ISLAMIC DEVELOPMENT BANK

ASIAN FINANCIAL CRISIS

AN OVERVIEW AND MAJOR LESSONS FOR IDB MEMBER COUNTRIES

Occasional Paper(1)
Economic Policy & Strategic Planning Department
Jumad Thani, 1419H (October 1998)

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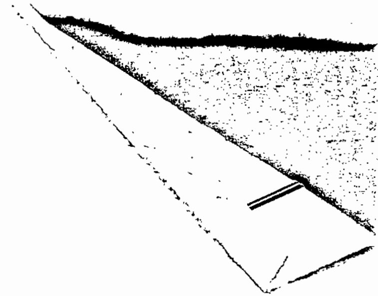

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FOREWORD

The Board of Executive Directors of the IDB suggested that the Bank considers preparing some occasional papers on selected current economic and financial issues facing member countries. The present paper entitled "Asian Financial Crisis : An Overview and Lessons for IDB Member Countries" is an attempt by an expert in the Economic Policy and Strategic Planning (EPSP) Department of the Bank to comply with that suggestion of the Board.

As indicated by the title, the paper tries to present an overview of [illegible]mensions of the crisis such as its nature, causes, impacts, and policy [illegible] to draw some lessons that could be helpful to member countries. [illegible]s areas where further efforts are required at national and [illegible]levels to safeguard member countries from such crises in the [illegible]ure.

While Dr. Faiz Mohammad, Section Head, Policy Planning, of the EPSP Department, has prepared the paper for the Bank, a number of experts and officials both inside and outside the Bank also made valuable contribution to its preparation. The Department is specially grateful to officials and experts at different ministries and institutions in Indonesia and Malaysia as well as at the Asian Development Bank for assisting the author in collecting data and exchanging views on the topic. Special thanks also go to those experts who prepared country experience papers on selected member countries that provided highly relevant background information for the paper. These experts include Dr. Anwar Nasution (Indonesia), Dr. Mohammad Ariff (Malaysia), Dr. Salman Syed Ali (Pakistan), and Dr. Suat Oksuz (Turkey).

Finally, thanks are due to members of the Economic Policy and Strategic Planning Department for their technical comments and observations and useful suggestions at all stages for completing the paper. This paper is a product of the technical staff and the judgements made herein do not necessarily reflect the views of the Islamic Development Bank and its Board of Executive Directors.

It is hoped that the findings and conclusions of the paper will be found useful by all interested in the subject in general and those in the IDB member countries in particular.

Muhammad Ahmad
Director
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Summary of Major Findings and Conclusions

0.1 As the financial crisis which hit the East Asian region about a year ago continues to unfold itself through adverse spillover effects on the global economy, there is a growing interest as well as need felt at the national and multilateral levels to understand its various dimensions. Accordingly, this paper is an attempt to leam about the nature and causes of the crisis and draw lessons that could be helpful to IDB member countries. The paper also identifies efforts that may be required at different levels to safeguard member countries from such crises in the future.

0.2 The paper first presents an overview of various dimensions of the crisis in general and then focuses specially on the experience of Indonesia and Malaysia. In order to see if there has been any impact of the crisis on member countries outside the East Asian region and to be able to compare development strategies in different countries, the paper also looks at the financial development experiences of Pakistan and Turkey. The two countries were selected as being among those IDB member countries that have a) relatively more developed financial markets, b) relatively higher shares of intra-trade in their total trade, and c), easier availability of the required data. Separate background documents were prepared on all the selected member countries. The paper is a synthesis of the information and ideas frorn the available literature, country experience (background) documents, and field visits to the affected IDB member countries.

0.3 The paper identifies three set of perspectives that have been used to explain the crisis. The first perspective which may be called the conventional perspective points to various national policy failure as among the major factors which led to the crisis in the region. The causes of the crisis which have been pointed out are: a) growing or high current account deficits coupled with pegged exchange rates, b) rapid increase in foreign capital inflows in general and that of portfolio investment in particular, leading to "bubble" in asset prices; c) excessive short-term foreign borrowing by the financial sector not always matched by the suitable asset-structure and risk coverage; d) institutional weaknesses and rigidities in the financial and corporate sectors to deal with sharp market fluctuations, e) problems of govemance both at the public and corporate levels; and f) moral hazards resulting from lack of transparency and failure of information. The second perspective recognizes the problems in the national policies but points out that the failures of

international capital market has played an equally important role in perpetuating the crisis. The third perspective considers the debt-based economic structure to be inherently unstable and finds excessive speculations in the international capital market to have further exacerbated instabilities.

0.4 The paper finds that the affected member countries are going to contract between 5-15% during 1998 but could experience turn-around by 1999. The social impact of the crisis is however more serious in countries like Indonesia and would require greater multilateral attention in the short-to-medium-run.

0.5 The paper does not find any major effect of the crisis on the economies of Pakistan and Turkey. Pakistan's trade with the region during 1997 went down by around 2 percentage points and, except for the end of 1997, there was no discernable impact of the crisis on the financial markets in Pakistan and Turkey.

Main Conclusions and Lessons for IDB Member Countries

0.6 The following main conclusions and lessons for IDB member countries emerge from the analyses in the paper:

0.6.1 It hardly needs to be emphasized that the economic and financial stability of a country depends primarily on the strength of its macroeconomic indicators, institutional capabilities, and suitable national policy responses to market changes. International efforts could play only a supportive role in this context.

0.6.2 Given the volume of international currency dealings and the so-called "hot money", it is however doubtful if the national efforts alone could guard the open developing economies from sharp market fluctuations. The process of development by nature dictates some degree of disequilibrium and the level of macroeconomic discipline usually prescribed but not easy to attain.

0.6.3 Countries targeting for high growth under open trade and investment policies must accord high priority to financial sector development and institutional capacity to deal with the sharp market fluctuations. High growth strategy is viable if based on sound economic strengthen rather than on popular sentiments.

0.6.4 Investment policies in member countries need to be used to direct the flows of foreign direct investment to promote real sector activities such as the development of infrastructure, agro-based activities, and the social sector.

0.6.5 Allowing the free convertibility of currencies and flow of capital are desirable long-run objectives. However, for most member countries, a more prudent approach would be to link liberalization of the capital account with the progress in trade and foreign exchange resources and the development of the financial sector.

0.6.6 The most fundamental step needed to start the process of integration with the global capital market is to have a strong and efficient financial and banking system.

0.6.7 Greater use of non-debt financial instruments could help in insulating the banks from financial shocks and minimizing the risk of future financial crises.

0.6.8 It is very important that some sectoral balance in the sources of growth is maintained even if it amounts to marginal adjustment in growth targets. Similarly, due emphasis should be placed on SMEs which depend on local material and have export potential to provide a more stable base for long-run economic growth.

0.6.9 In case an economy is hit by sharp economic fluctuations, or observes early signs of a crisis, it should not delay corrective measures.

0.6.10 Macroeconomic discipline needs to be made comprehensive including discipline at the sectoral level and, to the extent possible, at the enterprise level.

0.6.11 For effective external debt management, there is a need to maintain some balance between total debt liabilities (i.e. public and private both) and total foreign reserves.

0.6.12 In order to avoid the problem of moral hazards in the financial and corporate sectors, risk assessment and management need to be given central importance in the financing activities.

National and Multilateral Efforts Required to Avoid Financial Crises in Member Countries

0.7 The following major efforts are identified in the paper to avoid future financial crises in member countries:

0.7.1 Due to limitation on the national efforts in developing countries to achieve orderly inflows of foreign capital, some understanding at the international level may be required to influence the direction and composition of international capital and currency flows.

0.7.2 International cooperation through banking sector, financial intermediaries, and other suitable means is required to regulate the speculative behaviour. Similar cooperation is needed to check collusive behavior and other corporate malpractices in the international capital market.

0.7.3 There is need to consider the proposal to establish regional level stabilization funds with contributions from national and multilateral sources in IDB member countries. One of the objectives of such funds should be to promote capital market development in member countries.

0.7.4 Use of regional currencies wherever feasible in IDB member countries needs to be promoted while also enhancing the share of intra-trade among member countries.

0.7.5 Early Warning Systems (EWS) about financial developments in member countries may be established. Such systems could be created for different regions in member countries.

0.7.6 There is a need to create and strengthen the credit rating agencies at the OIC level with the purpose of promoting and facilitating intra-OIC investment.

0.7.7 The role of Islamic banks needs to be promoted to improve the long-run economic and financial stability in member countries.

0.7.8 The Asian financial crisis has created right psychological environment for greater acceptability of Islamic banking in member countries. National and multilateral efforts at the OIC level are therefore needed to promote such banking in member countries.

0.7.9 New Islamic modes of financing which could meet the requirement of a growing economy need to be developed.

0.7.10 Greater efforts are required to mobilize resources from Islamic financing and other institutions in IDB member countries to support the process of economic recovery in the economies affected by financial crisis.

0.7.11 The catalytic role of the IDB in supporting member countries facing financial difficulties could be further strengthened by greater cooperation among national and multilateral financing institutions in member countries.

0.7.12 Special attention needs to be paid to create enabling environment in IDB member countries to attract intra-investment.

0.7.13 Innovative ways need to be found to develop capital markets in member countries to avoid undue speculations and promote real sector growth. Trading norms and rules need to be designed accordingly.

Chapter One

INTRODUCTION AND BACKGROUND

1.1 The East Asian financial crisis, triggered by the devaluation of Thai baht in July 1997, is probably the most serious challenge the world economy has faced since the breakdown of the Bretton Woods system in the early 1970s. The crisis which was initially viewed by some as an opportunity rather than a problem[1] has already caused extensive damage to the economies of Indonesia, Malaysia, Philippines, South Korea, and Thailand, and prompted exchange rate depreciation in Singapore, Taiwan, China, and several other countries in the region. It also had adverse spillover effects on stock markets in Hong Kong and a number of other countries around the globe. Most recently, the crisis has aggravated the decline of Japanese economy and precipitated new spillover pressures in Latin America, Russia, and South Africa [25, 27].

1.2 What went wrong? How can one explain such a quick meltdown of some of the most vibrant economies which more than doubled their GDP per capita in a few years period through rapid growth coupled with structural changes in their manufacturing and trade bases and significant improvement in levels of human development, a phenomenon termed as East Asian Miracle?[2] What could be the major implications of this crisis for other countries in the region and the global economy, and what lessons, if any, could be learnt by other countries, particularly the emerging economies for which, in many respects, the East Asian economies were role models? How could the developing countries sustain a level of growth to be able to bridge the income gap vis-a-vis the developed countries without going through such instabilities ? These are some of the key questions which have seized the attention of thinkers and policy makers almost everywhere in the world. Although some attempts to explain these questions have already been made, the debate on them is expected to last beyond the Asian crisis itself.

1.3 While the debate is directly relevant to countries in the region and to other emerging economies, it is equally important to multilateral financing institutions like the IDB to be able to see how they could be more effective in assisting their member countries, particularly those facing the crisis. For

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1 Grenville [22, page2]

2 World Bank [54]

IDB, it has added significance as the Asian financial crisis has hit two of its relatively more developed member countries with adverse spillover effects on some other member countries. As an Islamic financing institution, dealing in real sector activities, it is also an occasion for the IDB to assess its role in the capital market development in member countries using non-interest based financial instruments. The Bank therefore conducted some in-house analyses[3] of the crisis about a year ago in order to arrive at certain initiatives to support the recovery efforts in Indonesia and Malaysia[4]. As part of those initiatives, the Bank also decided to prepare a more detailed study on the subject for the purpose of drawing lessons that could be helpful to member countries and to identify efforts that may be needed to safeguard member countries from such crises in the future. In order for the lessons to be more relevant to member countries, the study was expected to especially focus on Indonesia and Malaysia and also at the recent experience of some other IDB member countries against the backdrop of the Asian crisis. The current paper is an attempt in this direction.

Objectives of the Paper

1.4 The paper has three main objectives: 1) to present an overview of the nature and causes of the crisis as well as the overall difficulties ; 2) to identify the main lessons learnt from the crisis which could be helpful to IDB member countries; and 3) to identify the efforts required at different levels to safeguard member countries from such crises in the future.

Methodology and Data

1.5 Because of the global implications of the Asian financial crisis, a large body of literature has already been produced to explain its causes and consequences. This literature is unavoidable for any further work in this area. The paper therefore tries to evaluate the views expressed in the available literature in order to see their relevance to the IDB member countries. The paper also tries to develop alternative perspectives on the causes of the crisis and policy responses at different levels with a special focus on Indonesia and Malaysia.

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3 Fadlallah [20] and Islamic Development Bank [31,32] are among the early papers written at the IDB on the subject.

4 See Box 1.1 for the IDB efforts to achieve economic recovery in member countries in the region and assist some other member countries facing financial instabilities.

Box 1.1

Major Efforts of the Islamic Development Bank to Assist Member Countries Affected by the Asian Financial Crisis

Immediately after the financial crisis hit the East Asian region, the IDB has tried to find suitable ways within its means to assist its member countries affected by the crisis. Efforts made to this end have included arranging direct financial assistance on priority basis, creating financing facilities which could be especially used to promote investment in countries facing capital constraints due to the financial crisis, and participating in activities aimed at mobilizing resources for supporting economic recovery in these countries. Some of the specific efforts made by the IDB could be briefly stated below:

1. The IDB has pledged a package of US$ 500 million for both import financing and project assistance for Indonesia out of which US$ 280 million has already been sanctioned for the import of staple food, commodities, and medicines. The project aid pledged is going to be mainly on concessional terms. Moreover, as a token of solidarity by IDB and other Islamic banks, an additional financial package of US$ 100 million is being financed in order to provide investors to invest in Shariah-compatible equities in the Jakarta Stock Exchange.

2. As for Malaysia, the Bank has put in place a financial package of US$ 100 million to be invested largely in Shariah-compatible shares in Kuala Lumpur Stock Exchange. This is in addition to financing approved for Malaysia under other regular financing windows of the Bank.

