الجامعة الإسلامية العالمية ماليزيا

INTERNATIONAL ISLAMIC UNIVERSITY MALAYSIA

يونيبرسيتي إسلام انتارابغسا مليسيا

ASIA – ROAD TO RECOVERY

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MBA PROJECT PAPER

Submitted to the Management Center

International Islamic University Malaysia

In Partial Fulfillment of the Requirements

For the degree of

Master of Business Administration

August 2000

Copy no. 632540.
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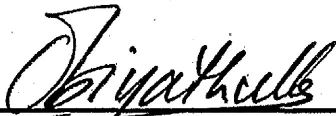

DR. OBIYATHULLA ISMATH BATCHA

Date: 12/8/2000

ACKNOWLEDGEMENTS

This project paper would not exist without the kindness, patience and encouragement of many people.

First, I would like to extend my heartfelt thanks to Dr. Obiyathulla Ismath Batcha for his guidance, intelligent advice, generous devotion of time, boundless kindness, invaluable assistance, insight and expertise.

Specials thanks to my parents for providing the foundation for my own path to happiness in life and encouragement. To my siblings and family who have enriched my life in more ways than I can express.

I would also like to extend warm thanks to all the lecturers in the MBA program for their assistance in many ways. Finally, wish to thanks my fellow classmates for making the past few years a rewarding experience.

ABSTRACT

The East Asian Currency Crisis of 1997 had a differential impact across the countries in East Asia and this was caused by several factors. This paper studies the situation in these countries since the crisis began and examines how the different policies imposed on these countries have assisted them to improve their economies.

As the analysis shows, there does not seem to be one, over-the-counter remedy applicable in all cases. Each countries appears to respond differently to similar policies. However referring to what these countries are facing it seems to make sense for the authorities to prescribe debt standstills and rollovers instead of just depending on confidence building measures. Further analysis shows that although these countries have implemented different policies to revive their economies, at a macroeconomic level, the forces driving the recovery process for the crisis countries can be summarized as Fiscal Expansion, Monetary Expansion, Export Led Growth, and Corporate Restructuring. Continued restructuring and more prudent policies will be needed to ensure future growth.

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Chapter 1.0

1.1: Introduction

It is now more than two years since the East Asia crisis began. After three decades of remarkable expansion, the severity and duration of the crisis has surprised all nations. The once booming countries like Malaysia, Thailand, South Korea and Indonesia that enjoyed double-digit GDP growth have contracted. The more fortunate countries in the region like Hong Kong, Taiwan and Singapore, with their strong financial systems and high reserves have so far managed to reduce the crisis impact and fight off the worst of the contagion that started from Thailand in July 1997.

The currency crisis that broke out in East Asia in 1997 and the crash in the equity markets have wiped out the savings of the people from all classes in the nations. The decline in equity values in the region has surpassed USD400 billion since 2nd July 1997[1]. The economic crisis was such a shock as it came after the most sustained expansion in history, will undoubtedly be as profound. In addition to all this, it has also triggered a regional banking crisis. A number of economists have cited financial liberalization against a background of weak financial fundamentals

[1] Asian Development Bank

and supervision, as increasing the vulnerability of the Asian economies to an external shock[2].

In response to the crisis, central banks have intervened trying to maintain the value of their currencies. However their efforts were in vain and subsequently they have chosen the alternative of floating the currency. Confronted with the mounting financial straits that worsened during the crisis, Thailand, Indonesia and South Korea turned to the International Monetary Fund (IMF) for assistance. The IMF has arranged the largest bailout ever, totaling a sum of USD118.6 billion for these countries (International Monetary Fund website). Thailand and Korea, after suffering a collapse in their financial systems, have established firmer values for their currencies and are rebuilding reserves. Malaysia, one of the crisis countries also implemented a capital control policy and is working on the merging of all local banks to establish a firmer banking system in the country. As for Indonesia, it is still fighting to regain a modicum of stability.

The new millennium for East Asia is all about changing ways in financial sector regulations; the way investment is done, the way resources are allocated and, in some cases the political governance of countries. Building resilience into the

[2] Glick, 1998; Bisignano, 1998

economic, financial and social intuitions would be to top priority of the East Asian countries.

1.2: Objectives and Motivation

The East Asian Currency Crisis that happened in 1997 had a different impact across the countries in East Asia and this was caused by different factors. Obiyathulla, (1998) has basically studied what factors led to the severe consequences in the crisis countries as opposed to less affected countries. The objective of this paper is to overview the causes of the crisis that hit the region. It also analyzes the situation in these countries since the crisis began and how the different policies imposed on these countries have assisted them to improve the economic crisis situation they have encountered.

Following Obiyathulla, (1998), this paper will be a study on seven countries in Asia; Thailand, Malaysia, Indonesia, South Korea, Singapore, Hong Kong and Taiwan. Of these seven countries some are in a crisis situation whereas others were less affected. In view of this, policy makers in the respective countries have taken a different stand in their policy decisions. As a result of the different policies made by these countries, the impact of recovery across the countries might vary and this paper is to examine the differential impact across the countries. The motivation of this paper is to examine how these policies have expedited or dampened the recovery in these countries. This paper has five

chapters. Chapter two provides a review of relevant literature. Chapter three will focus on the actions for crisis management. In chapter four we will look into the policy responses taken by the seven countries. Chapter five will discuss the resolutions and consequences of the actions and second section in this chapter is the conclusion.

