# ASIAN CRISIS:
# DISTILLING CRITICAL LESSONS

***Dilip K. Das***

No. 152

December 2000

The author would like to thank two anonymous referees for their useful comments.

UNCTAD/OSG/DP/152

Comments on this paper are invited and may be addressed to the author, c/o Editorial Assistant*, Macroeconomic and Development Policies, GDS, United Nations Conference on Trade and Development (UNCTAD), Palais des Nations, CH-1211 Geneva 10, Switzerland. Copies of *Discussion Papers* and *Reprint Series* may also be obtained from this address. New *Discussion Papers* are available on the website at: http://www.unctad.org/en/pub/pubframe.htm

---

* Tel. 022–907.5733; Fax 907.0274; E.mail: nicole.winch@unctad.org

***JEL*** classification: D810, E500, E590, F310 and G340.

**CONTENTS**

# ASIAN CRISIS: DISTILLING CRITICAL LESSONS

***Dilip K. Das*** *

*Economic Analysis and Research Division*
*Asian Development Bank, Manila*

*The virulent crisis that struck five Asian economies in mid-1997 and 1998 raised concern about the stability of the global financial system. The financial crisis and market turbulence caused a steep fall in output, and thus had high economic and social costs. The crisis-stricken economies made concerted endeavours to restructure, and by early 2000 we could justly say that these economies were on the recovery path. This development is well captured in the quarterly GDP movements of the five crisis-affected economies: Indonesia, Malaysia, the Philippines, the Republic of Korea and Thailand. One of the silver linings of adversity is that it teaches valuable lessons. In this Discussion Paper we take stock of the policy lessons of the Asian crisis. These lessons could help policy makers, inter alia, to cope with the increasingly integrated capital markets and heightened capital movements. Indeed, the lessons enumerated in this paper will not prevent future crises from occurring, but may reduce their probability and limit their effects when they do. The lessons that the Asian crisis has provided cover several policy areas including macroeconomics, microeconomics, banking and finance, prudential regulations, and global financial architecture. An attempt has been made to cover a wide canvas and focus on several, certainly not all, important areas.*

> "Panics do not destroy capital; they merely reveal the extent to which it has been previously destroyed by its betrayal into hopelessly unproductive works."
>
> John Stuart Mill (1867)

> "I do not dare state that they are simple; there isn't anywhere on earth a single page or simple word that is, since each thing implies the universe, whose most obvious trait is complexity."
>
> Jorge Luis Borges

> "But now, ah now, to learn from crises."
>
> Walt Whitman, in *Long, Too Long America*

---

* Dr. Dilip K. Das was educated at the Graduate Institute of International Studies, University of Geneva, Switzerland. He is presently with the Economic Analysis and Research Division of the Asian Development Bank, Manila. A former professor, Dr. Das's past affiliations include: the Australian National University; Graduate School of Business, University of Sydney; ESSEC, Paris; INSEAD, Fontainebleau, France; and Webster College, Geneva. Dr. Das has worked for the USAID and the World Bank as a consultant. He has contributed this article in his personal capacity. The views expressed in this paper do not reflect those of the Asian Development Bank or its Executive Directors.

# I. INTRODUCTION

Crises are inevitable. They appear to be an intrinsic feature of market-oriented credit and financial systems. As long as there are financial markets, there will be boom and bust cycles. The last two decades of the twentieth century saw several financial crises in different parts of the globe. These crises became increasingly virulent, caused widespread disruption to other emerging market economies, and even had repercussions on industrial economies. In some instances these crises were totally unexpected and affected countries which had enjoyed a strong economic performance up to that point in time. This was so much so that the economies which were part of the so-called Asian “miracle” and were able to eradicate a good deal of poverty in a short span of time went abruptly into severe contraction modes. The crises that struck these miracle Asian economies during mid-1997 and the contagion they set in motion have raised worries about the stability of the global financial system.

One of the silver linings of adversity is that it teaches valuable lessons. Learning these will not eliminate information asymmetries or financial crises. Yet, it is good to learn them well because, first, these crises have an increasingly high fiscal cost and the lessons minimize the vulnerability to crises; and, second, policy makers need to realize that, notwithstanding the macroeconomic instability associated with financial liberalization and short-term flows, financial globalization is here to stay. Financial globalization entails economic and financial management based on openness to, and increasing integration with, the global economy. None of the crisis-stricken Asian economies adopted policy measures delinking them from the global economy. Malaysia did adopt capital controls, but they were short-tem defensive measures, and were relaxed according to a pre-announced schedule. For the Asian economies, coping with financial globalization will necessarily be a part of the policy framework for the future.