3. The IDB has been well-aware of the problem facing Muslim Mindanao which could worsen due to the financial crisis in the region. The Bank has therefore already approved US$ 20 million grant to help build a part of the rural infrastructure and to promote income generating activities for the rural poor in Muslim Mindanao.

4. Recognizing the difficult financial situation facing some other member countries in the region, the IDB in collaboration with other Islamic financial institutions and commercial banks has established a Pakistan Fund of US$ 1.5 billion to enable the country to tide over its financial constraints.

5. The IDB has also supported efforts made to mobilize Islamic financing institutions under the auspices of International Islamic Forum for Science, Technology, and Human Resources Development (IIFTIHAR) to promote economic recovery in the affected IDB member countries.

1.6 In order to see if there has been any impact of the crisis on member countries outside the East Asian region and to be able to compare development strategies in different countries, the paper looks at the financial development experience of selected member countries. For this purpose, the countries were selected using three main criteria: a) countries having relatively more developed financial and capital markets, b) countries whose shares of intra-trade in their respective total trade are relatively large, and c) countries for which the required data were relatively easier to collect. Member countries such as Bangladesh, Egypt, Iran, Pakistan, Saudi Arabia, Turkey, and UAE all meet the above criteria. However, keeping in view the time and resource constraints, the paper focuses especially on Pakistan and Turkey only. Insight gained from their experience and from the nature of impact of the crisis on their economies is used to further strengthen the conclusions drawn from the case studies of Indonesia and Malaysia. To this end, separate country experience (background) documents were prepared on selected member countries by experts in respective countries.

1.7 The paper is therefore a synthesis of the data collected in-house, information and ideas taken from the available literature and the background documents, and views collected through field visits and is divided into six chapters. Chapter Two of the paper provides an overview of the crisis and evaluates its causes, impact, and policy responses in general. Chapter Three looks more closely at the significance of the crisis for Indonesia and Malaysia and compares their situations with other countries in the region which remained largely unaffected by the crisis. Chapter Four presents a resume of economic and financial developments in Pakistan and Turkey and some of the implications of the Asian crisis for these economies. Chapter Five discusses the main conclusions that could be drawn from the overview of various dimensions of the crisis and the lessons learnt that could be useful for IDB member countries. Efforts required at various levels to safeguard member countries from such crises have been identified in Chapter Six.

Chapter Two

AN OVERVIEW OF THE ASIAN FINANCIAL CRISIS

Key Features of the Economies Affected by the Crisis[5]

2.1 Before evaluating various aspects of the Asian financial crisis, a brief description of some of the key features of the affected economies namely Indonesia, South Korea (or Korea), Malaysia, Philippines, and Thailand is provided to serve as a background to the analysis that follows.

2.2 With the remarkable success of the Japanese experience of export-led industrial growth and socio-economic structural transformation in the sixties, there was a great deal of interest and desire in the region, and also in several other parts of the world, to follow the Japanese model. Accordingly, economies like South Korea, Taiwan, and Singapore were probably among the first to open their economies for foreign direct investment, undertake market reforms and expand their manufacturing bases for exports. Policies were also adopted to achieve greater human resources development, alleviation of poverty, and promote social progress. These policies paid handsome dividend as GDPs grew rapidly and in a matter of years, these economies attained the status of Newly Industrialized Economies (NIEs), with the industrial sector dominating production, trade, and employment structures. [30, 54].

2.3 In the cases of Malaysia, Thailand, and Indonesia, efforts to expand the manufacturing sectors gained greater momentum in the 1980s. Initially, foreign direct investment, mainly from Japan, played a major role in enhancing their manufacturing production but soon, investment from other industrial economies also became quite significant [50]. An important feature of these capital inflows was that they were largely (nearly 70% in the case of Malaysia during 1983-89 period) in the form of direct foreign investment or long-term credit [39].

2.4 During the early 1990s, the process of economic and financial reforms in these countries was further intensified. Philippines which so far has been less successful in attracting large foreign investment also undertook similar reforms. The main features of those reforms were: reduction of barriers to entry for financial institutions, deregulation of interest rates, relaxation of domestic credit

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5 The Asian Crisis has been a multidimensional phenomenon, affecting economic, social, political, and financial aspects of life in the affected countries. However, since the problems of the financial sectors are more widespread, it has been usually referred to as "financial crisis" in the literature, an expression retained in this paper too.

requirements, promotion of new financial instruments, and liberalization of capital accounts [30]. These measures, with varying degree, encouraged maintaining of foreign currency accounts by local and foreign residents in commercial banks, enabled banks to extend credit in foreign currencies in the domestic market, helped the private sector and banks to borrow directly from the international capital market, and made easier for foreigners to own shares of national listed companies, as well as invest in other national financial papers. The establishment of off-shore banks and their operations in the local and foreign financial and capital markets was also encouraged [30].

2.5 The objectives of these reforms was to fulfil the investment requirements of high growth targets and to benefit from the opportunities opened up by the globalization of capital. In some cases, they were also designed to allow a quantum jump in economic development in order for these countries to become fully developed economies within a targeted period[6].

2.6 Despite major market reforms, governments continued to play an important role in several areas. These included mainly the following:

(a) Credit and investment allocation to key sectors and projects;
(b) Keeping the exchange rate pegged to the US dollars; and
(c) Maintaining certain limits on the extent of foreign participation in the banking and some other areas of strategic priorities and national interest. However, compared to the previous practices in other developing countries, those restrictions could not be regarded as stringent.

Macroeconomic Performance in the Nineties

2.7 In most of these countries the momentum of growth which started in the eighties picked up further in the early 1990s. As a result, the average growth rate of the five affected economies was over 7% during 1991-95, compared to 6.5% for others, namely, China, Hong Kong, Singapore and Taiwan (Table 2.1). The affected economies also enjoyed high rates of national saving, (averaging around 34% of GDP compared to 32% for others). Most countries achieved export growth of over 10% during 1991-95, had moderate inflation rate (around 6%), some budget surpluses or insignificant deficits, and current account deficits averaging around 3% of GDP during the period. (Table 2.1 and Annex 1). The

6 The Malaysia "Vision 2020" Programme was essentially designed to achieve this target.

macroeconomic indicators however took some downtum starting 1996 but were still in healthy condition according to the standard criteria. Economic health became questionable with the onset of the financial crisis in the mid-1997 triggered by speculative attack on the currency and stock markets in the affected countries.

Nature and Evolution of the Crisis

2.8 Due to exports slowdown in several East Asian countries in 1996, and problems with current account deficits of countries like Malaysia and Thailand (although some concerns were expressed about the sustainability of growth and capital flows in those countries), it was rarely believed that there could be deep financial crisis in the region[7]. It was viewed that macro-economic indicators of those countries were strong enough to minimize the probability of any serious crisis [28].

2.9 The above optimistic view, however, could not prevail when Thailand devalued its currency by nearly 25% in July 1997, unleashing a chain reaction known as the "contagion effect". Initially perceived as a "political reaction based on adverse selection[8]", this reaction was probably caused by the increased investor weariness of "policy slippage" i.e. economic policies that work in the short or medium term but that lead eventually to the deterioration of long-run economic fundamentals. As a result, within a period of three months, besides the Baht which depreciated by nearly 40%, the Malaysian Ringgit and the Indonesian Rupiah lost over 20% of their values, and the Peso dropped by around 30% [8]. The Singapore dollar also depreciated, although the extent of its depreciation was relatively small (7.5%).

2.10 The currency crisis worsened particularly due to two important developments in the region: (1) The building of pressure on Korean Won in October 1997, and (2) Confusion over the implementation of reforms in Indonesia to overcome the problems associated with currency crisis. The Korean Won was reasonably stable until October 1997 when it started to depreciate. Its downward trend accelerated in mid-November 1997 and by mid-December, Korea allowed its currency to float freely [8]. As a result, by the end of December 1997, the Won depreciated by over 40% (Annex 2). This came as a major set-back to the region as Korea was one of the developed regional economies with sizeable trade and investment links with the region and the rest of the world.

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7 See UNCTAD [51] for early warning about the slowing of growth in the region.

8 See Ariff [7, page 12]. Adverse selection in this context may imply flight of capital from relatively less stable economic and financial environment in the affected countries to other countries offering more stable opportunities.

Table 2.1

Comparative Macroeconomic Indicators of Economies in East Asia

(Group Averages)

Items/Year		1991-95	1996	1997
GDP Growth (percent per annum)	Affected	7.3	7	4.4
	Others	6.5	5.7	6.5
Inflation rate (percent per annum)	Affected	6.1	5.8	5.1
	Others	4.9	3.7	2.5
Gross Domestic Saving/GDP (%)	Affected	33.9	33.3	32.8
	Others	31.8	31.5	31.3
Current Account Deficit/GDP (percent)	Affected	-3	-5	-3
	Others	4.1	4.9	4.2
Fiscal Balance/GDP (percent)	Affected	0.3	0.4	-0.2
	Others	-0.7	-2	1.4

Source: Lee, Rana [47], Affected Economies include: Indonesia, Korea, Malaysia, philippines and Thailand. Others include: China; Hong Kong; Singapore and Taiwan.

2.11 Although the Indonesian Rupiah had started depreciating since it was floated on August 14, 1997, its depreciation particularly picked up following the confusion over the implementation of reforms agreed under an IMF-led rescue package. The main sources of the confusion were a) initiative to mandate the Currency Board to manage the exchange rate which the IMF found unacceptable under its recovery package and b) the original 1998-99 budget estimates which were based on unrealistic exchange rates. As a result, there was some delay in receiving IMF funds under its recovery programme leading to depreciation of Rupiah by over 56% by the end of 1997. This trend further worsened in the following few months till Rupiah dropped to a record low level of 14,699 per one US dollar on June 15, 1998 (Annex 2). As regards other currencies, they recorded major depreciation between August to December 1997. The pace of depreciation however slowed down to some extent in the following months. The Korean Won and Thai Baht even recorded some turn-around between January to June 1998 (Annex 2).

From Currency to Stock Market Crisis

2.12 Due to doubts about the currency situation, stock markets in Korea and Thailand had been under pressure since the beginning of 1996 [8]. In the case of Malaysia and Philippines, however, the pressure began in early 1997 and became more serious after the on-set of currency crisis in July 1997. Investors in the region, particularly foreign investors had panicked due to sharp currency depreciation in the region and started to unload quickly their regional stocks

without much regard to the relative position of the individual markets. As a result, there were major set-backs in the stock markets of Malaysia and Thailand (losing around 55% during 1997), whereas the losses in Korea and Philippines were around 40%. (Annex 4). The Indonesian stocks remained less affected in the early phase of the crisis but with the sharp and continuous decline in Rupiah starting from the end of 1997 to June 1998, the trend was revised and the Indonesian stock suffered the worst loss in the region (losing around 75% till the middle of 1998).

2.13 The contagion effect of the currency crisis in the region spread to markets as far away as Latin America, Australia, and New Zealand. Within the region, the Singapore and Taiwanese dollars depreciated around 15% by December 30, 1997, and continued to slide further, albeit very slowly during 1998. Currency depreciation in India and Pakistan during the second half of 1997 and early 1998 were also associated to some extent with the currency crisis in the East Asian economies.

2.14 The only currency which remained unaffected despite repeated speculations was the Hong Kong dollar. This is attributed to the strong reserve position of the country which have been used to rescue the value of its currency. This is, however, not true for the values of its stocks which suffered sizeable losses during the last quarter of 1997 when the stock index dropped from 12,966 to around 9500 in the first week of October 1997 before recovering to 10,755 level on December 30, 1997. This, not only adversely affected the stock trends in Hong Kong and Indonesia during 1998 but the reverberations of this set-back were also felt in the major stock exchange centres throughout Europe, USA, and Japan. Some of these reverberations could be observed from the fact that during mid-1997 to mid-1998 stock markets in 9 out of 11 emerging economies shown in Annex 4, lost between 10% to 15% in their values. Losses in China and Russia were over 50% whereas in New Zealand around 23%. These markets have continued to slide further over the past three months also as the world leams more about various dimensions of the continuing crisis.

Liquidity Crisis

2.15 The fall in values of currencies and stocks prompted demand for the quick repatriation of short-term capital from several of these countries. However, the loan and asset structures of the banks and financial institutions which had borrowed short-term capital did not allow them quick recall of the required liquidity and also, after the depreciation of the currencies, private borrowers were not in a position to service their foreign currency debts. As a result, there was a liquidity crisis which worsened particularly with the quick

withdrawals of deposits from the banks by the local depositors for fear of bank defaults. This turned the liquidity crisis into a full-fledged financial crisis that first forced Thailand to seek IMF assistance which was provided under a $ 17.2 billion rescue programme. Indonesia and Korea also followed suit and concluded IMF-led international recovery programmes involving US$ 40 billion and US$ 58 billion, respectively.

Different Phases of the Crisis

2.16 An important feature of the Asian financial crisis is that it has moved into phases of optimism and pessimism. It escalated in the fourth quarter of 1997 particularly with Korea's foreign exchange crisis, worsened further due to confusion in Indonesia about implementing the IMF packages as noted above, then improved significantly in March 1998 after the international banks extended some $22 billion for settling short-term claims on its banks [27]. Since early May 1998, there has been a new phase of market pessimism and spillover of the crisis, precipitated by riots in Indonesia and growing evidence of the severity of the recession in the East Asian economies. The negative dynamics of this phase have been intensified by the decline of Japanese Yen and growing risk that China might be forced to devalue which may unleash a new round of competitive devaluations in the region. Recent devaluation of Russian Ruble and some currencies in Latin America has further fueled such pessimism which could mark a new phase in the continuation of crisis in Asia. The effect of this pessimism has already been felt by stock markets all over the world as noted above [Annex 4].

