CHAPTER 3

THE MYTH OF ASIA'S DEBACLE

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1. FROM AN ASIAN ECONOMIC CRISIS TO A WORLD ECONOMIC CRISIS

At the end of last year, the Institute of Developing Economies published an issue of the IDE Topic Report titled "East Asian Currency Crisis in 1997". Now a succeeding edition of the report is at press, which we decided to title "East Asian Economic Crisis" (Kunimune [1999]). In fact the situation has changed in this brief period of time making it more appropriate to call it an *economic* crisis, rather than a *currency* crisis. While experts in the world were trying hard to identify the causes for the currency crisis, the realities have metamorphosed into a general economic crisis.

The world is thus changing rapidly — too rapidly, I would say. As a consequence, we are afraid that the next report may have to be titled the *world* — instead of *East Asia* — economic crisis.

The months of August and September this year were particularly eventful.

The Hong Kong authorities' intervention in the stock market and the Malaysian government's regulation of exchange transactions made headline news, but they were overshadowed by Russia's moratorium and de facto default on its government bonds. The Russian economy is relatively small in size compared with that of Asia, let alone, the world economy. Why then did developments in Russia have a far greater impact than the Asian economic crisis?

Banks in advanced industrial countries did suffer from the Asian crisis, but what happened in Asia was within the range of international investors' expectations. Indeed, the Asian crisis offered active international investors (typically hedge funds) a golden opportunity for profiteering. Such investors also benefited from the fall of stock prices (by, say, short-selling).

In contrast, the ramifications of the Russian situation went far beyond what had been anticipated. Practically no investor expected the Russian government to throw in the towel only a month or so after the IMF's decision to support it. For this reason, a large number of investors are believed to have suffered colossal losses. Furthermore, damage is not limited to immediate losses. Indirect damage included, for instance, the bankruptcy of Long Term Capital Management (LTCM), which is a 'market neutral'-type hedge fund. Not that LTCM had poured much money into Russian bonds. It invested mainly in generally less risky bonds of industrial countries, betting on changes over time of interest differentials among these bonds, a bet carrying a fairly good profit expectancy. However, the Russian shock got the interest differentials moving in totally unexpected directions to those foreseen by the hedge funds. This came as the fatal blow to LTCM.

What horrifies the market most is not so much the ups and downs of prices but the occurrence of major unexpected events. In this context, the recent extraordinary yen appreciation may have caused serious disturbances too. Certainly, it was not a welcome phenomenon to traders.

The heavy losses suffered by hedge funds may have given some satisfaction to vengeful Asian countries which felt victimized by them. However, they have no reason to congratulate themselves, as the failure of hedge funds could trigger a global financial panic and credit crunch that will make their situation even more serious.[1]

Another danger is the possible spread of the currency crisis to Latin American countries. The current focus is on whether Brazil can defend its currency. Faced by this contingency, the United States has begun to urge the IMF to introduce a system of quick-loan extension. In fact, this about-face by the United States has upset some Asian countries, who point out that the United States opposed and killed a similar idea for the setting up of an Asian Monetary Fund only last year. Nonetheless, the important factor here is that the situation is so pressing that the U.S. has to sacrifice its consistency. For, if Brazil collapses, it will immediately affect the whole of Latin America, and the consequence might be a second great depression.

Initial undue optimism that prevailed about the East Asian economic crisis is partially responsible for aggravating the situation. As is often pointed out, two things happened in this period: the fall in the prices of oil and other primary products due to reduced demand in Asia and overproduction of industrial products on a global scale. Here it is important to note that falling primary product prices hit Russia and Latin American countries hardest.

Let us now consider the collapse of demand in the Asian region.

