Lessons from East Asia

C Rangarajan

A year has passed since the onset of the Asian financial crisis. We are not sure that we have seen the final act of the drama. The East Asian experience shows that if there is an open capital account, the recipient country must have a stricter system of monitoring the inflows. A supervisory control over the financial system must also be very stringent. A loose domestic financial system and large capital inflows are the worst combination. It invites danger. According to Rangarajan/ the lesson to draw from the East Asian crisis is that the capital account liberalization and reform of the financial system should move in tandem.

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East Asia covers a large number of countries which differ in population size and in terms of aggregate output. This group of nations comprises of China, Japan, and South Korea at the north and then extends to the Philippines, Taiwan/Malaysia, Thailand, Hong Kong, Indonesia, and Singapore. It can be readily seen that these countries do not constitute a homogenous group. Nevertheless, the marked characteristic of these countries in the recent years has been the very rapid growth they have achieved. The crisis has so far affected five countries — South Korea, Malaysia, Thailand, the Philippines, and Indonesia. The currencies of these countries came under severe pressure from the middle of 1997 which resulted in a heavy depreciation of their currencies in relation to the US dollar. The currency crisis in turn led to a severe domestic financial crisis and the two taken together have had the effect of bringing down the growth rate of these economies. In fact, it is feared that most of these countries which have traditionally had very strong growth rates may face a negative growth rate in 1997 and 1998. The tragedy of the crisis is that very few expected it. Not only was the extent of the crisis underestimated initially, but the spread of the contagion took everyone by surprise. A year has passed since the onset of the Asian financial crisis. We are not sure that we have seen the final act of the drama. It is feared that if the Japanese economy does not recover and the yen further depreciates, it may trigger a devaluation of the Chinese currency yuan which would impact again not only East Asia but also push many other parts of the world into a crisis. The recent Russian devaluation, though not directly related to the Asian crisis, is a pointer in this direction. In order to draw appropriate lessons from the East Asian crisis, we need to first understand the causes. It may then help us to draw appropriate lessons for us. However, as stated earlier, very few expected the crisis and, in fact, some of the causes which are brought out now were not even perceived. Economists, as they say, are good in theorizing after the events. It must be pointed out that most of these countries enjoyed a very high investment grade rating from the international credit rating agencies until the outbreak of the crisis.
Performance

Before we move on to describing the causes of the crisis, it may be useful to understand where these economies stood in early 1997. The average annual growth rate of South Korea between 1970-1996 was 8.4 per cent and that of Malaysia, Thailand, and Indonesia was 7.4 per cent, 7.5 per cent, and 6.8 per cent, respectively (Table 1). Thus, these countries grew at an average growth rate exceeding 7 per cent continuously over 25 years. Measured in purchasing power parity terms, the per capita GDP in 1996 of South Korea, Malaysia, and Thailand was $12,410, $9,703, and $8,370, respectively. This may be compared with the per capita GNP of $1,400 for India for 1995. These countries experienced very rapid changes in the structure of their production with a decline in the share of agriculture from 14 per cent to 7 per cent in South Korea between 1980-1995; from 23 per cent to 13 per cent in Malaysia; from 20 per cent to 11 per cent in Thailand; and from 31 per cent to 16 per cent in Indonesia. Industry and services have been contributing almost equal shares to non-agricultural GDP though the share of services is higher in South Korea, Thailand, and Indonesia, whereas the share of industry is higher in Malaysia. This extraordinary growth in GDP was reflected in a substantial improvement in the education, health, and medical facilities available. For example, the adult literacy rate has been 82 per cent in South Korea, 83 per cent in Malaysia, 94 per cent in Thailand, and 84 per cent in Indonesia. The high growth rates of these economies over two decades and more were sustained by substantial capital inflows. Between 1989-1995, the average annual net private capital flows amounted to 2.1 per cent of the GDP in South Korea, 10.2 of GDP in Malaysia, and 4.2 per cent of GDP in Indonesia. At the peak, net private capital inflows accounted for as much as 17.4 per cent of GDP in Malaysia in 1993 and 12.7 per cent of GDP in Thailand in 1995. Estimates show that, in 1996, Indonesia, Thailand, South Korea, Malaysia, and the Philippines received $93 billion. Of course, in 1997, there was an outflow of $12 billion resulting in a turnaround of $105 billion equivalent to 10 per cent of the combined GDP of these countries.