2.17 An important phase of this crisis is the growing concern about the adequacy of public funds to face such crises which are becoming far more frequent and serious in different parts of the world. These concerns have been prompted particularly due to the ineffectiveness of multi-billion dollar recovery package in Russia where currency and stock markets have suffered major losses over the past 3-4 months. Perpetuation of instabilities in Russia is sending shock waves to investors in all major capital centres in the world, but particularly in the USA and Europe with major sources of private and public capital flows to Russia. As a result, only in three weeks, from July 17 to August 11, 1998, the dollar-based stock market indices in USA and Europe on average fell by around 10% [27].

Evaluating the Underlying Causes of the Asian Crisis

2.18 There is a widespread support to the view that unlike some of the economic crises of the early 1990s in different parts of the world, the crisis in

Asia was not caused by the failure of macro-economic fundamentals.[9]. This is so because as noted earlier, most affected economies have had high national saving rates, low inflation rates, registered high growth till 1996, practically no fiscal deficit, and current account deficits (except in one or two cases) which were not as dangerously high compared to several other developing countries in the world (Annex 1). However, major differences in point of views exist about the exact nature of causes which could explain the crisis. Those views are discussed below under three types of perspectives[10] :

(a) The first perspective which may be termed as the conventional perspective as it has been commonly used to analyze the crisis points to various national policy failures and weaknesses in the financial and corporate sectors in managing the capital inflows with sufficient prudence and due diligence as among the major factors which led to the creation of crisis in the region. This perspective is usually supported by multilateral institutions such as the Asian Development Bank (ADB), International Monetary Fund (IMF) and the World Bank as reflected in their recovery packages agreed with some of the affected economies[11].

(b) The alternative perspectives recognize the problems in the national economic and financial management but point out that the failure of the international capital market has played an equally important role in triggering as well as perpetuating the Asian crisis. They therefore call for broader reforms covering the international capital markets and the national policy responses.

(c) One of the alternative perspectives considers debt-base economic structure to be inherently unstable and finds excessive speculation at the international level to have further exacerbated such instabilities. This perspective is close to the concept of Islamic banking and could also be used to explain different aspects of the Asian financial crisis.

(a) Conventional perspective

2.19 The 1997 Asian Development Outlook presents a synthesized view of the major causes of the Asian financial crisis from the conventional perspective [8]. Accordingly, major causes of the crisis can be grouped under five different headings:

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9 This view has been expressed in several writings on the subject, such as Akyus [2] Ariff [7], Malaysia [39] Moreno et al [40] and Rhee [49].

10 For references on various perspectives, see the relevant parts of the text below.

11 See Box 2.3 and Annex 8 for details of various IMF recovery packages.

i. Increase in current account deficit and appreciation of the exchange rate;
ii. Problems emanating from the rapid inflow of foreign capital;
iii. Financial sector weakness;
iv. Weakness in the corporate governance
v. Moral hazards and failure of information.

These points are briefly explained below using the latest available data.

i) <u>Increase in current account deficit and appreciation of the exchange rate</u>

2.20 It has been argued that due to growing current account deficits and appreciation of real exchange rates in most affected economies in the region, vulnerability of their currencies to speculative attack had increased over time. Malaysia and Thailand are particularly cited for prolonged and large (over 7% of GDP) current account deficits during 1991-95, which in the case of Thailand reached nearly 9% of GDP in 1996 (Annex 1). This had prompted several attacks on Thai Bath in the beginning of 1997 which were defended by the Bank of Thailand by depleting its reserves. However, with the growing difficulties in rolling-over the short-term debts owed to Japanese Banks in the mid-1997, Thailand was no more in a position to use its reserves to defend its pegged exchanged rate. The panic-stricken investors soon figured out that, to some extent. Other affected countries in the region suffered from similar current account difficulties which prompted a contagious reaction spill covering other currency and stock markets. The deterioration in the current account deficit occurred due to three main reasons: (1) Exports slow down for Thailand and Malaysia for some of the labour intensive goods such as garments and footwear; (2) decrease in the exports of semiconductors and other electronic goods produced in the region (by Korea in particular) due to cyclical decline in demand for these products; and (3) increase in imports (both for consumption and investment goods), because of appreciation of the real exchange rates.

ii) <u>Problems emanating from the inflow of private foreign capital</u>

2.21 The most crucial causes which have been held responsible for triggering as well as for perpetuating the crisis in the affected economies are rooted in the inflow of foreign capital. This is one problem where the affected economies shared lot of similarities which probably prompted the foreign investors to treat them as one region despite some major differences in their individual strengths and weaknesses.

2.22 The main features of the private capital flows to the affected economies observed from data presented in Tables 2.2 to 2.4 and Annex 5 to 8 are as follows:

2.22.1 First, there was a dramatic increase in the (net) private capital flows in all affected economies between 1990 and 1996[12]. Those flows as percentages of GDP went up, from 5.6 in 1990 to 10.1 in 1996 for Indonesia, from 0.8% to 5.9% for Korea, from 3.3% to 17.3% in Malaysia, from 2.4% to 9.3% in Philippines, and from 4.9% to 8.9% in Thailand. On cumulative basis, the total flows ranged between 17% and 68% of GDPs of these countries. Although, during 1997, a significant reversal took place in those flows, the debt overhang of the accumulated flows had already become very serious.

2.22.2 Second, there was a major change in the composition of the private capital flows. Prior to 1990, it was mostly in the form of foreign direct investment or long-term bank credit. By 1994-96, the share of portfolio investment increased from average 4% for 1982-90 to average 31% for 1994-96 (Annex 5). This was bound to increase the vulnerability and susceptibility of the economies to external influences as stock markets are usually the first to respond to change in the economy [20].

2.22.3 Third, between 60 and 75% of the private borrowing by the affected countries from foreign banks during 1991 to 1997 was short-term debt (Table 2.3). By June 1997, the share of this type of debt as percentage of foreign exchange earnings had reached 190 for Indonesia, 350 for South Korea, 75 for Malaysia, 85 for Philippines, and 180 for Thailand (Table 2.4). The inability of Indonesia, Korea and Thailand to serve their short-term debt could be clearly seen from these trends. Vulnerability on account of foreign liabilities of the banking sector had particularly increased in the cases of Malaysia, Philippines and Thailand during 1990 to 1996.

12 Due to heavy capital inflows in East Asia, Paul Krugman has been critical of the quality of growth in the region for quite sometime. He maintained that growth in most of these economies was input-driven mainly due to foreign capital inflows [37].

Table 2.2

Trends in Private Capital Flows in Asian Economies Affected by Asian Financial Crisis, 1990-1996, Selected Years.

Country Year	Net Capital flows US$ billion	As % of GDP
Indonesia		
1990	6.39	5.6
1994	6.87	3.9
1996	23.17	10.1
Cumulative till 1996	69.2	30.6
Korea		
1990	2.06	0.8
1994	9.82	2.6
1996	26.67	5.9
Cumulative till 1996	81.3	16.8
Malaysia		
1990	1.43	3.3
1994	8.13	11.2
1996	17.13	17.3
Cumulative till 1996	67.6	68.1
Philippine		
1990	1.06	2.4
1994	5.43	8.5
1996	7.76	9.3
Cumulative till 1996	22.72	27.1
Thailand		
1990	6.71	4.9
1994	5.43	3.7
1996	17.61	8.9
Cumulative till 1996	74.71	41.4

Source: Calculation based on data from Rana [47] and Malaysia [39]

Table 2.3

Short-Term Borrowing Asian Countries from Foreign Banks

Country	(in billion US$)	As percentage of: Total borrowing	As percentage of: Foreign Reserves	As percentage of: Gross Domestic Product
Indonesia				
1990	NA	NA	NA	NA
1994	18.8	61	177	11
1997	34.6	59	174	17
Korea				
1990	16.5	68	115	7
1994	34.9	73	165	9
1997	70.2	68	211	16
Malaysia				
1990	1.8	26	23	4
1994	8.2	59	26	11
1997	16.2	56	63	17
Philippines				
1990	3.1	34	342	7
1994	2.6	43	41	4
1997	8.3	59	86	10
Thailand				
1990	6,4	58	54	7
1994	27.1	74	101	19
1997	45.6	66	148	29
Taiwan				
1990	9.0	91	14	6
1994	17.1	93	19	7
1997	22.0	87	24	8

* From member countries of Bank of Settlement (BIS). Data relate to mid-point of each year.
Sources: Moreno et al [40]. Original data from BIS and IMF sources.

Table 2.4

Banking Sector External Exposure of Affected Economies in Asia

(Foreign Liabilities as % of Foreign Assets)

S. No	Country	1990	1996
1.	Indonesia	110	140
2.	South Korea	105	120
3.	Malaysia	120	225
4.	Philippines	70	160
5.	Thailand	200	700

Source: Rhee [49], Asian Development Bank

2.23 The surges in capital inflows in the affected economies took place because of four reasons: (a) weak growth in Japan and Europe in the early 1990s led to decline in interest rates as well as investment opportunities. Investors in those countries therefore started looking for investment opportunities abroad; (b) emergence of large institutional investors using pension and mutual funds, for buying securities in the emerging markets; (c) increase in investment opportunities in the East Asian economies after the financial liberalization in late 1980s and early 1990s; and (d) high interest-rate differentials available in most affected economies with little exchange risk created a sense of security among investors [8,30]. This, however, tumed out to be false as lack of hedging against currency risk seriously eroded the ability of the domestic borrowers to service their foreign debt. Even the government guarantees proved unhelpful due to severe liquidity constraints resulting from rapid outflow of foreign capital.

2.24 It has been pointed out that an important factor which contributed to accelerating the surges of capital inflows was the herd-like mentality of the foreign investors. Benerjee (9) and Krugman (33) point out that fund managers and investors do sometimes behave like sheep-herd in making investment decisions. They just follow the trend set by others without necessarily requiring full information as doing so is more safe rather than acting independently and being punished for making mistakes.

iii) <u>Financial Sector Weaknesses</u>

2.25 The upsurge of private foreign capital brought about three sets of imbalances in the banking sectors of the effected countries. First, there was a systematic increase in foreign liabilities of the commercial banks compared to

the values of their foreign assets (Table 2.4). Second, much of the collateral that the banking sector accepted for loan was estate and equities, assets whose prices contained a large "bubble" element [7,8,30,40]. Finally, there was a mismatch in the maturity structure of the bank assets and liabilities. The banks in general were borrowing short and lending long. These imbalances made the banking sectors critically vulnerable to any sudden economic change. Accordingly, if for some reason, confidence in the economy were to shatter or the capital flows were to be reversed, that would result in serious damages to the banking sector.

iv) Weakness in Corporate Governance

2.26 In almost all affected economies, the typical governance structure of private companies was based on family ownership of enterprize where extending guarantees to subsidiaries has been very common. This, coupled with company laws and the implicit government guarantee to rescue businesses in trouble, contributed to high-risk borrowing and risky investment behaviour. As a result, some private companies expanded their business to a large number of fields using borrowed funds. This was particularly noticed in the case of mega corporations (choibols) in Korea. With the over-extension of financing to risky projects, there was alarming increase in corporate vulnerabilities. Another major problem which is regarded as one of structural weakness of the corporate sector in some of these countries is the dependence of certain segments of the business community on government support and favour for contracts and credit. This environment, beside creating socio-economic problems, is one of the major bottlenecks which did not allow the corporate sector to become strong enough to absorb financial shocks [8, 40, 53]

v) Moral Hazards and Failure of Information

2.27 Moral hazard is a situation "when someone can reap the rewards from their actions when things go well but not suffer the full consequences when things go badly[13]." It is argued that problems of moral hazard have prevailed in several of the affected economies mainly in three forms: (a) creation of artificial interest rate differentials to encourage borrowing from abroad and lending at home at higher interest which encouraged investment in high risk projects, (b) extension of guarantees by the government and banks, apparently under collusive arrangements, and c) foreign borrowing by the private sector without

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13 Greenspan [21] and Grenville [22, page 6]

proper securitization and hedging. These factors created false sense of security among foreign investors who, after feeling that governments in the affected countries might not be in a position to honour all their guarantees, started pulling their capital in a panic. Lack of transparency and deliberate attempts to tamper with accounting and financial data of companies in some of these countries also created a credibility gap and contributed to the loss of foreign investors' confidence.

Timing of the Crisis

2.28 Within the conventional perspective, an attempt has also been made to explain why Asia did not experience crisis of this magnitude before while the problems cited above were there for quite sometime. Two possible reasons are offered to respond to this question: First, it is argued that there has been some financial sector problems in the past in the region but they remained disguised under the strength of rapid growth [40]. Examples of such crises include major bank insolvencies in Thailand during 1983-87. Similar insolvencies were experienced in Malaysia during 1985-87 and Indonesia in 1994. Some signs of serious difficulties in the corporate sector were also observed in Korea in 1997 which led to downgrading of the ranking of some banks by Moody's and Standard & Poors. Second, the countries in the region were much more integrated with the global financial markets in the 1990s than before. In this way, during the recent years, they became more prone to instabilities caused by fluctuations in the international capital market [40].

Alternative Perspectives on the Underlying Causes of the Crisis

i) Combined effect of major Causes

2.29 While explaining the nature and causes of the crisis, an interesting point has been made by Grenville when he argues that rather than any one particular factor, the Asian crisis, like some of the previous crises, was the result of a combination of certain factors [22]. In his view, the combination which proved deadly in the cases of East Asian economies was the volatile foreign capital flows and the fragile financial sector. In his view, therefore, measures need to be taken to reform both ends of the foreign capital, namely the recipient side and the supplier side. While stressing the need for greater prudence on the recipient side, he opines that capital suppliers should not expect market purity while dealing with countries where different institutions are yet to be developed further. He also supports the idea that the long term reforms must include prudential measures to discourage short-term capital and foreign currency exposures to insulate the banking sector.

ii) Problems of the International Capital Market Causing the Asian Crisis

2.30 There are at least four arguments developed to suggest that part of the problems which led to the financial crisis in Asia related to the behaviour of the international capital markets.

2.30.1 First, it is observed that the crisis in Thailand was triggered after the Japanese banks, due to their own problems, stopped rolling over the short-term debts of their partners in Thailand and Korea at a time when the former was trying to resist the pressure on currency [7]. This caused a major blow to the already weak financial condition in Thailand pushing it to devalue its currency.