Chapter 2.0

2.1: Literature Review

In the past, many international economists have designed currency-crisis theories to explain the situation. These theories focus mainly and often exclusively on the exchange rate and other assets prices are left in the background. In the "first generation" crisis model (Krugman 1979; Flood & Garber 1984), the government runs a deficit that is fully monetized. The exchange rate is fixed if there are reserves above the critical level otherwise the country should allow the currency to float. The government runs a money-financed budget deficit assumed to use a limited stock of reserves to peg its exchange rate. Under perfect capital mobility and perfect foresight, the domestic interest rate is equal to the international one. Purchasing power parity holds with zero world inflation so that the domestic price level equals the exchange rate. However, when the underlying fundamentals are inconsistent with the pegged exchange rate it would be vulnerable to a currency attack. Some of the fundamentals that drive the first generation crisis models are huge budget deficits, runaway monetary expansion, reserve losses and a high inflation rate. Using this model to explain currency crisis where there are no monetary excesses or budget deficits is not likely.

This leads to the second-generation models (Obstfeld 1994,1995) which included in their analysis that a speculative attack on a currency can develop either as a result of a predicted future deterioration in fundamentals or purely through self-fulfilling prophecy. A government chooses whether or not to defend a pegged currency rate making a tradeoff between short-run macroeconomic flexibility and long-run credibility. Here, countries will be prone to attack when defending the parity is more expensive i.e. higher interest rates, their fundamentals have deteriorated to certain levels and the market expects that defense will ultimately fail.

Goldfajn and Valdes, (1997)[3], is a paper studying whether exchange rate expectation and overvaluation are predictors of a currency crisis. This study uses survey data for 26 countries over the past 13 years. The possible role of the real exchange rate as a summary variable notwithstanding expectations should incorporate all information available, including other leading indicators when predicting a crisis. The results show contradictory evidence that expectations cannot predict a crisis. The negative result obtained from the Mexican and Thailand cases when used as sample has further supported this. Therefore, from the perspective adopted in the study, exchange rate crises are largely unpredictable events.

[3] Are Currency Crisis Predictable

Another model was put forward by Bernanke and Gertler in 1989. In this model it is mentioned that investment is often wealth-constrained, meaning that when firms face limits on their leverage, the level of investment is strongly affected by the net worth of their owners. And suppose also that for some reason many firms have substantial debt denominated in foreign currency. In such a situation two possibilities can emerge. First, a loss of confidence by foreign investors can be self-justifying, because capital flight leads to a plunge in the currency, and the balance-sheet effects of this plunge lead to a collapse in domestic investment. Second, the normal response to recession - namely, printing money - becomes ineffective, even counter-productive, because loose monetary policy would reinforce the currency depreciation, and thereby worsen the balance-sheet crunch. And hence the Asian crisis: seemingly irrelevant events caused a self-fulfilling loss of confidence, and conventional macroeconomic remedies were not available.

In his recent paper "Analytical Afterthought On the Asian Crisis" (Paul Krugman, 1999) has described what he calls "A cartoon model of financial crisis", simplified "1997" crisis model to explain the recent Asian crisis. A cartoon model of financial crisis models is a combination of the Mundell-Fleming model that has been the workhorse of open-economy macroeconomics since the 1960s

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and the strong open-economy Bernanke-Gertler (1989) effect together. In the Mundell-Fleming model it is assumed that the domestic and foreign interest rates are equal. These simultaneously determine the outputs and exchange rates of the economy. The aggregate output in the country is moving in an opposite direction with the exchange rate because depreciation in currency value would increase net exports and therefore stimulates the economy.

By adding the Bernanke-Gertler model, this would turn into a model that can yield a crisis. In this model it is assumed that many firms are highly leveraged and that a substantial part of their debt is denominated in foreign currency. In addition to the above, under some circumstances their investment will be constrained by their balance sheets. Then the aggregate demand equation will have to include a direct dependence of domestic demand on the real exchange rate, together with net exports that depend on the real exchange rate:

(1') $y = D(y, i, eP^*/P) + NX(eP^*/P, y)$

Based on the model above, if the real exchange rate is very favorable then few firms would be balance sheet constrained; so if the exchange rate depreciate but marginally only the direct effect of the real exchange rate on aggregate demand would be minor. However, when there is a very *unfavorable* real exchange rate,

firms with foreign-currency debt would be unable to invest at all, and therefore the direct exchange rate has an effect on demand, and therefore the direct exchange-rate effect on demand, which would be trivial at the margin. This was the situation encountered by Asian countries during the currency crisis. When the exchange rate moved against them and in view that the exchange rate exposure positions were not hedged, companies were faced with currency depreciation problems. (The economy would be like Indonesia today: the corporate sector basically bankrupt and unable to invest).