In what follows, we enumerate the major lessons of the Asian crisis for policy makers. An attempt has been made to cover several important, certainly not all, crisis-related areas. This paper essentially deals with the five crisis-stricken Asian economies, namely Indonesia, Malaysia, the Philippines, the Republic of Korea and Thailand. Therefore, in terms of structure the paper has multiple foci and is comprehensive. Section II dwells on the 1990–1996 boom in financial flows to Asian economies, while section III focuses on the short-term financial flows which were decried by many as one of “the principal causal factors” behind the Asian crisis. Section IV explores the causes behind vulnerability to crisis, and section V deals with the prickly issue of capital account liberalization. Section VI focuses on the idiosyncrasies of the banking and financial sector that lead to a crisis situation, and in section VII we try to see what are the principal policy measures needed to improve the performance of this sector. The Asian crisis spawned a large number of corporate, banking and financial sector insolvencies. Sector VIII attempts to suggest policy measures to contain them. Poor credit-rating and risk-assessment services and inadequate commitment to proper project appraisal created the so-called “crony capitalism” in Asian economies. Section IX attempts to chalk a way out of it. The inflexibility of the exchange rate regime was another thorny issue for the Asian economies, which is discussed in section X. A great deal of debate has been generated on the role of the International Monetary

Fund (IMF) in the crisis economies. There are strong views supporting, as well as opposing, IMF remedies. Sections XI presents a balanced view on the role of IMF. The need for an international lender of last resort generated a similar debate, which is focused on in section XII. Section XIII is devoted to a summary of the policy lessons. The social issues associated with the crisis are the subject of another parallel paper, so they are not dealt with in this paper.

## II. CAPITAL INFLOWS

The 1990–1996 period is known as a boom period for capital market financial flows to the emerging market economies. All the economic and financial crises of the 1990s were preceded by large capital inflows into those economies. A confluence of liberalization advances in information technology and networking leading to reduced transaction costs and greater capital market integration caused this boom;
together these factors spawned financial globalization. Many emerging market economies were transformed from near financial autarkies to globally integrated ones. In addition, institutional investors in the industrial economies, in an attempt to diversify their portfolios and increase the rate of return grew, became increasingly inclined to invest in the emerging market economies. These developments in the global capital markets substantially improved access of the emerging market Asian economies to the pool of global savings. However, the flip side of the coin is that a spurt in capital inflows during the 1990s has been identified by some as one of the causal factors behind the recent woes of the Asian economies (IMF, 1998). In the five crisis-stricken Asian economies – Indonesia, Malaysia, the Philippines, the Republic of Korea and Thailand – the rise in capital inflows resulted in historically large external deficits, which reflected the excess of investment spending over domestic savings. These deficits were $41 billion in 1995 and $55 billion in 1996. As a proportion of the GDP of the five crisis-affected economies, the levels of deficits were respectively 4.0 per cent for 1995 and 4.9 per cent for 1996, which is high by international standards. As foreign investors reassessed their financial exposure to Asia in 1997, they began to withdraw, and the current account deficits of the same set of five economies fell to $27 billion (or 2.6 per cent of GDP) in 1997. Financial flows recorded a reversal in 1998 and the deficit turned into a surplus (IIF, 1998). Microeconomic distortions inter alia exacerbated the pernicious impact of capital outflows in these five economies.

If carefully sequenced policies are adopted, some of the risk associated with large capital inflows can be mitigated. Sterilization of capital flows, at least in the early stage, is one such policy. Little wonder that this is the most frequently adopted policy by central bankers in the capital-importing economies. But in spite of the popularity of sterilization, central bankers cannot resort to it for long periods because of its fiscal cost. Policy makers will soon need to turn to the nominal exchange rate for a defensive strategy. However, if the exchange rate regime they adopt is the de facto pegged exchange rate regime, they cannot use the nominal exchange rate as a defensive instrument. In fact, this is what happened in the five crisis-affected Asian economies.