2.30.2 Second, the sharp reversal of large amounts of foreign capital, due to an unprecedented[14] reaction of the investors to financial condition in the region, was something which hardly any country could have easily absorbed no matter how strong were its financial and institutional bases. In case of the affected economies, these outflows played a major role in deepening the crisis. This type of reactions also indicates the presence of market imperfections in the form of the global capital market as a few large investors could change the market condition [30].

2.30.3 Third, it is argued that part of the reason for excessive borrowing by the private sector in the East Asian economies was the easy availability of foreign capital which put little pressure on the borrowers to undertake prudential measures to avoid instabilities (1).

2.30.4 Fourth, a more fundamental question has been raised about the ability of the recipient countries to protect their economic fundamentals and adopt prudential measures when there is rapid increase in the inflow of foreign capital. The capital flows usually push greater credit creation which ultimately spills over from the financing of safe and productive investment to risky and speculative assets. This may push the growth process but at the same time lead to deterioration in the external balance due to increased demand for imports. On the other hand, if the government tries to continuously sterilize the capital flows, it could accumulate debt liabilities putting pressure on the budgetary position . The international capital market, therefore, cannot expect the local financial condition to remain stable if the supply of capital is not tuned to the economic and financial development in the recipient economies.

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14 It was unprecedented in the sense that never before a large number of countries in one region experienced such a quick outflow of capital in a short period of time.

iii) Islamic Banking and Finance Perspective

2.31 With the growing instabilities in the international capital market and due to severity of the Asian financial crisis and its implications for the global economy, the ideas expressed about instability of debt-based financing and about the role of excessive speculations in aggravating stock market instabilities also provides some explanation of the Asian crisis. According to this perspective the fundamental sources of instabilities in the world economy are threefold: a) Huge size of global debt which is maintained by further borrowing; 2) Speculation which has become similar to gambling facilitated by continuous dissemination of information about stocks and currencies through electronic media; and 3) the use of credit facility for dealing in stocks (see Box 2.1). These problems give rise to investment behaviour which is highly unstable and completely detached from the real growth of the economy. In the case of Asian economies it was quite visible that there was a rapid increase in portfolio investment whereas the real sector had started to slow down. This type of imbalance is likely to be common due to excessive focus of the international information system on the financial markets rather than on the real side of the economy. This, when coupled with excessive credit growth to finance less productive sectors such as properties and speculative stock trading , created conditions which could not withstand any fluctuations in the economy.

2.32 Such problems however would have been far less serious in an equity-based banking and financial system. Under this system, deposit-holders are like shareholders and are not guaranteed the nominal values of their deposits. Therefore, changes in real values of the bank liabilities due to currency depreciation or other factors automatically adjusted in the asset side of the balance sheet. As a result, the banks do not face any imbalance in the real values of their assets and liabilities, a common problem under the debt-based system and a major source of financial instabilities (see Box 2.2).

2.33 When placed with in the Islamic Financing framework, the equity-based banking system would also promote the real transactions and would not finance speculative activities. Under this financial arrangement, foreign capital flows would promote economic growth without creating any serious macro-level imbalance between assets and liabilities.

Box 2.1

Maurice Alais on Potential Instability of the World Economy

- "The World economy as a whole rests today on gigantic pyramids of debts, buttressed one against another in a fragile equilibrium. Never in the past had such a colossal accumulation of promises to pay been witnessed. Undoubtedly, never will it be so difficult to master."

- "Be it speculation on currencies or speculation on stocks and shares, the world has become one big casino with gaming tables distributed along every latitude and longitude. The game and the bids, in which millions of players take part, never cease. The American quotations are followed by those from Tokyo and Hong Kong, from London, Frankfurt and Paris. Everywhere speculation is supported by credit since one can buy without paying and sell without owning."

- "The credit mechanism as it operates today and which is based on a partial coverage of deposits, on ex nihilo creation of money, and on the long term lending of funds borrowed on short term, in effect considerably amplifies economic disorders. In fact all the major crises of the ninteen and twentieth centuries have been due to an excessive growth of credit, of promises to pay and of their monetization, and to the speculation generated and enabled by this growth. Both in the case of exchange rates and in that of share prices there arises more often than not a gap between the data of the economy in real terms and the nominal prices determined by speculation. Frenzied and feverish speculation is everywhere enabled, fuelled and amplified by the credit as it operates today. Never in the past had it attained such a magnitude."

- "It is paradoxical that speculation, which basically should have a useful and stabilizing influence if it operated within an appropriate institutional framework, has become fundamentally destabilizing and consequently harmful in the present institutional framework. Indeed the responsibility for the disorders we see does not lie with the speculators themselves, but with the present institutional framework, which is totally inappropriate."

Source: Maurice Alais [3].

Box 2.2

Mohsin Khan on the Suitability of Islamic Banking to Resist Shocks

Mohsin Khan in his seminal article entitled "Islamic Interest Free Banking: A Theoretical Analysis", takes the view that "the replacement of interest by some type of profit-sharing arrangement makes the Islamic system an equity-based system, as opposed to a traditional interest-based system. Using this concept of equity participation, he develops a simple theoritical model to examine the working of the Islamic banking system. He shows that the Islamic system may well turn out to be better suited than the interest-based banking system to adjust to shocks that can lead to banking crises. In an equity-based system, shocks to the asset positions of banks are immediately absorbed by changes in the nominal values of shares (deposits) held by the public in banks. Therefore, the real values of assets and liabilities would be equal at all points in time. In the traditional banking system, since the nominal value of deposits is guaranteed, such shocks can cause a divergency between real assets and real liabilities, and it is not clear how this disequilibrium would be corrected and how long the process of adjustment would take. On the basis of the analysis, the paper yields the important insight that from an economic standpoint the principal difference between the Islamic and traditional banking systems is not that one allows interest payments and the other does not.The more relevant distinction is that the Islamic system treats deposits as shares and accordingly does not guarantee their nominal value, whereas in the traditional system such deposits are guaranteed either by the banks or by the government."

Source: Khan and Mirakhor [33, pp. xi – xii]

Impacts and Policy Responses

Impacts

2.34 Among the major impact of the crisis is the sharp decline in capital flows to the affected economies which, according to one estimate, turned from net inflows of US$ 93 billion in 1996 to net outflow of US$ 12 billion in 1997 [8, 27]. Capital flows from commercial banks have also followed the same trend, declining from positive US$ 56 billion in 1996 to negative US$ 21 billion in 1997. The outflow on account of portfolio investment was also quite sharp, standing at US$ 12 billion till March 1998 compared to inflow of US$ 12 billion a year before. There has been enormous increase in non-performing loans and problems relating to capital adequacy of financial institutions. According to an early estimate, rates of non-performing loans vary between 10-35 percent in affected countries. The financial crisis has posed a serious liquidity problem for enterprises due to which a large number of enterprises are facing bankruptcy. This problem has been more serious in South Korea where according to one estimate around 30,000 small and medium enterprises are likely to go bankrupt. However, such problems are not confined to Korea only. Thailand and Indonesia also face this problem but more seriously in the large formal sectoral. Liquidity crunch has seriously eroded the productive activities and the export potential in these economies.

2.35 There has been dramatic increase in interest rate in all these countries (in some case as part of the IMF programme[15]) in order to discourage credit expansion and achieve exchange rate stability. However, as it will be discussed further in the case of Indonesia, this policy has accentuated the problems of the real sector.

2.36 As regards GDP growth, the effect of the crisis was not fully accounted for during the end of 1997. As a result the early estimates indicated only small downward adjustments in the growth rates. However with the prolonging of the crisis, growth figures present a very depressing picture of these economies. Recent estimates show that in the fiscal year ending July 1998, Indonesia's economy contracted by 14 percent, Malaysia's 6-7 per cent , and South Korea's and Thailand's economies shrank by 7 percent and 8 percent, respectively. Growth estimates in dollar terms present even gloomier picture of some of the affected economies in 1998. According to these estimates, all the economies

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15 *See Annex 8 for macroeconomic targets for different affected countries under the IMF-Recovery Programmes.*

posted negative growth during 1997 which, during 1997-98, could be as worse as about 70%. For others, the forecast for 1998 are negative growth rates between 20 and 30%. The effect of reduction in economic growth will vary among different segments of society (Table 2.5).

2.37 What is however already well-established is that unemployment and the incidence of poverty in countries like Indonesia and Thailand have already assumed alarming proportions, going up to 50% or more in both of them. Food security, health and education sectors have also suffered due to resource constraints. (Some further information about the impact of the crisis on social dimension and other aspects of the economy is presented in Chapter Three where the country experiences of Indonesia and Malaysia are discussed).

2.38 Some estimates of the impact on trade have also been made at the International Institute of Finance (IIF). According to those estimates, one time impact of the crisis was expected to be an increase in the trade balance of the seven East Asian economies by US$ 100 billion to US$ 150 billion. On the other hand, the crisis is expected to leave negative impact on GDP growth in other parts of the world which for 1998 is estimated to be as follows: 0.6 percent in the EU, 0.7 percent in the USA, and 1.4 percent in Japan [25].

Policy Responses

2.39 Among the major policy responses, with or without IMF package, have been: tight monetary policy using high interest rates; maintaining tight fiscal policy in general with some relaxation for providing social safety nets; major reduction or postponement in public sector investments to restructure foreign and domestic loans, undertaking financial sector reforms, streamlining and strengthening prudential regulation and bankruptcy laws and efforts to improve corporate governance for ensuring transparency, greater efficiency and competitiveness. These responses are elaborated when we study the cases of Indonesia and Malaysia in subsequent chapters. Key features of the recovery measures planned or undertaken by different countries with or without IMF-support are summarized in Box 2.3.

2.40 Despite efforts made at different levels, economic recovery has still eluded most of the affected countries. On the contrary, some of them have gone into deeper recession as indicated by the sharp contraction of GDP growth reported above. Therefore questions are being asked whether the policies adopted under rescue package led by the multilateral institutions were overly

contractionary and inadvertently pushed the economies into deeper recession[16]. In some cases, departure from contracting monetary and fiscal policies have also been observed to achieve economic recovery. Malaysia represents the most important example of this trend which is elaborated further in Chapter Three along with other specific aspects of the Malaysian experience of the Asian financial crisis.

Table 2.5

Gross Domestic Product Forecasts for Asia

Country	1996-97 Change (%)	1997-98 Change (%)	1998-98 Change (%)
Indonesia	-11	-69.7	+34.4
S. Korea	-10.5	-35.5	-1.8
Malaysia	-2.0	-29.2	0.0
Philippines	-2.5	-21.2	0.0
Thailand	-15.2	27.6	+6.2
Hong Kong	+4.9	0.0	+2.9
China	+9.3	+4.2	+4.3

Source: Newsweek, August 27, 1998. forecasts by Bloomberg, Bear Sterns, Consensus of Private Forecasts

16 See World Bank [55]

Box 2.3

Key Features of Major Recovery Measures Palnned or Undertaken With Or Without IMF Support in Selected East Asian Economies[17]

1. Financial Sector Reforms

* Closure of insolvent financial institutions, with their assets transferred to a resolution or restructuring agency (Korea, Indonesia and Thailand) together with recapitalization and mergers of others (all countries) including Malaysia but not under IMF sponsorship.
* Announcement of limited use of public funds for bank restructuring and actual funds used made explicit in the budget (all countries).
* Measures to significantly strengthen prudential regulations, including loan classification and provisioning requirements, capital adequacy standards (all countries).
* Measures to strengthen disclosure, accounting and auditing standards, and the legal and supervisory frameworks (all countries).
* Liberalization of foreign investment in ownership/management of banks (Korea, Indonesia and Thailand).
* The introduction of more stringent conditions for official liquidity support (Indonesia, Malaysia and Thailand) . In Malaysia, without IMF sponsorship).
* Strengthen prudential regulation on loan exposures (Korea, Malaysia and the Philippines).
* Introduce funded deposit insurance scheme (planned in Indonesia and Thailand; under consideration in Malaysia; already in place in Korea and the Philippines).

2. Competition and Governance Policies

* Liberalize restrictive marketing arrangements for a variety of key commodities (Indonesia).
* Establish competitive procedures for privatization of government assets and for procurement (Indonesia, Malaysia, and Thailand).
* Announcement of limited use of public funds to bail-out private corporations (all countries except the Philippines).

.../...

17 The Philippines already implementing an IMF-supported programme before the crisis. For Indonesia, Korea and Thailand, programmes were prepared between August-December 1997. Malaysia is not under the IMF programme but has been in contact with the Fund on these matters. Countries to which different measures are applicable have been identified in brackets.

* Introduce/strengthen bankruptcy laws and exit policies (Indonesia, Korea and Thailand).
* Accelerate privatization and closure of non-viable public enterprises (Indonesia).
* Strengthen corporate disclosure standards (Korea).
* Liberalization of foreign investment in ownership/management in sectors other than the financial sector (Korea, Indonesia, Malaysia and Thailand).

3. Trade Reforms

* Reduce import tariffs and export taxes (Indonesia).
* Ease quantitative import and/or export restrictions (Indonesia and Korea).

4. Social Sector Policies

* Labor-intensive public works programmes (Indonesia, Thailand), and expansion of unemployment insurance system (Korea).
    - Protect low-income groups from the rise in the prices of food and other essentials (Indonesia, Philippines, Malaysia).

.../

Source: Kochhar et. al [35].

Chapter Three

CASE STUDIES OF INDONESIA AND MALAYSIA

3.1 Despite sharing some common features which might have caused the financial crisis in the region, the affected economies are quite distinct in their levels of development, growth experience, production structures, levels of indebtedness etc. These distinctions could also be gauged by reactions of their markets to the financial crisis, the nature of impact felt, and types of policies adopted to overcome the crisis. Therefore a closer look at each of these economies could provide better understanding of the crisis and the lessons to be learnt from it. Here, two cases of Indonesia and Malaysia are selected for this purpose as they are member countries of the IDB.