Table 3-1 shows changes over time of imports by East Asian countries. In 1997, Japan imported \$338.8 billion, or approximately 6%, of world total imports of \$5,615 billion. The imports of Thailand, Indonesia, Malaysia, and South Korea totaled \$328.2 billion, which is about equal to

Table 3-1. Asian Exports

	Total Exports (billion US$)			Share in the World Exports (%)	
	1996	1997	Change	1996	1997
Thailand	72.3	62.9	−9.5	1.3	1.1
Indonesia	42.9	41.7	−1.2	0.8	0.7
South Korea	150.3	144.6	−5.7	2.8	2.6
Malaysia	78.4	79.0	0.6	1.5	1.4
Subtotal	344.0	328.2	−15.8	6.4	5.8
Philippines	34.1	38.3	4.2	0.6	0.7
China	138.9	142.2	3.2	2.6	2.5
Asia	1039.9	1,059.9	20.0	19.4	18.9
Hong Kong	198.6	208.6	10.1	3.7	3.7
Singapore	131.3	132.4	1.1	2.4	2.4
U.S.A.	822.0	899.0	77.0	15.3	16.0
Japan	349.2	338.8	−10.4	6.5	6.0
World	5,367.5	5,614.6	247.1	100.0	100.0

Source: *International Financial Statistics*, IMF

Japan's imports. Altogether these countries represented 12% of world imports. The slowdown seen in these economies has generated serious global deflationary pressure. In fact, the imports of the five countries diminished by more than $26 billion from 1996 through 1997, which is equal to about 10% of the world's trade increment for the year.

Whereas the above figures are from 1997, it was after the middle of that year that the East Asian economies began to deteriorate seriously. In 1998, the situation has worsened with every passing month, not only in the said five countries but also in Hong Kong, Singapore, and the Philippines. By the end of this year, the whole region will have registered a drastic import decline. According to press reports, sales of automobiles in the crisis-hit East Asian countries are expected to drop by (not to) 70% from the previous year.

Therefore, it goes without mentioning, that the collapse of demand in East Asia will seriously affect the world supply-demand situation.

If I may be allowed the indulgence of hindsight, the priority task that should have been tackled in East Asia was recovery of growth. Instead, the rest of the world imposed what they considered to be necessary adjustments on the East Asian countries that were suffering from currency crises. However, the situation seems to have backfired and now the rest of the world is also paying a price.

2. FAILURE OF THE HIGH INTEREST POLICY AND A WRONG POLICY MIX

What then were the mistakes committed in the prescriptions given to East Asian countries? As time is limited here, I shall consider only on a few major points.[2]

Firstly, I think the main failure was in policy combination. The diagnosis that East Asian financial systems had problems and financial reconstruction was necessary is correct. The prescription that interest rates should be raised to halt plummeting exchange rates was also *conditionally* correct. (I will come back to the conditions later). However, the combining of these two theses, each of which was correct, was wrong. It resulted in the prescription that East Asian governments should raise interest rates to stabilize exchange rates and resolutely scrap bad banks. This *combination* was a disaster.

How erroneous it was is seen from the recent Indonesian situation. Take a look at Table 3-2. The table shows change over time of the interest rates in Indonesia as published by the Central Bank of Indonesia. In July this year, the interest on three-month time deposits, which is a cost factor for banks, was 43% per annum while the loan interest rate, which is banks' revenue, was 34% for short-term loans (or working capital loans) and 23% for long-term loans (or investment loans). The differential reached 10-20 percentage points. Considering the Central Bank bond rate (SBI rate) of over 55%, the banks' financial costs are even heavier if they borrow funds on short-term inter-bank markets instead of from depositors. Looking back, the banks' interest rates on loans extended, both long-term and short-term, until July last year, were higher than the rates they paid to depositors. From August that year on, deposit interest rates began to exceed the long-term loan interest rates but still stayed slightly below, or equal to, the short-term loan interest rates. But from June this year, deposit interest rates moved above even the short-term loan interest rates. This situation remained unchanged in the second half of August this year when I visited Indonesia. Indonesian Bank Reconstruction Agency (IBRA) sources warned that if this trend continued for another six months, there would be no bank in Indonesia capable of operating its business.