Table 1

Indonesia: External Debt Data

Indonesia		**1997**	**1998**	**1999**
External Debt (gross)	US$bn	140.5	150.9	146.4
	% GDP	104.1	163.7	102.6

**Source: Bank Indonesia*

Although when the value of the exchange rate declines there would be a direct effect on export competitiveness as goods are becoming cheaper for foreign nations, in an intermediate range the effect might be large enough to outweigh the direct effect on export competitiveness. In short, over that range depreciation of the currency in any country there would be a contractionary rather than an expansionary economy situation.

The above mentioned is a cartoon version of an Asian-style financial crisis. A trigger point for a currency crisis can be by a whiff of political instability, a financial crisis in another country that investors, or even deliberate market manipulation by big speculators and as a result there is a sudden large currency depreciation. The result of this depreciation is that it has created havoc with balance sheets and the economy plunges into the crisis equilibrium.

Emerging market economies have been buffeted by deep and protracted crises that have been characterized by sharp capital flow reversal (Calvo & Reinhart; 1999) and output collapses and exacerbated by serious banking problem. During crises it is more difficult for an emerging country to have access to the international capital market. Therefore, very often they need to rely on short-term debt financing and this also means that their private and public sectors are expected to repay existing loans on short notice. When this happens, the policy options available to these countries are severely restricted.

During the currency crisis, these countries were faced with such a problem. During such a situation, a country would like to implement expansionary policies, which could offset some of the devastating effects of capital flow reversals. However, implementation of the capital control policy may not be appealing for

many countries. These countries are reluctant to enforce capital control into their economy as they are hesitating to reverse the process of financial liberalization or accept the inflationary consequences that are often associated with such a policy.

Market indicators such as interest rate spreads and credit rating were clearly ineffective in predicting the Asian financial crisis. The Asian Financial crisis raises questions about the relevance of early warning indicators, Kaminsky (1998) present early warning indicators and their relevance to the Asian financial crisis. In this study an empirical model was used incorporating the experience of 100 financial crises in 20 countries. Kaminsky's study is a recent summary of ongoing research on early warning indicators of financial crises based on measures of fundamental problems in the current and capital account, growth slowdowns, credit cycles and weakness in the financial sector. This study concluded that the Asian currency crisis, with the exception of Indonesia, could have been predicted on the basis of historical experience.

Chapter 3.0

3.1: Options for Crisis Management

The financial crisis that hit Asia happened so fast and required these countries to respond to the crisis in a very quick manner to manage the situation. The policy makers do not have the luxury of time to implement a new financial architecture but in fact are facing difficulty in maintaining a structure that seemed to be collapsing. Under such pressure what can policy makers do to respond to the situation?

There are five types of conventional attempts at crisis management that one can use in such a situation. The following are some of the possible policies that governments can implement to improve the situation.

3.1.1: Fiscal policy

During a crisis the government has options to either implement an expansionary or contractionary policy with its budget. In the early stages of the crisis the IMF imposed fiscal austerity; currently the recovery is being partly driven by deficit spending.

When governments implement fiscal austerity, it does not necessary help or cures an Asian-style crisis. With a fiscal contraction it would cause the output in the country to decline and in this case if anything, this may eliminate the "good" equilibrium and guarantee that the crisis actually happens. However, if fiscal austerity creates market confidence - which is to say that the market has some incorrect model of the situation in which austerity is the right answer - then it could work, because when there are multiple equilibria, belief can create its own reality. But then perhaps one should try other confidence-inducing measures that do not objectively push the economy in the wrong direction.

Fiscal expansion, on the other hand, will encourage output and spending in the economies and if undertaken on a sufficient scale can rule out the crisis equilibrium. However, there is a concern as to whether countries are able to

undertake such expansion on the needed scale. Deficit spending strengthens the yen, just as Mundell-Fleming would predict; but it may not be a usable option for smaller nations that are debtors rather than creditors.

3.1.2: IMF financial support

The IMF financial support is where the international organization will put together sources of funds that can be mobilized and provides the troubled country with a credit line. When providing a country with a credit line, the IMF will expect the crisis country to implement a program that is in line with IMF expectations.

The IMF provides the country with additional funds to intervene in the currency exchange market - more dollars to support the baht, won or whatever the currency is. Leaving aside monetary policy, this is an attempt to use sterilized intervention to move the exchange rate away from the crisis equilibrium. Besides this, the IMF would also expect to see reform in the country financial sector if necessary and improve transparency in the system.

The trouble with this policy is, of course, immediately apparent: in a world of high and increasing capital mobility, sterilized intervention is a tool of limited effectiveness. It can still work: capital isn't really as mobile as it is sometimes claimed to be, foreign exchange markets in developing countries often remain surprisingly thin, and within limits, intervention can work simply because people think it will work. But leaving aside the psychological impact, it is hard to escape

the sense that the importance and effectiveness of credit lines to troubled economies has been exaggerated. Calling the IMF the international lender of last resort sounds impressive; calling it, more accurately, the "sterilized intervenor of last resort" probably more accurately conveys the limits of what a few billion dollars can accomplish.