The Case of Indonesia

3.2 With the on-set of the currency crisis in July 1997, initial view in some quarters was that in terms of economic fundamentals, Indonesia was relatively better placed and hence it should remain less affected. This view was based on the following resources: (1) unlike Thailand and Malaysia, the current account deficit of Indonesia was not very high (between 2 and 5% of GDP over the past 3 years); 2) compared to other regional currencies, Indonesia had allowed a wider band within which rupiah was allowed to move, thus causing less serious problems of currency appreciation, and 3) its export growth had not suffered as severe setback as did by those of Thailand and South Korea, and (4) no fiscal deficits (on the contrary it had small budget surplus between 1993-96). However, soon after the contagions hit the economy, it turned out that Indonesia was probably the most vulnerable and fragile economy in the whole region. The result is that not only its currency and stocks have depreciated by large proportions, it is facing some of the most difficult economic financial, social, and political challenges.

3.3 In quantitative terms, besides sharp decrease in the value of its currency and stocks, there has been a huge increase in the average inter-bank call money rate which, during January - March 1998, went up to over 57% (compared to around 12% a year ago). The GDP growth rate dropped from 7.8% in 1996 to 5% in 1997 and it is estimated to be negative 10-15% during 1998 [55][18] The open unemployment rate increased from 4.9% in 1996 to 7.5%

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18 Also see Annex Table 3.1 and Annex 9

in 1997 whereas the inflation rate jumped from around 5% in 1996 to over 34% in 1997 [41].

Table 3.1
Latest position of Key Economic and Financial Indicators
Of Indonesia and Malaysia*

Indicators	Indonesia	Malaysia
GDP Gorwth (%)	-6.2(Q1)	-6.8 (Q2)
Industrial Production Growth (%)	10.7 (Q3)	-6.0 (June)
Consumer Prices % change	+81.2 (August)	+5.8 (July)
Trade Balance (US$ billion)	+19.2 (June)	+6.4(June)
Current Account (US$ billion)	-2.1 (Q1)	-4.8 (1997)
Foreign Resources (US$ billion)	18.0 (June)	19.7 (May)
Foreign Resources a year ago (1997) (US$ billion)	20.3	26.3
Short Term Interest Rates (%) per Annum	57.7	7.68

Source: The Economist, September 12, 1998 *Data relate to 1998 unless mentioned otherwise.

Explaining the Crisis in Indonesia

3.4 It is widely viewed that like other affected economies, the initial shock to Indonesian economy came from the regional contagions discussed above. However the spread and extent to which the crisis engulfed the financial and corporate sectors indicate that the economy suffered from some structural economic, financial, and political problems resulting from growth strategy, policy slippages, and unsustainable exposure to global capital market.

3.5 A brief description of those problems and the way they specifically affected the
Indonesian economy is given below.

3.5.1 Unrealistic pace of economic and financial liberalization: Although economic financial liberalization was considered essential to promote private sector development and attract foreign investment, the pace and the extent to which Indonesia undertook such liberalization was not found consistent with its

institutional capacity and level of development. Besides allowing free currency exchange and foreign currency deposits, Indonesia removed all restrictions on foreign equity ownership to allow 100 percent ownership in most industries. Restrictions on foreign investors' participation in domestic stock market were also removed and foreign banks were permitted to establish joint ventures with domestic banks. Since 1992, domestic firms have been permitted to list up to 30% of their equity on foreign stock exchange. All these policy changes had far-reaching implications on the capital account and the financial sector which contributed in deepening the crisis in the country [30,40].

3.5.2 Artificial Growth and Stability Performance: The low rate of inflation, high growth of GDP and that of the non-oil exports which were often quoted as indicators of sound economic fundamentals were largely artificial [41]. The government used to pay expensive subsidies to control prices of state vended products in order to keep inflation rate low. This could have been justified as a short-run policy to attain stability but to prolong it over decades could not be done without creating serious market distortions and misallocation of resources. As regard to high growth of GDP during 1998, it was mostly associated with the "bubble" industries, including construction, public utilities, services etc. Most of the growth took place in sectors such as electronics, sports shoes, textiles and garments which had least dependence on domestic inputs and were associated with firms from East Asia (mainly Japan, South Korea, and Taiwan). Industries using domestic resources such as palm oil and wood products faced numerous constraints including quotas (See Annex 11 for shares of various sectors in GDP in Indonesia).

3.5.3 Exchange Rate Appreciation and Increase in the Current Account Deficit: Although Indonesia had allowed some flexibility in its exchange rate, the rupiah continued to appreciate reaching about 10% level by the first quarter of 1997 [41]. The exchange rate appreciation reduced the competitiveness of its exports which were already under pressure due to general slow down in the regional trade. As a result, there was a jump in the current account deficit as percentage of GDP during 1996 and 1997 from 2.4% to 3.3%.

3.5.4 Excessive Growth in the Stock of Debt: As a macro indicator, the stock of foreign debt of Indonesia had reached to alarming levels by world standards. In 1996 its total external debt reached to US$131.4 billion (from US$ 66.9 billion in 1990)[19]. As a result, its debt-service ratio increased from 30% in 1990 to 34% in 1996. Of this, nearly 55% was short-term debt with average maturity of

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19 See Annex 9

1.5 year [41]. In addition, there was short-term debt of US$ 15 billion denominated in local currency. This structure of private debt liability when placed against the foreign reserves of the country which stood at around US$ 20 billion in the beginning of 1997 was bound to raise concems about is capability to meet its foreign liabilities. In relative term, Indonesian short-term debt was 1.9 times the foreign reserves as compared to 0.75 for Malaysia and around 1.8 for Thailand[20].

3.5.5 Banking Crisis: The banking crisis in Indonesia evolved, to same extent, in the some manner as it did in other countries, particularly Thailand. The banks which had given implicit guarantee from the central bank that they would not be allowed to fail attracted large short-term foreign capital which was on-lent for long term uses without due regard to commercial risk. The bank credit on average grew between 20 and 30 per annum during the past five years (Annex 10). For the private banks, this rate was as high as 42% in some years which bore no relationship to the GDP growth which was around 8% per annum during the same period. Among several problems, one of the obvious consequences of excessive credit expansion was a big increase in the Incremental Capital Output Ratio, (ICOR), a measure of capital intensity and to some extent efficiency of capital use. This ratio went up from 3.1 in 1988-92 to 4.2 in 1992-97. In this situation, a sharp currency depreciation led to many fold increase in local cost of foreign debt since most of this debt was not hedged and the size of the bank liabilities was large.

3.5.6 Problems Relating to Govemance: Problems associated with the govemance of the banking sector and the corporate sector are also considered among the major causes of the financial crisis in Indonesia. Due to these problems, the process of economic growth was not accompanied by promotion of entrepreneurship with widespread roots. The corporate sector which was nurtured in this environment could not therefore survive on its own strength and efficiency after the country was hit by the financial crisis.

3.5.7 The Political Uncertainties: The currency crisis hit Indonesia at a time when there were some political uncertainties associated with Presidential election in 1997. The govemment response to the currency crisis was therefore somewhat delayed. This caused a delay in the flow of funds from IMF which had brokered an intemationally sponsored recovery package of US$ 43 billion for Indonesia in October 1997 [24,41].

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20 See Table 2.4 in Chapter Two above

3.5.8 Natural Factors: Indonesia suffered one of the worst El-Nino drought of this century around the same period when it was hit by the currency crisis. The effect of El-Nino was to postpone planting of rice, delay the next cropping season, and lower yields. As a result , total rice production in 1997 fell by 4%. Large areas of the country were affected not only by irregular rain but also by smoke and haze generated by forest fires [53].

Policy Responses

3.6 The initial policy response in Indonesia was to defend the moving exchange rate band system by expanding it from 8% to 12%. This was supported by tight monetary policy and efforts to mop up excess liquidity which also included shifting of public sector deposits to Bank Indonesia. Although these measures slowed down the depreciation of rupiah to some extent, they resulted in about four times increase in interest rates and a liquidity crisis for the banks and the real sector. The government cut down 244 public sector related projects worth US$ 37 billion and sought IMF led assistance to recapitalize the financial sector. However, it could not implement the other provision, of the IMF package as required which resulted in suspension of the IMF funds and a revised agreement with the IMF on January 15, 1998. In between, the Rupiah depreciated very heavily (reaching to Rp 13500 per US dollar till January 15, 1998) which tempted the government to try with the idea of currency board system which was strongly opposed by the IMF [41].

3.7 Currently, the major policy changes under implementation are those agreed under the IMF economic reform programme which include a financial commitment of about US$ 43.0 billion consisting of US$ 10 billion from the IMF, US$ 4.5 billion from the World Bank, and US$ 3.5 billion from the Asian Development Bank. The rest is from second line sources and US$ 5 billion from Indonesian own sources. Beside the financial package the main provisions of the IMF reform programme cover the following areas [see Annex 8 and Box 2.3 also]:

3.7.1 Macro-economic policies including monetary and fiscal policies: The key features of the reform here are strengthening prudential regulations and to undertake austerity measures, including lowering subsidies on fuel and electricity generally, raising Bank of Indonesia certificate (SBI) discount rate, and undertaking measures to tighten credit and monetary expansion to targeted levels, and allowing full autonomy to the central bank (Bank of Indonesia).

3.7.2 Financial Sector Restructuring: This includes liquidations of 16 non-viable banks including some of the state banks, enhancing minimum capital

requirement for banks, and undertaking a host of other measures to reform the financial sector. An important feature of the financial restraints was the creation of Indonesia Bank Restructuring Agency (IBRA). This agency will act as lender of the last resort for the banks as well as improve the guarantee system and banking restructure process. The IBRA will draw its funds from the Ministry of Finance and be responsible to the same for its activities. The financial reforms also include abolishing the restrictions on the opening of foreign bank branches and removing 49% limit on foreign investors in listed companies except that in the banking sector [41,53].

3.7.3 Structural Reforms in the Real Sector: These cover reforms in foreign trade and investment, reduction in various tariffs, and removal of restrictions on foreign investment in palm oil plantation and retail trade.

3.7.4 Social Safety nets: These include maintaining government budget expenditures on health and education, increased support for low income people, credit for small scale enterprises, and promotion of labor intensive projects.

3.8 In order to solve the problem of private debt, an agreement between the government, private sector of Indonesia and the structuring committee of foreign lenders was reached in Frankfurt, Germany, in June, 1998, to set up an institution to be called the Indonesian Debt Restructuring Agency (INDRA). The INDRA will provide exchange rate risk protection and assurance to the availability of foreign exchange to private debt or that agree with their creditors to restructure their external debt for period of eight years with three years of grace during which no principal will be payable [For details of this agreement see Annex 19].

Challenges Ahead

3.9 The IMF programme stipulates growth, inflation, and some monitoring and fiscal balance targets for Indonesia for the year 1998. A list of targets for Indonesia is presented along with those for some other countries in Annex 8 and projections. In reality, however, the country faces numerous challenges in achieving those targets. Contrary to initially estimated growth in GDP, the latest estimates and projections by various agencies show the economy to contract by 10-15% during 1998, 5-10% during 1999, and may stop sliding by the year 2000 [55]. Political uncertainties associated with the presidential elections scheduled for December 1999 coupled with very high interest rates and other tight monetary measures are not allowing quick recovery. The current base lending rate is around 60% , which is way beyond the reach of most enterprises. Inflation rate is estimated around 80%, which has drastically reduced the

purchasing power causing the absolute poverty to reach beyond 50%. With the contraction of the economy, open unemployment is also anticipated to be well above the level estimated in the beginning of the year.

3.10 There are however, encouraging signs on four accounts: 1) current account balance has improved, thanks to relatively greater decrease in imports than the exports; 2) exchange rate has shown some sign of stabilizing around RP 10000 per US dollar; 3) small and medium enterprises not dependent on imported material have shown tendency and prospects of renewed growth; and 4) Islamic banks have remained relatively unscathed from the financial crisis and their resilience has been recognized by the central bank. Under the new Bank Indonesia regulations, they will be treated at par with other banks for providing "lender of the last resort" facility.

The Case of Malaysia

3.11 Malaysia was also initially hit by the regional contagion. At the early stage of the crisis, foreign analysts and international fund managers had placed Malaysia in the same category with the other countries in the region. The currencies and stock markets were very closely coupled with those of neighboring countries although there was no clear reason why this should have been so as Malaysia had relatively stronger economic financial position and political stability which could have helped the country to tide over market fluctuations if they were not caused by quick outflow of capital.

Malaysia Prior to the Crisis

3.12 There were many favourable features of the Malaysian economy prior to the crisis in 1997. During the five year leading up to 1996, its real GDP growth averaged 8.7 per cent per annum, inflation was around 3.8 per cent, and the unemployment rate for 1996 was only 2.5 per cent. Unlike some other East Asian economies with high external debt, it had external debt of US$ 43 billion with debt service ratio at only 6.1 per cent of exports, compared to 34 per cent for Indonesia [Annexes 9, 14]. The banking sector was also apparently quite healthy, with non-performing loans (NPLs) at only 3.6 per cent of total loans in June 1997. The saving rate at 38.5 per cent in 1996 was one of the highest in the region. Micro level inefficiencies similar to those in neighboring countries were also not as widespread in the Malaysian economy. However, with currency crisis in the neighboring countries, the ringgit was also viewed being over-valued and came under speculative attack.

Causes for Concern

3.13 There were however, some disturbing signs before the crisis which had caused concerns among the investors. Those are listed below:

3.13.1 It is viewed that the economy has been consistently growing above what is deemed as its potential growth path since 1991. This generated price pressures, especially in the form of wage increases above productivity gains. Growth during this period was primarily input driven rather than efficiency-driven. The Incremental Capital Output ratio (ICOR) rose from 3.0 in 1988 to 6.5 in 1997 because of high level of the capital stock accumulation [39].