What contributed to the high growth of these countries has been the subject of many studies. The East Asian experience has very often been described as the East Asian miracle. While many would like to point out that the growth performance of these countries is an indication of the success of markets, there are several who would claim that state intervention in various forms was endemic in these countries. However, there was one feature that was common to most of these countries and that was outward orientation. Export promotion was the key element in their strategy of growth. The growth process was also facilitated by substantial rise in their savings rate. The average savings rate of these countries during this period exceeded 30 per cent except in the Philippines. With substantial capital inflows to which a reference was made earlier, the investment rate of these countries was even higher. No wonder, when these countries suddenly faced a downturn, many were taken by surprise. However, when one applies the microscope to the functioning of these economies, it is obvious that there were several weaknesses which the success of these economies pushed them under the carpet. It is not as if these economies moved smoothly over the past 25 years. There were hiccups. For example, South Korea's GDP fell by 3 per cent in 1980; Indonesia and the Philippines suffered financial crisis in 1983; Thailand in 1984; and Malaysia and Singapore in 1985. Taiwan encountered a banking crisis in 1989. However, each time, these countries bounced back. The main difference between these crisis and the present crisis is that while the earlier events were isolated, this time, all the four countries were caught in it together.

Events

The story began in early 1997. The Thai baht came under pressure in February, 1997. Thailand had been

Table 1: Selected Economic Indicators

<table>
<thead>
<tr>
<th>Country</th>
<th>GDP Per Capita PPP Terms 1996, $</th>
<th>GDP Growth Rate (Annual Average %) 1970-96</th>
<th>Domestic Saving (% to GDP) 1990-96</th>
<th>Fixed Capital Formation (% to GDP) 1990-96</th>
<th>Current Account Balance (% to GDP) 1990-96</th>
</tr>
</thead>
<tbody>
<tr>
<td>South Korea</td>
<td>12410</td>
<td>8.4</td>
<td>35.0</td>
<td>36.7</td>
<td>-1.9</td>
</tr>
<tr>
<td>Thailand</td>
<td>8370</td>
<td>7.4</td>
<td>34.2</td>
<td>40.4</td>
<td>-6.9</td>
</tr>
<tr>
<td>Malaysia</td>
<td>9703</td>
<td>7.5</td>
<td>32.1</td>
<td>38.3</td>
<td>-6.0</td>
</tr>
<tr>
<td>Philippines</td>
<td>3060</td>
<td>3.2&quot;</td>
<td>18.8</td>
<td>22.5</td>
<td>-4.2</td>
</tr>
<tr>
<td>Indonesia</td>
<td>4280</td>
<td>6.8</td>
<td>30.1</td>
<td>33.4</td>
<td>-2.6</td>
</tr>
</tbody>
</table>

*1975-96.
The process of depreciation continued into 1998. As on August 14, 1998, as compared with July 1997, the Thai baht had depreciated by 41 per cent. South Korean won by 35 per cent, the Philippine peso by 39 per cent, and the Malaysian ringgit by 40 per cent. The Indonesian currency suffered, the worst. A multitude of factors — economic and political — contributed to the Indonesian rupiah falling by 81 per cent.

A currency crisis of this magnitude cannot but have disastrous consequences for the economies. Credibility in the currencies has to be established against heavy odds. South Korea, Indonesia, and Thailand had to approach the International Monetary Fund for assistance. While there is some criticism of the approach adopted by the IMF in meeting the situation, it is nevertheless true that the IMF put together a massive programme of $112 billion to assist. The assistance to Indonesia was of the order of $36.6 billion, to Korea $58.2 billion, and to Thailand 17.1 billion. As on end June 1998, the amount disbursed to all these countries amounted to $23.8 billion. As indicated earlier, the decline in real GDP is expected to be very substantial — over 10 per cent in Indonesia, 4 to 5 per cent in South Korea, and about 2 per cent in Malaysia. The financial structure in all these countries is being subject to drastic revamping as many financial institutions in these countries suffered from severe drawbacks.