Can this be a way to reconstruct financial systems? No financial specialist, however able, can save the Indonesian economy given the existing set of circumstances. Accountants invited from industrial countries are now busy checking the balance sheets of Indonesian banks. But such inspections are totally meaningless as long as the banks continue to suffer from extreme losses from the reverse interest rate gap. Their balance sheets are rapidly deteriorating as the accountants check them. It is not financial reconstruction that is under way in Indonesia. What is under way is a process

Table 3-2. Interest rates in Indonesia

1997	SBI	SBPU	Deposit	Working capital	Investment	1998	SBI	SBPU	Deposit	Working Capital	Investment
Jan.	10.94	15.38	16.85	19.05	16.36	Jan.	15.70	21.00	22.86	25.57	18.96
Feb.	9.75	15.38	16.66	19.00	16.41	Feb.	24.29	23.31	24.00	25.63	19.18
Mar.	8.46	14.29	16.47	18.88	16.37	Mar.	26.62	28.63	27.26	27.80	20.16
Apr.	8.42	14.88	16.25	18.82	16.38	Apr.	45.16	52.00	29.40	29.47	21.64
May	8.64	15.61	16.06	18.79	16.26	May	51.35	58.67	32.95	33.21	22.84
June	8.19	14.85	15.93	18.56	16.19	June	56.28	60.00	40.63	33.79	27.70
July	9.05	11.15	15.84	18.59	16.02	July	55.87	60.00	43.01	34.12	23.38
Aug.	11.21	—	21.73	25.13	19.68	Aug.3Q	70.14	68.00	46.23	—	—
Sep.	14.58	—	26.22	26.41	20.34	Aug.4Q	70.43	70.00	47.51	—	—
Oct.	18.11	20.00	27.73	26.76	20.14	Sep.1Q	70.59	70.00	48.61	—	—
Nov.	17.38	20.00	26.51	26.42	19.77	Sep.2Q	69.99	70.00	49.68	—	—
Dec.	17.38	—	23.92	25.40	18.94						

Source: Bank Indonesia

of financial destruction. It is no surprise that the bad loan ratio in Indonesia is exceeding 60 percent.[3]

Lessons

Unfortunately, the current situation is that the best and the brightest are destroying the Indonesian economy using theories which, taken separately, are correct. However, when complex problems are entangled and encompass a broad range of specifics as is the case with the current Asian crisis, it is essential to pass a correct judgment about which problem must be preferentially resolved. Of course it is important to try to analyze individual problems correctly, but as can be seen from the Indonesian case, a bad combination of separately correct prescriptions can invite disastrous consequences.[4]

What then should have been done?

It is true, a financial crisis requires rigorous and quick treatment. But the treatment is effective only when it is combined with stimulation to the economy and lower interest rates. The required prescriptions would therefore have to be a combination of expansionary macro policy including interest rate reduction and rigorous implementation of structural reform including financial reform.[5]

A proposal to lower interest rates may immediately be met by this rebuttal: Are you going to give up exchange rate stabilization then? What matters here is whether alternative proposals to higher interest rates exist or not. If there are none, one should follow a policy of high interest rates no matter how negative its consequences may be. Conversely, if there are alternatives, one should examine them with regard to their advantages and disadvantages, and choose the most appropriate one to the given circumstances. In fact, theoretically there are two alternatives to high interest rate policy, which have already been proposed by some experts.

One is Krugman's proposal for the regulation of capital transactions (or shortly, capital control). The other argues abandonment of exchange rate stabilization efforts (proposed by Sachs and others). Here, I will explain the inter-relationships among the three proposals, namely the above two and a third put forward by the IMF. Krugman [1998] labels the IMF proposal "Plan A" and his own "Plan B". I will label the one proposed by Mr. Sachs and others "Plan C".

It is generally said that there is compatibility between any two of the following three policy objectives, (1) free capital movement (free capital transactions), (2) freedom of interest rate control (e.g. lower interest rates), and (3) exchange rate stabilization. But it is impossible to pursue the three goals simultaneously. This means you should give up one objective. And the above three plans differ over which policy objective should be dis-

Table 3-3. Policy Options

	Free Capital Transactions	Control of Interest Rates	Exchange Rate Stability	Proponents
Plan A	YES	NO	YES	IMF
Plan B	NO	YES	YES	Krugman
Plan C	YES	YES	NO	Sachs and others

Two of the three goals can be simultaneously pursued; but one must always be given up.

carded (see Table 3-3).