3.13.2 Despite having one of the highest saving rates in the world, Malaysia ran into current account deficit problem because of its high investment rate [Annex 13]. The investment boom led to the current account deficit and when coupled with the declining efficiency in capital utilization, became a legitimate cause of concern.

3.13.3 Since 1995, total loans had been growing at a rapid pace[21]. The monthly total loans growth (year-on-year) was around 28-30 per cent in 1997. For most of 1997, loans to the property sector were growing above 30 per cent and amounted to 26 per cent of total loans. Loans for the purchase of stock and shares during 1993-97 grew at an average rate of 35 per cent per year. Following the rapid expansion of credit, private domestic debt escalated in the past few years [7,39].

Currency and Stock Market Crisis in Malaysia

3.14 Malaysia's decade-long growth record came to an abrupt halt with the depreciation of the ringgit. The fall of the Thai baht raised concerns about the resilience of the exchange rate arrangements in the region. Initially, Malaysia tried to defend the ringgit but this strategy proved costly, and the ringgit was allowed to depreciate, from RM2.50 to RM2.61 per US dollar and gradually to RM3.00 on September 2, 1997. It sank to an all time low level of RM4.88 on January 7, 1998, before recovering along with the regional stock markets. Following poor local corporate performance and negative developments in Japan, the ringgit weakened and was trading around RM 4.2 before the government announced the adoption of fixed exchange rate on September 1, 1998 and fixed the US dollar exchange rate at RM 3.8 [7 and Annex 2].

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21 See Tables 2.2 and 2.3 in Chapter Two.

3.15 The turbulence at the Kuala Lumpur Stock Exchange (KLSE) was closely tied to the ringgit depreciation. Although the KLSE started declining in the early part of 1997, the fall grew in earnest after Thailand announced the floatation of the baht. In order to prevent currency speculation, in early August 1997, Bank Negara imposed a US$2 million limit on outstanding non-commercial related ringgit offer-side swap transactions with any single foreign customer [39]. However, this and other measures adopted later failed to stop market panic and the KLSE composite index plunged from 1271 in February 25, 1997 to 477 point on 12 January 1988, with a loss of about 63 per cent. The KLSE composite index recovered briefly around March 1998 but gradually slided to 467 on 7, July 1998. By the third week of August, the KLSE index had become as low as 285, before recovering to 390 on September 9, 1998 [Annex 3].

Effects of the Crisis

3.16 Currency movements have varying implications on competitiveness and external trade, and investment. Because of the ringgit depreciation, Malaysia's competitiveness has been enhanced after taking into account a combination of the currencies of Malaysia trading and correcting for inflation among the countries. Malaysia's real effective exchange rate has declined starting from July 1997 [39].

3.17 The currency depreciation has generally helped improving the balance in the current account. With cheaper ringgit, exports grew faster (by 0.5% in dollar term in 1997) than imports (increased by 0.2 in 1997) which has helped to reduce the size of the current account deficit (39 and Annex 14).

3.18 On the other hand, palm oil price is quoted in US dollars and had risen significantly from RM1,215 per tonne in June 1997 to RM2,366 per tone in April 1998 with strong world demand for vegetable oils and the export ban on palm oil by Indonesia. Some of the other impacts of worsening exchange rates include the following:

3.18.1 Increase in domestic prices as a result of rising costs of imported intermediate goods. This would also cause real household income and real wages to fall.

3.18.2 Proportionate increase in the value of external exposure as it is denominated in foreign currencies. At the end of April 1998, the Federal Government's external debts amounted to RM11.3 billion which under the old exchange rate would have been RM8 billion [39].

3.18.3 Deceleration in the growth of domestic private investments as a result of exchange rate uncertainties, low business confidence, and credit crunch.

3.18.4 The GDP growth rate which was anticipated to be around zero per cent in 1998 is now forecast to be negative 6-7%. This has put increasing pressure on the policy makers to accelerate policy reforms to bring about economic recovery.

Policy Responses

3.19 Initially, Malaysia was less pessimistic about the extent of its financial turbulence. Hence, it took some time to come up with the required response. Nevertheless, in its budget for 1998, a number of fiscal and monetary measures were suggested to cut public expenditure including those on mega projects, limit monetary expansion and strengthen accounting standards. Several other measures were announced to tighten credit expansion. This also included, among others, increase in Bank Negara three-month intervention rate from 10% to 11%. Financial institutions were required to prepare and report their aggregate states on non-performing loans (NPLs) and financial soundness [7,39]. Malaysia, however, did not apply for any IMF assistance to achieve economic recovery. *Instead, it injected its pension funds worth RM $ 37 billion to support the* key stocks and recapitalize the financial sector. At the same time, it adopted a number of measures to reform the banking sector which in spirit were similar to those adopted in other countries under IMF Programme [7,39].

<u>Other Financial and Fiscal Adjustments</u>

3.20 The government till the middle of August 1998 has tried to maintain a tight monetary policy as part of an economic policy reform package. Accordingly, the broad money (M3) growth was targeted at 12 per cent with a view to achieve 2-3% GDP growth and inflation rate of 7-10%. However, the economy slowed down excessively during the first month of 1998 and it was feared to contract by 6-7%. This has prompted the government to ease the monetary policy and allow interest rate to come down by 50 basis points on August 1998 [12]. Earlier on, the government was encouraged by the reserve position which improved during the second quarter of 1998. It has encouraged the public expenditure to increase for areas such as: a) vital construction projects which can be implemented in collaboration with the private sector, b) health, education, and housing (in the low and middle categories for which there is still demand and where debt recovery rate is quite satisfactory), and c) social safety nets which involve generating gainful activities. In the area of corporate reform, the government is overseeing a merger programme for finance

companies which would see the consolidation of 39 finance institutions into 8 [39].

3.21 Given that the main problem that banks and finance companies are grappling with is the growing size of its non-performing loans (NPLs), the govemment has recently proposed the setting up of an Asset Management Company (AMC) that will buy up banks' NPLs and manage them. Later, when the economy picks up, the AMC is aimed at reviving still-viable assets and allowing banks to focus on their daily operations, both of which the govemment hopes would assist in the economic recovery need of about RM 25 billion to acquire the troubled loans and assets in the banking system. To kick-off the scheme, approximately RM 10 billion of the financing for the AMC will come from the issuance of bonds locally and abroad [7,12].

Promoting Regional Responses

3.22 Malaysia has also been quite active in promoting regional responses to overcome the current crises and prevent the recurrence of such crisis in the future. The initiatives taken in this regard include 1) Promoting the use of regional currencies rather than the US dollar for settling regional trade payments, 2) promoting intra-regional trade, 3) and establishing a regional early warning system. This will be established at the ASEAN headquarters with the technical assistance from the Asian Development Bank under "Manila Framework" agreed by the ASEAN Foreign Ministers in Manila, Philippines in November 1997 [7].

3.23 For the promotion of regional currencies, Bilateral Payments Arrangement (BPA) has been proposed by the ASEAN Central banks and agreed to also under the Manila Framework. This remains still to be implemented at the regional level, though Egypt and Sudan have already signed BPA with Malaysia. Since intra-ASEAN trade has relatively less "trade-creation" potentials, Malaysia has pursued quite actively markets in other regions including IDB member countries [7].

Challenges and Prospects

3.24 Despite being in relatively strong financial position among the affected economies, recovery in Malaysia continues to remain uncertain. This was particularly signalled by GDP growth performance of the first two quarters of 1998 in which it was estimated to have actually contracted by 6-7 percent on annualized basis. The second serious problem was the exchange rate deterioration as ringgit, before the recent adoption of the fixed exchange rate,

continued to slide. As a result, the investor confidence in the stock market in particular showed no sign of turn around. The Kuala Lumpur Stock Exchange fell dramatically from over 400 in July 1998 to 285 points in the last week of August 1998. The financial and corporate sectors have also not shown any significant recovery mainly due to liquidity constraints. Foreign private capital is still keeping away from the region which also affects Malaysia. For the international financial community, structural financial and corporate reforms are necessary in all countries in the region including Malaysia. And unless significant improvement in governance in these sectors is achieved and foreign investment is provided equal access in all sectors including banking and finance, it might be difficult to enhance the private capital inflows into these economies. As a result, the economies like Malaysia which did not receive any IMF - sponsored financial assistance have the challenging task of adjustment without significant increase in the capital inflows. The additional challenges to be met in this process are the inflation and unemployment which have continued to increase as a result of contraction in the economy after the crisis.

Recent Measures and Major Policy Changes to Achieve Economic Recovery

3.25 On September 1, 1998, the government announced a new policy to regulate currency transactions and capital flows. Accordingly, trading in ringgit outside Malaysia has been banned by freezing country's external accounts i.e. pool of ringgit owned by foreigners including currency dealers and stock market investors. Transfer from such accounts to resident accounts was to be made by September 30, 1998, after which government approval will be required to transfer money from such funds. Similarly, all purchases and sales of ringgit financial assets would be allowed through authorized depository institutions. There would be limits on transfer of ringgit and foreign currencies to and from Malaysia. Similarly, foreign traders would settle their transactions in foreign currencies only.

3.26 These measures, when combined with relaxation in monetary and fiscal policies, indicate a major departure from the early policy which aimed at slowing aggregate demand. However, looking at the recessionary trends in the economy, it has been found more prudent to inject money into the banking system with a view to boost aggregate demand and reinvigorate the real sector. As a result , credit availability is going to increase and public expenditures in selected sectors such as those mentioned above are likely to increase. The government by freeing itself from exchange fluctuations would like to concentrate more now on reviving the economy by less tight monetary and fiscal measures. The government has taken these measures probably because the

prolonged contraction of the economy under previous policies would have been socially very costly and taken longer period for recovery. This could be evidenced from the experience of Thailand and Indonesia. Even in Korea, strict corporate reforms and fiscal controls have been relaxed to deal with labour unions indicating that strict compliance with tight fiscal controls as required by the IMF programme may be difficult to implement. Malaysia of course has taken a different route which aims to rehabilitate the productive activities without waiting for major structural reforms. The inherent risks in this approach are: 1) further decrease in foreign capital inflows, 2) compounding of market inefficiencies, 3) Increased inflationary pressures , and 4) uncertainties about export growth and growing pressures on the current account deficits.

3.27 In the short-run, these policies could, however, prove beneficial by bringing about financial stability, reversing the recessionary trends, and avoiding undesirable social implications. The key test of these policies will be the extent to which it can win the investors confidence and help create conducive business conditions within a changed political environment.

Analysis of Reasons why Taiwan, Singapore, and Hong Kong were less Vulnerable to the Economic Crisis[22]

3.28 Much has been discussed and many reasons proposed as to why countries like Indonesia, Thailand, South Korea, and Malaysia have been vulnerable to the financial crisis. Less attention though has been paid to analyzing the factors that have made countries like Taiwan, Singapore, and Hong Kong less susceptible to the contagion effect. Logic tells us that if a set of factors have made the former group of countries weak, then surely it is the opposite of these factors that have made the latter group of countries strong. Evidence suggests that this hypothesis is true to a certain extent. Below are some of the more salient factors that have made these countries more resilient in weathering the economic storm.

1. Huge International Reserves

3.29 Taiwan, Singapore, and Hong Kong have relatively large international reserves which were used to successfully defend their currencies at the onset of the crisis. Taiwan's international reserves in 1996 was around US$ 94 billion, Singapore had nearly US$ 77 billion, while Hong Kong had at its disposal around

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22 This Section draws heavily on the information and ideas from the Background Document prepared by Ariff [7] for the IDB.

US$ 64 billion. The relatively low population, high growth rates, and relatively developed nature of these countries have enabled them to apportion large percentages of their GDP into building up their reserves. It is also apparent that this measure has been part of a conscious effort on the part of these countries to have a defence mechanism in the case of emergencies such as this. No doubt this strategy is part of a larger security strategy that these countries have in place given the rather precarious geographic, social, and political position that these countries share. Large current account surpluses are also a factor that these countries have in common, with Singapore enjoying a surplus of over US$ 14 billion, Taiwan US$ 10.5 billion, and Hong Kong over US$ 9 billion. Besides signalling strong economic fundamentals, these surpluses were important factors because they allowed the govemments of these three countries to have some leeway to respond to the crisis in a way that did not induce widespread panic.

2. **More Mature, Liberal Financial System**

3.30 Taiwan, Hong Kong, and Singapore are well known as regional financial centres and have been so for a number of years. It is viewed that the reason, Taiwan is economically strong lies in the sequence of the economic reforms that it has implemented since the country's birth in 1949. Theoretically, economic liberalization should begin with the promise of price stability and a balanced budget. Trade liberalization should then be emphasized, only then followed by capital liberalization. In addition, domestic financial liberalization should come before international capital liberalization. In examining the Taiwan experience at least, it was found that Taiwan had closely followed the above-mentioned sequence of economic reform over the years.

3.31 All the affected economies opened their capital account without strengthening their financial institutions and corporate sectors. They also had weak prudential arrangements and institutional capability to deal with economic shocks. On the other, hand economies like Taiwan, Hong Kong, and Singapore made it a practice to have more open and transparent financial and economic systems. This enabled the latter group of countries to withstand sharp fluctuations in the international capital market.

3. **Productivity Driven**

3.32 The growth of Southeast countries hit by the crisis was primarily driven by new investment, and not increase in productivity. However, the growth in Taiwan, Hong Kong and Singapore have more or less been driven by productivity increases. These countries have all reached a point in their

economic growth where they can no longer depend solely on increases in labour and capital investment to fuel further growth. Instead, they have to focus on total factor productivity (TFP), that is getting qualitative improvements from its use of labor and capital or making smarter use of labour and capital resources and encouraging innovations to achieve greater output per unit of input. By being aware of this and implementing the necessary policies, the governments have been able to refrain to a certain extent from excessive external borrowing, and excessive reliance on migrant labour -- both key factors in the fall of Thailand and Malaysia. In 1996, Taiwan's investment financing saw a net outflow of NT$ 282.6 billion, and Singapore a net outflow of S$ 19943.8 million.