Corporate borrowers need to realize that large inflows can have a potentially destabilizing impact on the financial system. Policies need to be designed in such a manner that excessive reliance on external debt is avoided. Cautious management of capital inflows is a critical lesson of the Asian crisis. Having large foreign debts makes an economy vulnerable, especially when the currency is convertible and therefore subject to speculation. It was the rapid build-up of external debt that, more than anything else, led to the development of crises in Indonesia, the Republic of Korea and Thailand, and, to a smaller extent, in Malaysia. Emerging market economies should not allow a large build-up of external debts, no matter how successful they are at exporting. Successful exporting economies sometime grow complacent about rapidly rising levels of external capital inflows because policy makers are lulled into thinking that high export levels can cover them. A bitter lesson from the crisis is that high current export earnings alone are insufficient to ensure that debts, particularly short-term ones (see section III), can be serviced. Export growth rate can precipitously decelerate – the growth rate of merchandise exports in Asia decelerated from 18 per cent in 1995 to 3.5 per cent in 1996 (WTO, 1998). There can also be periods of high import growth and a large outflow of funds due to repatriation of foreign-owned profits, or withdrawal of short-term investments.

The ultimate objective of capital inflows is to ensure that the borrowing economy improves its economic fundamentals, while the debt level remains sustainable. Debt sustainability is conventionally determined in the context of the balance of payments and the budget deficit, and more precisely in terms of the current-account deficit and fiscal deficit. The lesson from the recent crises is that policy makers need to shift from these traditional approaches to a “holistic” one. That is, all the various categories of debt, external and domestic, public and private, long-term and short-term, should be taken into account to assess the size of the debt overhang and sustainability. When economies have an open-capital account, the dividing line between domestic and external debt becomes nebulous. Policy makers should try to ensure that there is never a question mark over the timely repayment ability of the government or private-sector borrowers. Some industrial economies (like Australia, Ireland and Sweden) are already managing their debt within this holistic framework.

The lesson that due caution should be exercised while importing capital has not been lost on policy makers and corporate borrowers. There is a growing realization that overinvestment in the past boom years created financial distortions, eroded capital efficiency and made economies vulnerable to shocks. Fewer external bonds will therefore be issued in Asia, especially by corporations. Unlike in the past, regional governments are less likely to borrow, at least in the near future, from the international capital markets. The current-account balances are soon unlikely to slip back into deficits. All over Asia, particularly in the Republic of Korea and in Thailand, governments have already started issuing bonds in their local markets. Although liquidity has continued to be a problem and many institutional features of a well-functioning market – such as market-driven issuance practices, efficient settlement systems, repo and futures markets – are either weak or missing (Eschweiler, 1999).

## III. SHORT-TERM CAPITAL FLOWS

Apart from the macroeconomic instability in the post-1997 period referred to in sections I and II above, there is convincing historical evidence that short-term capital movements contribute to volatility in financial markets, which in turn leads to macroeconomic instability. The new orthodoxy about having a financially open system has crumbled under the weight of the extremely high costs paid by the crisis- stricken Asian economies. This observation is in keeping with the celebrated Brecher-Alejandro (1987) thesis that free capital flows, in the presence of trade distortions, can be immiserizing, or would have less than apparent value. Recently Professor Bhagwati, a noted free trade advocate, has also argued strongly against free capital movements.[1] There may be occasions when short-term capital movements need to be controlled, without being in fundamental disagreement with financial globalization. Such control can be successfully exercised at the source or the entry point. Monetary authorities should keep tabs on and control short-term borrowings denominated in foreign currencies by firms. Corporate managers, who are responsible for the bulk of short-term borrowings, should recognize and assess appropriately the risk of short-term borrowings. It should be factored into their financial calculations.

A flexible exchange rate also discourages excessive short-term capital inflows by allowing the exchange rate to adjust itself with the inflows and outflows of capital. Short-term investors and borrowers have to factor the exchange rate risk into their calculations before investing or borrowing. Conversely, an exchange rate peg lends inflexibility to an exchange rate regime, providing short-term lenders and borrowers with a guarantee against adverse exchange rate movements. The Asian crisis has demonstrated that lenders and borrowers both perceive an exchange rate peg as a link in the chain of implicit guarantees. Under these circumstances, the high nominal interest rates characteristic of emerging markets can, and did, lead to large short-term capital inflows. This was observed during the 1992–1993 European currency crisis as well as during the Asian crisis (Goldstein and Folkerts-Landau, 1993; Adams et al., 1998; Das, 2000). If the nominal exchange rate is not pegged, the risk associated with the flexible exchange rate can play a useful, albeit limited, role in moderating the volume of short-term capital inflows. When the exchange rate is not pegged, firms hedge their short-term flows to protect themselves from unexpected and large movements in the