Asian countries

- A sovereign state can only depend on itself if facing a liquidity crisis
- Prudent to take steps to prevent such a crisis from happening in the first place

1. Either avoid having currency and maturity mismatches
2. Build up reserves
3. Minimize carry trading

Foreign reserves in 1990 and 2007 in billions of 2007 USD



IMF

IMF got pilloried

- It had been a cheerleader for the build–up of imbalances
- It misjudged the nature of the crisis throughout
- In the beginning it praised the fundamentals, but emphasized problems with moral hazard, corruption and weak regulation as well as monetary and fiscal discipline
- Best not to pursue that in the midst of a liquidity crisis
- IMF suffering from the successful generals problem, in this case the Latin America crisis of the previous two decades
- It focused too much on macroeconomic fundamental problems at the expense of the fundamental problems in the financial markets

Heavy handedness

However

- Many of the reform programs were needed
- Politicians protected narrow interests in name of attacking IMF
- The only time the IMF has leverage is when it is lending money
- Some countries — Korea — have successfully reformed
- Others would have benefited from reforms
- IMF cannot work as a ILOLR

In sum: The record is mixed. Not nearly as bad as often claimed, but far from spotless
Most of the crisis countries have not exactly been good stewards of their own economies

Wider Lessons

Wider lessons

- The Asian crisis was classical
- The build–up of imbalances that were visible to all, but everybody was somehow blind to them
- Most damaging decisions were not those made before but during the crisis
- The countries' governments have not taken on board the necessary lessons, except Korea
- Entranced domestic interests will resist any reform
- If imposed from the outside, politicians can use nationalism as a tool to protect narrow interests

Learning from crises

- Some countries learn from crises
  - Turkey 2001
  - Korea
- Others do not
  - Argentina 2002
  - Malaysia, Indonesia, Thailand

Links to phase I of current global crisis (2007–2009)

- Moral hazard brushed aside
- No mention of structural reforms at the height of crisis
- Almost infinite amounts of liquidity provided
- Interest rates historically low
- Financial system preserved
- Demonstrates the difference in fighting a crisis at home or in other countries

Links to sovereign debt crisis

- Imbalances similar
  - Especially private sector borrowing in Spain and Ireland
- Consequence of imbalances similar
- Only in "other countries" like Greece, Portugal or Italy are structural reforms demanded
- Asian crisis mistakes are being repeated — need to consider the political consequences