4. **Emphasis on Research and Development (R&D) and Skills and Training**

3.33 Singapore and Taiwan especially have invested much time and funds into research and development programmes, the former spent 1.12 percent of its GDP in 1994 on this account. By emphasizing research and development and providing attractive incentives for local companies to engage in such activities, the respective govemments are also creating a conducive and competitive environment to encourage knowledge intensive and innovation-based activities. This in tum encouraged large multi-nationals and corporations, especially those involved in high-tech industries to invest in Singapore and Taiwan. These investments are usually long-term in nature.

5. **High Growth Without Persistent Imbalances**

3.34 Compared to most of the affected economies, an important distinguishing feature of the economies not affected by the Asian crises has been the absence of persistent macro or sectoral disequilibria (imbalances). While following high growth strategies, these countries have been relatively more prompt in correcting such imbalances which made them less susceptible to financial instabilities. On the other hand, most affected economies tried to follow high growth strategies by staying in states of disequilibria. This was probably justified on the ground that too much concern about such imbalances would not allow those countries to target for high growth levels required to bridge the development gap between them and the developed countries.

Chapter Four

FINANCIAL DEVELOPMENTS IN SELECTED MEMBER COUNTRIES

Although it might take some time before the implications of the Asian crisis on IDB member countries could be adequately assessed, a preliminary attempt to this end has been made here by studying the financial developments in Pakistan and Turkey. These countries like several other IDB member countries followed liberal economic policies over the past several years, encouraged inflows of foreign capital, and have relatively active stock and currency markets. Therefore, it might be useful to look at their experiences of financial and capital developments to be able to evaluate the lessons to be leamt from the Asian financial crisis.

The Case of Pakistan[23]

4.1 Pakistan is a low income country agro-based economy. It experienced a brief period of accelerated growth (including that of the manufacturing sector) in the sixties. In the seventies, its growth remained subdued due to nationalization of large manufacturing activities. The decade of the 1980s was a retum to the free market the pace of liberalization of the financial and capital market picked up significantly in the 1990s when free exchange of currencies and foreign currency accounts were allowed. Foreign investors were also allowed to invest in almost all fields under various incentives. This encouraged direct investment in various sectors particularly in the energy sector. Foreign portfolio investment flows also increased in the early 1990s [Table

4.2 However, due to continuous depreciation of the Pakistan currency (rupee) over the past four years, this trend has been reversed. Recent trends in the stock prices whereby the index at the Karachi Stock Exchange went down from over 25200 about three years ago to less than 900 in August 1998 has caused a major blow to foreign portfolio investment [Table 4.2]. This situation is quite similar to the Asian crisis. While an obvious factor responsible for deterioration in the currency and stock values in Pakistan is the economic sanctions imposed by G-7 countries and uncertainties about the IMF assistance under Extended Structural Adjustment Facility (ESAF), it is also being linked to the financial instability in the region due to the Asian financial crisis.

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23 This section draws heavily on information and ideas from the Background Paper prepared by Ali [4] for the IDB.

4.3 One of major problems facing the country, however, is its large extemal debt. Due to persistent budget deficits and current account imbalances, Pakistan have been borrowing quite heavily during the past two decades in particular. As a result, its total extemal debt which was less than US$ 10 billion in the early 1980s reached around US$ 35 billion in 1998 [Annex 15]. The intemal debt is also of the same magnitude. The external debt servicing in 1997 was about 28% of the export earnings (compared to 34% for Indonesia and 6% for Malaysia). The entire development budget of the country is financed by internal and extemal borrowing.

Table 4.1

Net Foreign Investment in Pakistan

(1984-85 to 1996-97, Selected years)

Year	Direct Investment	Portfolio Investment	Total
1984 – 85	70	23	93
(%)	(75.3)	(24.7)	(100)
1990-91	237	99	336
(%)	(70.5)	(29.5)	(100)
1994-95	444	1280	1724
(%)	(25.8)	(74.2)	(100)
1995-96	1102	159	1261
(%)	(87.4)	(12.6)	(100)
1996-97	684	378	1062
(%)	(64.4)	(35.6)	(100)
1997-98*	413.8	197.9	611.7
(%)	(67.6)	(32.4)	(100)

*For July 1997 to February 1998

Source: Based on data from State Bank of Pakistan, Annual Report, Various Issues

Table 4.2

Profile of Karachi Stock Exchange, Pakistan

End June	1992	1995	1996	1997	Up to March 1998
New Companies Listed	98	65	38	14	2
Fund Mobilized (Rs. Billion)	21.2	37.8	20.8	15.5	1.5
Listed Capital (Rs. Billion)	58.2	134.4	202.7	208.8	210.3
Turnover of shares (in million)	955	2229	52100	8095	11438
KSE 100 Index	1244	1497	1340	1753	1553
Daily Turnover of shares (million)	3.3	13.9	29.4	56.1	62.5
Aggregate Market Capitalization (Rs. Billion)	203.8	293.3	368.2	469.2	427.1

*This stood at around 890 in mid-August 1998

Source: Salman Ali [4] Original data from Karachi Stock Exchange

4.4 It is however viewed that although the rupee has depreciated by around 30% during the past three months, the overall economic activities in Pakistan have not been affected as dramatically as is the case in the affected Asian economies. In 1998, the GDP growth in Pakistan is projected to be around 5 percent with inflation at 10% and the base lending rate staying around 15% [Annex 15].

Financial Sector Development

4.5 Starting from a very insignificant position at the birth of Pakistan, the financial sector has grown substantially over the last 50 years. Efforts of both public and private sectors contributed to its development. In the post liberalization period, the State Bank of Pakistan (SBP) has been given more autonomy in conducing monetary policy. In conducing monetary policy, the SBP has shifted from direct instruments (such as sectoral credit allocations) to indirect instruments of monetary control (such as market operations). The thrust of liberalization program is to encourage private capital inflows, reduce budget deficits thereby improving the capacity of the economy to meet its international payment obligations.

4.6 The most recent institutional changes in the financial sector have increased the relative importance of the capital markets. The share of stock market in fund mobilization has considerably increased since 1990s. For

instance, its share which stood at less than 5% in 1990 increased to 19.1% in 1994-95 partly because of foreign capital inflows. The share of the banking sector however has continued to be still high [Annex 16].

Stability / Fragility of the Financial Sector

4.7 The following features could highlight the stability of the financial sector in Pakistan:

4.7.1 The financial sector in Pakistan is dominated by higher growth of banking sector relative to the growth of long-term investment institutions like capital and securities market. Due to constrained role of capital market, the commercial banks in Pakistan are concurrently playing dual roles of short and long term financing. Although two more stock markets in addition to Karachi Stock Exchange have been functioning, their role in mobilizing savings is significantly smaller than the banking sector.

4.7.2 The performance of Pakistan's financial sector in terms of improvements in regulation informant, and timely utilization of credit has been weak due to its internal weaknesses. For example, large amounts of foreign sanctioned loans remain with the lending agencies for long time. In 1996-97 the amount of outstanding foreign loans sanctioned to Pakistan was US$ 31,729 million of which US$ 23,145 million was disbursed while the amount that remained undisbursed was US$ 8,584 million, which is a substantial proportion of the total [4].

4.7.3 A large amount of loans issued since 1980s have turned out to be bad debt. The total amount of stuck up loans of Rs. 1 million and above was Rs. 113.2 billion at the end June 1996 which increased to Rs.143.47 billion by December 31, 1997. This was about 18% of the total advances [4]. Financial institutions in Pakistan are, therefore, exposed to greater portfolio risk because of the concentrated structure of the loan portfolio..

4.7.4 Pakistan's financial sector is also exposed to growing foreign exchange risk. The external exposure of the banking sector measured in terms of foreign liabilities as percentage of foreign assets has risen over time and stood at 218 in 1996 which is similar to many countries affected by Asian financial crisis. A major portion such liabilities was however, borrowed by the government from foreign currency account to overcome its current account deficits [4].

4.7.5 The central bank is in the process of restoring credibility and sound functioning of the financial sector. However, difficulties are still being encountered in liberalizing the stock market and in the privatization of the state-owned financial institutions.

Hindrances to Financial Sector Development

4.8 Some of the hindrances to growth of the financial sector and its stability are as follows [4]:

4.8.1 High rate of inflation has contributed to a negative real rate of return on deposits which usually have been negative 4-5 percent.

4.8.2 Excessive use of non-bank sources to borrow money for budgetary financing by giving very high rates of return ranging from 12% to 30%. This has segmented the financial markets and is a source of financial disintermediation.

4.8.3 The spread between the borrowing and the lending rates of banks is high. For example, weighted average rate of return on deposits was 6.8% in June 1997, while the weighted average return on advances for the same period was 14.55%.

4.8.4 The ratio of advances to deposits of banking sector has declined from 70% in 1991 to 59% in 1996 due to slow growth in investment.

4.8.5 Excessive dollarization of the economy due to lack of confidence in the exchange rate has discouraged investment in the real sector. It also affects the banking sector in the form of less demand for loans and / or increased risk characteristic of the banks' portfolios.

Implications of Asian Crisis for Pakistan

Effect on the Real Sector

4.9 The repercussions of this crisis on Pakistan's real sector can come from three channels: i) direct channel through trade with affected South East Asian countries; ii) indirect channel through trade with countries that have been influenced adversely due to the greater links with those countries e.g. Japan, and iii) dynamic channel through changing terms of trade of Pakistan with rest of the world brought about by massive depreciation of currencies of the crisis hit economies.

4.10 Looking at the trade statistics, we find that on average 13% of Pakistan exports during 1993-94 and 1996-97 were directed towards Asian, South Korean, and Japanese markets. Of this, about half went to Japan. The import side reflects more integration of Pakistan with the region as during the said period, 22% of Pakistan's imports came from this area. During 1996-97, some decrease in trade with the region was noticed as percentage of its exports dropped to 11.2% and that of imports to 18.5% [Annex 17].

Financial Sector

4.11 The implications of the Asian crisis on Pakistan's financial sector depend on the linkages between their banking and capital markets. As regards commercial banking sector, no significant private sector borrowing and lending relationships other than trade credit exist. Therefore, no impact can be expected from this side. Some positive effect was expected on the stock market as studies showed initially some positive effect on the Karachi Stock Exchange stocks. This trend, however, changed due to instability in the exchange rate in the aftermath of the nuclear test related sanctions by the G-7 countries.

Foreign Capital Inflows

4.12 As regards inflow of foreign investment, some increase was observed in this account after the Asian crisis. During the eight month period between July 1997 to February 1998, foreign private investment to the tune of US$ 611.7 million came into the country (which is 13% increase from last year during the same months). Out of this, US$ 413.8 million consisted of Foreign Direct Investment (an increase of 8% from comparable period last year) and US$ 197.9 million portfolio investment (an increase of 25.4% from the comparable period last year). The highest amount of portfolio investment in Pakistan during the crisis period came from Hong Kong which was US$ 174.0 million during July 1997 to February 1998.

External Borrowing

4.13 Another implication of this crisis for Pakistan's economy is for the external borrowing by the government. After the decline in concessional long-term loans from multilateral donor agencies, government was increasingly resorting to short-term borrowing from the international market to service its existing loans. After the East Asian financial crisis, the government may find it even more costly to raise funds from the foreign capital markets because of two reasons: i) large amount of loanable funds of the multilateral donor agencies have been absorbed in the efforts to bail-out the troubled economies of East

Asia, which further reduce the possibility of obtaining loans at concessional rates. ii) the private investors and institutions now perceive the whole Asian region as risky without bothering to look into details of individual economies. Therefore the majority is reluctant to provide any money and those which do will demand higher risk premium.

The Case of Turkey[24]

4.14 Turkey embarked on a process of industrialization within the framework of five-year development plans and pursued a protectionist policy stressing import-substitution over the course of the 1960s and 1970s. The first two five-year development plans (1963-1972) set targets for industrial growth to be achieved through heavy dose of capital formation by both private and public sectors and regulated trade. The exchange rate was fixed with multiple rates applicable. With the two development plans, Turkey entered the 1970s with high growth, low inflation rate, and a healthy balance of payments. In the second half of the 1970s, the economy began to falter and suffered from severe internal and external imbalances. The situation further aggravated in the 1980 due to heavy public borrowing and inflation and the efforts to recover the economy proved no success, as resource gap widened and shortages developed, while negative interest rates undermined the flow of financial funds and intermediation. Relatively more mature and dynamic, the Turkish economy was to be seen to experience boom-and-bust cycles in the subsequent decades, in spite of a more liberalized and more market-oriented economy.

Macroeconomic Performance and the Financial Crisis in the 1990s

4.15 The task facing the new government on the economic side was formidable, with inflation running at almost 70%, and a heavy and growing debt burden. Although committed to continue the free-market economic policies, it was not in a position to devise and implement the structural adjustment or an austerity programme. During the years 1990-93, growth rate fluctuated reaching peak 9.4% in 1990, to a low of 0.4% in 1991, while the annual rate of inflation chronically stayed at 60-70% [43].

4.16 Inflationary pressures stemming from deficit financing, loose monetary policy and laxity of fiscal policy, and worsening of the external balance culminated in yet another crisis situation at the beginning of the

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24 This section draws heavily on information and ideas from the Background Documents prepared by Oksuz [43] for the IDB.

1994. The financial crisis of 1994 was a real internal shock for the Turkish economy. In fact, Turkey survived a similar if not worse crisis than the one recently experienced in Asia. Growing twin deficits, and deficit financing with heavy reliance on the central bank resources gave rise to a heavy currency substitution against the depreciating lira, which intensified after a downgrading on credit-rating. It was a correct reading by the markets that budgetary position and the resulting monetary situation had became unsustainable. The financial crisis in early 1994 came after, without any coincidence, as the public sector borrowing rate stayed above 10% of GDP during the previous three consecutive years. Loss of confidence exposed itself in the money market, with domestic currency not being able to perform the function of store of value. The lira was devalued 14% against the US dollar on 26 January 1994, which did not reverse the capital outflow. As the Central Bank continued to soak the market with liquidity, currency substitution and hence the lira depreciation continued and the overnight real interest rates rose above 200% level. Excess demand for foreign exchange could not be eliminated as outflow and run from the lira continued, despite astronomically high interest rates. Foreign exchange reserves which stood at $ 6.2 billion by the end of 1993 fell to $ 3.2 billion in March 1994. The crisis brewed in the financial sector, and then spreading to the real sector, led to the collapse of three private banks [43, 57].