All these countries are trying to rebuild their economies. The political fall out of this crisis was seen very much in Indonesia and Thailand. At least in the case of Thailand, after some initial dithering, a new political administration committed to a reconstruction programme came to be put in place. However, the process was much more prolonged in Indonesia which is also one of the reasons for the continued uncertainty in that country. Efforts are on in all these countries to restructure their economies in terms of creating a transparent competitive system in the real and financial sectors. However, the process of restructuring is likely to be painful and can lead to social unrest because of the severe impact on employment on account of contraction of output. The situation continues to remain murky. The absence of signs of recovery in Japan has also made the task of reconstruction more difficult.

Causes
A variety of factors have been identified as responsible for the crisis. They can be divided into four broad categories: domestic macroeconomic factors, weakness in the financial sector, external macroeconomic factors, and changes in the external environment. Before going into the details of these factors, one must also refer to the argument that has often been repeated that a major cause for the crisis is "sentiments" or "panic" or "herd instinct." Particularly, the contagion effect, according to some, was caused by sheer panic. Investors failed to make a distinction between one country and another and clubbed together various countries under the common appellation of East Asia which resulted in a cessation of capital inflow and withdrawal of capital from all the countries. This factor perhaps explains for the contagion spreading so fast. However, it is also true that, but for some fundamental weaknesses, this could not have been sustained. As one commentator put it: "The trigger was sentiment but vulnerability was due to fundamentals."
Domestic Macroeconomic Factors
In retrospect, it was clear that these economies suffered from several weaknesses. The system lacked transparency. Allocation of resources was not always guided by rational criteria. Indonesia is perhaps the extreme example of what has been described as crony capitalism. However, some elements of this were present in all the countries. In fact, some economists, even prior to the advent of the crisis in these economies, have questioned the efficiency of the economies. In fact, one of the leading economists had expressed that the high growth rate of these economies was due to the high level of inputs rather than the efficiency of the capital use (Krugman, 1994). The investment rate was over 35 per cent in these economies except in Indonesia. The incremental capital-output ratio was indeed high. While the structure of these economies underwent substantial changes, it was also true that they were more efficient in the production of goods which were being vacated by the developed countries as they moved up from one stage to another. However, their efficiency was put to severe test when they had to compete in relation to some of the sophisticated goods. Questions have also been raised about excessive investments in unproductive activities and luxury constructions. Perhaps, some of these factors did not attract serious attention so long as these economies were growing fast. Some even went to the extent of identifying these as part of the Asian values.

Weaknesses in the Financial Sector
Truly the Achilles heel was the financial sector. A major factor in causing the crisis relates to weaknesses in the financial sector. Banks were not subject to effective prudential regulation and supervision or asset liability management. This was so at least in some of these countries. This coupled with poor governance and lack of internal controls resulted in excessive leverage and excessive credit expansion directed to unproductive investments. Financial reporting and disclosure norms in these countries were far from satisfactory. This kind of regime encouraged large domestic credit expansion. The pegged exchange rate system also resulted in investments being financed by short-term external debt. Globalization of the financial market was not accompanied by an appropriate information system. Lack of transparency delayed public realization of the magnitude of the problem. In fact, the major problem today in Japan is the weaknesses of the financial system, which are coming in the way of quick recovery of Japan. Heavy lending against real estate was considered to be one of the safest forms of lending but when land prices began to fall, it put several banks into difficulties.

External Macroeconomic Factors
These countries, no doubt, had experienced very strong export growth. The average rate of growth of exports was between 12 and 20 per cent. However, these countries ran a very high current account deficit. Many of these countries had current account deficits going over 5 per cent of GDP. In particular, current account deficits became large in Thailand and Malaysia in 1995. Even in Indonesia and South Korea, there was a worsening of the current account deficit in 1995 to 3.3 per cent and 2 per cent respectively from very modest levels in the preceding years. The very high level of current account deficit made these countries vulnerable to external shocks. So long as the capital inflows filled up the current account deficit, the economies did well and performed well. However, once the sentiment changed, and capital inflows were replaced by capital outflows, it had severe consequences. Also, with the economies running high current account deficits, export growth rate becomes vital. When the growth rate of exports of Thailand fell drastically in 1996, it triggered a lack of confidence in the currency. In the management of the external sector, there were again other shortcomings; pegged exchange rates provided incentive for domestic residents to borrow from external sources. In many cases, the corporates borrowed from foreign markets on a short-term basis to finance long-term investment. Many of these went unnoticed until the crisis blew in the face of these countries. Short-term debt constituted around 30 per cent of the external debt of Thailand. This was true of South Korea as well. A high level of short-term debt makes the country vulnerable because of the continuous need of rollovers which can be extremely difficult at times of crisis. The composition of capital flows which was initially dominated by foreign direct investments moved towards greater dependence on short-term banking and portfolio flows which can enhance vulnerability to attacks. Questions have also been raised about the appropriateness of maintaining a pegged exchange rate by some of these countries. So long as dollar was depreciating against yen it favoured these countries; the position became tough when dollar started strengthening against yen. The real effective exchange rate of Thailand remained constant around 100 between 1990 and 1996 but thereafter it started moving up.