Therefore, if the negative aspect of a high interest rate policy is unbearably serious, either Plan B or Plan C should be the choice. But not Plan A (The fact that the IMF is unusually adherent to high interest rate policy seems to reveal an undisclosed priority consideration — free capital transactions besides exchange rate stability).

3. DEBATE ON IMF REFORM

As the seriousness of the East Asian crisis becomes obvious to everybody, voices calling for IMF reform have become louder. This is a welcome development. Nonetheless, it should be noted that discussion centers not so much on ways to overcome the existing crisis as to prevent a future one. Therefore, as I see it, most participants in the debate avoid the task of squarely facing existing problems.

When the crisis occurred, many economists were enthusiastic about identifying its causes and only a few concerned themselves with thrashing out crisis-countermeasures. At that time I was resigned to this state of affairs and expected that in due course people would start discussing countermeasures.

But even now, as the October joint convention of the IMF and the World Bank typically showed, the experts are preoccupied with preventive measures (for the next crisis). In their eyes it is logical to jump from clarification of causes to future crisis-prevention. Is what happened not a reflection of a concealed desire on the part of economists and policy makers to run away from the realities?

It is of course important to increase transparency through information disclosure by the IMF and aid-receiving countries. Speedy disbursement is also welcome. But what is urgently needed is to examine whether the IMF's actual policy on the crisis-hit Asian countries is appropriate or not.

As I said earlier, one of the major mistakes the IMF committed was that it chose the wrong policy mix combining a hike in interest rates with liquidation of mismanaged banks. Why were these mistakes committed? I suspect that it was because the IMF did not think at all about the overall consequences of such a policy. This mentality, I argue, in turn stemmed from the fact that (1) IMF conditionalities have become too many and that therefore (2) the IMF can do little more than check a given country's situation against each individual conditionality. This is an evil typically resulting from manual-based practices.

4. TO BE SIMPLE !

The IMF has taken upon itself too many tasks. IMF reform therefore should be guided by the principle that the IMF should not attempt to do everything by itself.

The IMF is an agency equipped with excellent staff and excellent systems. Nevertheless, it cannot escape all the negative consequences of its being a bureaucratic organization. A salient weakness of the bureaucratic structure is that it is impossible for it to cut duties. Indeed, bureaucracy has a chronic tendency to create new duties. In this manner, IMF conditionalities proliferate and become increasingly meticulous largely because of these dynamics, as is the case with all bureaucratic organizations.

Criticisms are constantly leveled at the IMF that it is imposing conditionalities while ignoring the realities of the countries concerned. But this is most likely not calculated behavior by IMF staffers, but rather, an eventuality resulting from the IMF's limited human resources and the nature of the loan schemes. Reacting to criticisms, some argue that the IMF should provide prescriptions more sensitive to the given situation of each developing country. Though plausible at first glance, this argument could deliver a consequence opposite to that intended. We should not demand that the IMF be burdened with more functions than it already has. If we do, we would be depriving the IMF of whatever leeway it still has left in terms of time and staff, in effect causing it to produce even more unrealistic diagnoses and prescriptions. Rather, we should limit the roles demanded of the IMF so that it can mobilize its staff more effectively on focal issues. As a matter of fact, the IMF is not omnipotent. No matter how able its staff, the IMF can hardly be expected to write prescriptions for all the situations that may arise while monitoring their implementation.

Generally speaking, weaknesses of bureaucracy can be solved by political initiatives. In the case of the IMF, it is up to political leaders of the member countries to take the initiative to ensure that its roles are streamlined and workloads abated. However, here we should be careful not to be trapped by the argument that personnel should be cut because workloads are reduced. The point is that the numerous roles assigned to the IMF should be curtailed while its capacity is maintained. Thereby ensuring that the IMF can work better to achieve its purpose.

In a nutshell, my proposal is function-slimming, not body-slimming of the IMF. For this to be done, discussion should be geared toward determining which functions should be strengthened and which abandoned.