External Environment
Besides the domestic factors, exogenous factors also precipitated the crisis. The devaluation of the yuan in 1994 and the consequent loss of competitiveness by many of the East Asian countries; the sluggishness
in Japan's economic growth which depressed the demand for exports from Asia; the glut in supply of exportables from Asia; and the improved economic prospects in the US — these also contributed to the precipitation of the crisis. While all these factors in isolation might not have resulted in a crisis, their combined effect pulled these countries into a crisis. Years of high growth, outward-oriented policies, moderate inflation, healthy fiscal positions, and high level of reserves attracted large private investment capital flows in the 1990s. Private capital flows are in one sense fair-weather friends. The mobility of the capital can work both ways. Once the credibility comes under cloud, the outflow of the capital also gathers momentum.

**Some Issues for the International Community**

The crisis has given rise to many issues, some of which have to be tackled by the countries themselves and others by the international community. The question of restructuring the economy, revamping the financial sector, and introducing appropriate changes in the exchange rate regime are issues that have to be addressed by the concerned countries themselves. However, the crisis has also raised certain issues relating to the role of international financial institutions like the IMF and the regulation of international capital and financial markets.

One interesting question that has been raised in the context of the crisis has been whether the crisis amounts to failure of the market. It is true that the markets failed to detect some of the weaknesses in the functioning of the system in these countries and punish them; in fact, the markets overlooked these deficiencies. In that sense, the crisis is an example of market failure. However, it is also a case of government failure as the governments in these countries failed to fulfil some of their responsibilities. Regulation of financial markets has always been regarded as one of the major responsibilities of the state. As indicated earlier, serious deficiencies have been noted in the functioning of the financial system in these countries. This apart, government also intervened in the system in ways which are inimical to the system as well. The misallocation of resources within these economies is due partly to wrong government interventions. Neither the government nor the market emerged well out of the crisis. The crisis is a failure of the government and the market.

The international agencies such as the IMF did come to the help of the countries. In fact, the magnitude of the programmes mounted by the IMF is much larger than what is normally done. However, apart from timing and quantum, questions have been raised about the content of the IMF programmes (Sachs, 1997, 1998; Stiglitz, 1997). IMF programmes emphasize both stabilization and structural reform. As part of stabilization, the countries were required to raise the rate of interest in order to stem the outflow of capital and to prevent further depreciation of the currency. Some have questioned this approach. It has been argued that in a situation where the financial system was under stress, raising the rate of interest would only result in making the problem more intractable (Wade and Veneroso, 1998). Further, some critics have found fault with the wide-ranging character of structural reforms. Given the fact that currency stability was important, it was not unreasonable for IMF to call on these countries to raise the rate of interest. Restoring the credibility of the investors in the currency was extremely important to stem the outflow. It is quite true that when the entire economy is in distress, raising the rate of interest has other implications. There is no doubt that if these countries have to come out of the crisis, they have to undertake both stabilization and structural reform measures.

**International Capital Markets**

Globalization of capital markets has had the effect of redistributing the world savings and enabling countries which are productive to take advantage of the available savings. The East Asian economies have clearly been the prime beneficiaries of the globalization of the capital markets. As mentioned earlier, in 1996, the total amount of capital inflow into the five Asian countries was $93 billion. However, international capital markets can also act, on occasions, perversely. Financial markets are always known to over-shoot and under-shoot. Once sentiments change, there can be an outward rush. It has also been argued by some of the countries, particularly Malaysia, that large international funds by virtue of their size can destabilize small economies. Malaysia's argument has been that the fall in the value of the ringgit was not justified by fundamentals, and the steep decline in the value of the ringgit in relation to dollar was as a consequence of speculative activities of some large hedge funds. While speculative activities can bring about sharp fluctuations in exchange rates over the short term, any decline in the currency over a period of time cannot simply be attributed to speculative forces. However, the question of some kind of regulation of the international capital markets has assumed importance. There are groups and committees examining whether some restrictions can be
Countries that have high current account deficits are briefly listed: What are the lessons to be learnt from the crisis? Let me briefly list them:

- Countries that have high current account deficits are vulnerable, even if accompanied by high growth. If the capital inflows are affected or if exports fail to grow, these countries come under heavy stress. The appropriate level of the current account deficit of each country must be decided in the light of its own experiences. There are some economists who contend that the size of the current account deficit is irrelevant. But the Asian experience clearly points out the danger of countries running very high level of current account deficit.

The matter of financing the current account deficit assumes significant importance. The East Asian crisis emphasizes the need for a watch on volatile flows which have destabilizing effects on the economy. Foreign direct investment is generally considered more permanent in character and is claimed to be less volatile than portfolio investments. However, portfolio flows are complementary to foreign direct investment and by its very nature, in and out movement of the portfolio flows is greater. However, the real concern is over short-term flows which are sometimes described as 'hot money.' Certainly, short-term debt as a proportion of total external debt has to be kept within reasonable levels.

- When the capital account is open, the exposures of private sector need to be monitored. While some effort is made normally to monitor the short-term exposure of banks, not enough information, very often, is available to the countries regarding the exposure of corporates. It is important that the exposures of the private sector are properly hedged.

- There is no consensus regarding an ideal exchange rate regime. While no particular exchange rate regime can provide insurance against any crisis, nevertheless, a strong appreciation in real exchange rate can cause problems. When the nominal exchange rate remains the same (despite real appreciation), it may lull private borrowers into a sense of complacency and prevent them from taking cover for their exposures.

- An important lesson which the Asian crisis offers is the need for strengthening the domestic financial system. A strong financial sector is critical to sustainable growth. For the financial system to remain sound, the most important requirement is for a regulatory and supervisory framework which enforces transparency, competition, and accountability. Information disclosure should conform to international best practices and internationally acceptable accounting standards. The Asian crisis also points to the danger of excessive credit expansion. In many of these countries, the banks went into a credit spree. Particularly in the context of large capital inflows, a mechanism should be in place to strengthen internal controls, identify, monitor, and measure risks, and to conform to reasonable debt equity ratios.

- Liberalization of the capital account can land a country in serious problems, if it is not accompanied by an appropriate regulatory framework relating to the financial system. However, the Asian crisis is not an argument against capital account liberalization. These countries immensely benefited in the past by large capital inflows. Capital account liberalization is not a discrete event. It is a process and can be done in stages. The lesson to draw from East Asian crisis is that the capital account liberalization and reform of the financial system should move in tandem.

The external sector of the Indian economy has been growing in importance. It is a reflection of the
increasing integration of the Indian economy with the rest of the world. Exports and imports taken together today stand at about 22 per cent of our GDP. If international transactions in services are included, the degree of openness of the Indian economy is well over 30 per cent. Being part of the international trading system has many advantages. However, it is equally necessary to ensure that this sector is managed appropriately. After the crisis year of 1991-92, policy makers in India have been extremely conscious of the need to ensure that the current account deficit remains at an appropriate level. The High Level Committee on Balance of Payments in 1992 recommended a level of 1.6 per cent of the GDP for the current account deficit, based primarily on an annual growth of 15 per cent in exports and the assessment of the normal capital flows. For the Ninth Plan, a document circulated by the Planning Commission assumes that the current account deficit can be of the order of 2.4 per cent for a growth rate of 7 per cent. The size of the current account deficit should be managed at a level which ensures that the debt service ratio or a broader concept, the liability service ratio (including profit and divided payments) is kept below say 20 per cent. In the present milieu, the current account deficit of the order of around 2 per cent satisfies the required and feasible level. A modest current account deficit and a calibrated capital inflows with a stress on low level of short-term debt should be the guiding factors in the management of our external sector.

References