To facilitate such discussion, it would be necessary to briefly examine the evolution of the roles undertaken by the IMF. In the beginning, the IMF's task was to help member countries tackle *short-term* balance of payments problems (e.g. macro-economic stabilization policy). Following Latin America's debt crisis in the 1980s, the IMF assumed the role of mediator in the debt negotiation processes. In the wake of the collapse of the Bretton Woods system, the IMF had already shifted its emphasis to involvement in developing countries in the form of assisting in structural reform.[6] In the 1990s, as the task of helping transitional economies emerged, support for structural reform came to carry even more weight. Having passed these phases, the IMF now has three major roles to play, namely (1) supporting macroeconomic stabilization policies, (2) mediating over debt negotiations (or work-out), and (3) helping in structural reform.

Of the existing three roles, the IMF should now concentrate on macroeconomic stabilization policies, and then endeavor to strengthen debt mediator functions as its second priority. Its functions involving structural reform should be drastically reviewed and curtailed. However, there are some points of caution regarding each of the three roles.

Concerning macroeconomic stabilization policies, thorough discussion is needed from the viewpoint of economic theories. Choice of a proper policy mix is of course the case in point. High interest rate policy should not be deemed a panacea, and proper criteria should be worked out conforming to the given country's situation.

The mediator role in debt settlement processes should be strengthened. For instance, the IMF does not seem to have taken necessary mediating initiatives over the obviously very important private sector debt issue of Indonesia. Furthermore, it is necessary that there be a guarantee that the IMF works as a genuinely neutral mediator. By this I mean that some organizational arrangement must be in place that prevents the IMF from unwittingly acting on behalf of lenders.

Concerning the structural reform support role, it is advised that the IMF limits itself to activities that are supplementary to the macro-stabilization task (resolution of balance-of-payments problems). In the case of East Asia, a controversial issue that may arise with regard to this task would be how financial system reform (which is classified as structural reform) should be handled. I do agree that financial reform is necessary. But precisely because it is important, we should not rush it. Indeed, it is arguable that this task falls outside the scope of the IMF and should be allocated to the World Bank, other development banks, and the Bank of International Settlement as well as the central banks of industrialized countries, which are all better equipped to collaborate to support such reform.[7]

My conclusion consists of the following two proposals:
(1) IMF conditionalities should be reduced and consolidated for the purpose of facilitating settlement of balance of payments problems by macroeconomic stabilization policies. The IMF's role regarding structural reform policy should be limited to a minimum level while other international agencies be required to play supplementary roles in this regard.
(2) Private debtors are having difficulties in successfully renegotiating external debt conditions with lenders and, this in turn is an obstacle to the settlement of balance of payments problems. This is precisely the area in which the IMF, as a neutral party, is encouraged to take the initiative for settlement.

Notes

[1] This development has given rise to the discussion that the international financial market itself is problematic. This involves an interesting point relevant to the Asian economic crisis, too, which I did not mention in this paper. I solicit attention to the forthcoming issue of the IDE Spot Survey (Kunimune [1999], chapter 2).
[2] For detailed analysis, see Kunimune [1999].
[3] A possible rebuttal to this is that currency devaluation, if let loose, would inflate corporate debts to foreign sources and eventually aggravate the financial crisis. But from this point of view, there would be no difference between an exchange rate decline of 50% and 80% since, whichever the figure, it would anyway cause insolvency of most debtor companies.
[4] Unusualness of this combination should be obvious to anyone at a glance. I know of no financial crisis experienced in advanced industrial countries where the interest rate was raised as a countermeasure.
[5] Another factor that can be added is settlement of the private sector's external debts. While this is a very important problem, little attention has so far been paid to it. Indonesia introduced the INDRA scheme addressing this issue, but the scheme in fact only defers settlement to the distant future.
[6] See Kunimune [1999], Chapter 4, Section 2.
[7] Sachs [1998] pointed out that the bank closure in November last year invited the Indonesian financial crisis. This is another illustration of the IMF's lack of necessary know-how in handling financial problems.

References

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