4.17 The country was forced to launch a stabilization programme on April 5,1994, which was supported with a 14-month stand-by agreement with the IMF. The programme incorporated fiscal and monetary measures, including a devaluation of the lira. It sought to increase public revenues through higher tax revenues and restrain public expenditures. Yet, despite the announcement of various fiscal and monetary measures in response to the crisis, the exchange market was still not settled; the lira-dollar exchange rate, which was 25.032 on April 5 touched TL 40.000 / $ 1 on April 7 [43]. However, the implementation of the measures led over time to some positive results; as far as inflation and the balance of payments is concerned. Within a short period of time, the rate of inflation assumed a declining trend and the current account balance improved as a result of growth in exports and slackening demand for imports. But, the real sector had severely contracted causing the growth to come to a stop. It was in 1995 and 1996 that the economy could recover and come back to the sustainable growth pace.

Development of the Financial System

4.18 The financial system in Turkey is organized around four major institutions: 1) Central Bank, 2) Commercial banks; 3) Special Finance Houses,

and 4) Stock Exchange. Among these, nearly 55% of the financial assets in 1996 were held by the banks, about 20% by stock market and 19% by the Central Bank [Tables 4.2 and 4.3]. The Turkish Central bank (TCMB) is an independent institution having control over monetary policy. In reality however, its role has been dominated by marketing of government papers (bonds and Treasury bills). This has eroded its influence in many respects as the public debt accumulated influence the interest rate, exchange rate, and price stability.

Table 4.2

Total Financial in Turkey, 1986-97 Selected Years

(TL Trillion)

S. No.	Assets	1986	1990	1994	1997
1.	Total Deposits	13.2	85.5	1104.5	6963.9
2.	Fixed Deposits	1.7	19.7	541.0	3332.6
3.	Public Securities	4.2	41.4	698.9	4421.0
4.	Private Stocks/Securities	1.1	16.1	130.8	571.9
5.	Financial Assets/GNP (%)	34.0	32.0	46.4	30.9
6.	Money Supply (M2) as % of GNP	23.8	18.0	16.2	10.4

Source: Suat Oksuz [43]
Original data from Turkish Central Bank and Under Secretariat of Treasury, Government of Turkey
TL: Turkish lira

Table 4.3

Aggregate Assets of Turkey's Financial Intermediaries (1992-96)

(TL billion)

	1992	1993	1994	1995	1996
TCMB	186,391	290,127	757,584	1.486,928	2.997,996
Banks	532,300	1.027,108	1.928,152	3.954,802	8.611,237
SFH	7,882	16,886	41,777	84,960	198,433
Insurance Com.	9,000	19,121	41,059	83,510	194,597
Financial Leasing	7,415	20,148	45,891	105,787	233,528
Stock Market*	182,239	374,335	753,749	1.508,758	3.220,875

* values of securities at the Istanbul Stock Exchange.

Source: Adopted from Oksuz [43]. Original data from Undesecretariat of Treasury, Main Indicators of the Turkish Financial System, December 1996; TCMB; Creative Yayincilik, Turkiye Finans Yilligi, 1996 ve 1997, Istanbul

4.19 Major monetary indicators of the past few years indicate that exchange rate, interest rate and other major monetary variables were closely associated with the government borrowing. In 1994, when Turkey faced a crisis similar to Asian currency crisis, there was a big increase in the short term borrowing by the public sector. This was preceded by three other major developments: 1) About 15% increase in the total credit of the central bank in two years (1991-1993), 2) Almost three times increase in the foreign exchange liabilities of the central bank (from TL 14534 trillion to TL 46555 trillion), and 3) An increase of nearly 300% in the private debt (from US$ 2.2 billion to US$ 6.0 billion). The net effect of all of these factors was a drop in the value of the Turkish Lira by nearly 60% in one year (between 1993-1994). This development to some extent was similar to the situation faced by some of the countries affected by the Asian financial crisis [43, 57].

4.20 It is however interesting to note that despite massive decrease in the exchange rate, inflow of foreign loan continued to increase. This has been attributed to very big interest rate margin offered by the Treasury Bills [Annex 19]. Since exchange rate depreciation has lagged behind the interest rate, it has paid the banking sector to borrow in foreign currency and convert and invest in lira account. This policy has adversely affected lending to the real economy for long term investment. This could be clearly seen from the stock market situation [Annex 19]. The composite stock index in Turkey decreased from 833 in 1993 to 413 in 1994 dollar based and then to 383 in 1995. Turkish economy however has adopted this structural change in the real sector and the trade and financial sectors have behaved accordingly. As a result, despite unstable exchange rates and distorted financial development, no major disturbance in the economic activities as noticed in the East Asian economies has been observed. On the contrary, there has been some turnaround in the stock market in 1995 as well as improvement in the current account balance owing to what is called "suite case exports" originating form the large informal economy. However, despite this marginal improvement, the Turkish economy has continued to face major economic and financial challenges due to high inflation and high interest rate and continuous increase in domestic and foreign borrowing.

Implications of the Asian Financial Crisis for Turkey

4.21 As the Turkish economy has been a crisis-economy all the way, the Asian crisis is probably not going to produce any significant disturbances at least in the short-term. The impact of the crisis on the Turkish economy can be seen in two ways; one on the real sector and the other on the financial sector. It is observed that the Turkish stock market came under the spell of the Asian crisis in August 1997, then recovered quickly; both the trading volume and the index

climbed in October, 1997. While the Asian bourse were retreating, the Turkish securities market was on the upbeat in the last quarter of 1997. Therefore, the Turkish financial market seems to have brushed aside the negative spillovers of the crisis, and in fact may have benefitted somewhat from the global effects of the crisis, as some funds became diverted away from the Far Eastern markets.

4.22 Given non-stringent capital controls and extensive liberalization of trade and financial sector together with the convertibility of the lira, and its growing dependence on external capital, the Turkish economy is bound to feel impacts of a regional or global financial crisis of this dimension. There are, however, two scenarios: First the Asian crisis has resulted in international capital to become more expensive and investors to become relatively more risk-sensitive in investing in the emerging markets. Over a period of time, Turkey may be expected to face a contraction in both short and long-term capital flows. Overseas investors may choose to invest in stocks or in less risky options in the money market with wait-and-see attitude. Second, the Asian crisis would bring benefit for the Turkish economy as part of the funds directed away from the region, would be channeled into the Turkish capital market. Provided that fundamentals do not present a more gloomy prospects for the Turkish economy in general, and the stock market in particular, and exchange risks are covered, there may be some capital inflows in the year 1998 and later as the Istanbul Stock Exchange (ISE) performed exceptionally well last year among the world stock markets [Annex 18].

4.23 The crisis has also shown that it has become even more important for developing countries, as for Turkey, which among themselves compete for global funds, to enhance their international rating scale ,financial credibility, economic stability and structure. Turkey can be seen as adversely affected and is expected to come to grip with the situation which brought about by the crisis, as the countries will be trying to promote their exports and looking for external funds. In the medium and longer term, the crisis could adversely affect the Turkish exports as the world economy and the industrialized countries experience slower growth, which is reflected on the downward revision of the world growth rate by the IMF. The severe and most direct adverse bearing on the Turkish exports may come as a result of high rate of depreciation of the Asian currencies, enabling them to compete favorably with Turkish exportable, including camping in the third markets, namely in the OECD, provided that these countries sustain a recovery in output.

4.24 The crisis may pose another long-term implications for countries like Turkey, as the region's companies are being forced to restructure and become more competitive. Likewise, the Asian banking industry may eventually emerge

leaner, transparent, and more efficiently regulated than before. The Turkish development experience starting with 1994 financial crisis has some similarities with the Asian financial crisis as its major source of instability was also the fluctuations in the capital account. However, unlike most Asian economies, Turkey has more diversified trade structure and limited exposure to short-term foreign capital. Therefore, despite very high interest rates and hyper inflation, the economy has continued to move forward with frequent fluctuations.

4.25 Both Pakistan and Turkey have experienced financial instabilities despite following moderate growth targets. Their instabilities, however, have not assumed serious proportions due to limited size of foreign capital inflows when compared to the East Asian economies. Nevertheless, some correlation between foreign portfolio investment and stock market instabilities could be discerned from both the cases.

Chapter Five

MAIN CONCLUSIONS AND LESSONS FOR IDB MEMBER COUNTRIES

Conclusions

5.1 Perhaps the most important conclusion which could be drawn from the analysis of this paper is that greater economic interdependence between countries and globalization has increased the probability of economic and financial crises in the world. These crises could be homegrown or imposed by contagions operating through trade and investment interlinkages. Their probability could be minimized by pooling national and international efforts and policy responses and by finding innovating ways of managing international capital flows.

Growth and Stability

5.2 Useful conclusions about growth and stability can be drawn from the Asian financial crisis. First of all, while high growth and stability are not necessarily conflicting objectives for emerging economies, achieving high growth with stability requires sound macroeconomic policies, prudent financial and corporate sectors management, promptness in correcting economic and financial imbalances, and institutional capabilities to respond to and withstand sharp market fluctuations.

5.3 Secondly, two other crucial factors which would determine the success of the growth strategy are the quality of growth and its distribution across sectors and social segments. Narrowly-based growth, with skewed distribution, as has been the case with some countries in the region, is not only prone to financial turmoil s but also breeds social and political instabilities.

Thirdly, from the point of growth strategy, an important distinction perhaps need to be made between the policy stance regarding trade liberalization and the one relating to capital account liberalization. While the former may be essentially aimed at overcoming saving and foreign exchange gap, the former involves more choices in selecting the size, mix, and timing of capital flows. Therefore, while liberal trade and investment strategy of the East Asian countries could still be emulated by other developing countries for

achieving high growth, there is a need to be more cautious about the destabilizing aspects of capital inflows (more on this to follow).

5.5 Fourth, targeting for high growth rate over certain period may be desirable but would be unsustainable if it is done by sacrificing economic fundamentals over a long period.

Foreign Capital Flows

5.6 International currency exchange which stood at $ 1.2 trillion a day in 1995 compared to US$ 195 billion a decade ago[25], and facilitated by information technology, leads to a severe erosion in the sovereign control over national currencies. This could have far-reaching implications for the national policy formulation, particularly the monetary and exchange rate policies.

5.7 With the globalization of capital flows, currency and stock markets in developing countries have to accommodate international speculative behaviour in addition to the one emanating from the local markets. This, inevitably, adds new destabilizing factors in the national markets until they are fully integrated with the global markets. Such integration is, however, not going to be realized in the short-to-medium terms.

5.8 Quick and large inflows and reversibility of private capital highlight the increasing role of large fund managers who can influence the market behaviour. Without regulating their behaviour, orderly functioning of the international capital market may not be achieved.

5.9 Due to sharp fluctuations in the international capital market, global movement towards less volatile investment options is likely to pick up over the short-to-medium term and this would also affect investment behaviour in member countries.

5.10 The experience of the countries affected by the Asian crisis with the foreign direct investment (FDI) has been mixed. Generally the FDI has been found useful as it supplemented the saving-investment, foreign exchange, and technology gaps, strengthened manufacturing bases, and allowed high export growth. However, in some of the affected economies, it remained concentrated in a few industries which depended on imported raw material and technology and was mainly export-oriented despite the fact that they had large domestic

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25 Malaysia [39]

markets. In this process, most indigenous activities in the rural and agricultural sector as well as small and medium enterprises (SMEs) were marginalized. This imbalance has particularly contributed in slowing down the recovery process in countries like Indonesia.

5.11 Foreign capital inflows leading to disproportionate appreciation of asset prices are most likely going to cause market instabilities. Well thought-out and dynamic investment policies are required to direct such flows to create better sectoral and asset-market balances.

5.12 In view of the fact that global indebtedness of the private sector is likely to grow overtime, the capital flows must be directed towards the real sector in order to avoid additional financial instability.

Crisis Prevention

5.13 While it is true that the risk of another financial crisis in future cannot be completely eliminated, it is widely accepted among professionals and scholars that measures such as the following could contribute in minimizing such risk[26]: (a) Maintenance of strong economic fundamentals through prudent policies; (b) Adherence of the financial sector to international best practices on prudential regulations and guidelines; (c) Enhancement of the disclosure of key data and information on an accurate and timely basis; (d) Improvement of governance in the corporate sector and in public policy-making; (e) Comprehensive risk management system to deal with risks from foreign borrowing; and (f) Making the IMF country assessment more transparent so that all others concerned could be aware of the basis of the IMF conclusions. This point becomes particularly important in view of the fact that in the cases of affected economies in Asia, little forewarning was available about the likelihood of such a crisis.

5.14 Monetary sterilization and increasing interest rates to restrain credit expansion and stabilize the exchange rate could be useful tools for preventing financial instabilities. However, they need to be carefully applied as increase in short-term interest rates resulting from sterilization could discourage long term investment demand and make less risky assets such as government papers more attractive. Excessive use of sterilization policy could also adversely affect the public indebtedness and become a source of instability.

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26 See Carrigan [15,16] and International Institute of Finance [26]

5.15 Given the volume of international currency dealing and the so called "hot money", it remains highly doubtful if the national level efforts through fiscal and monetary discipline and other prudential arrangement can alone guard the open developing economies from sharp market fluctuations. The process of development by nature dictates some degree of disequilibria and the level of macroeconomic discipline usually prescribed is not easy to attain to begin with. This task becomes even harder if the developing countries (including emerging economies) have to deal with wild fluctuations in the capital market relying on their existing institutional structures only.

Crisis Resolution

5.16 Within the conventional perspective, there seems widespread support to the following set of policies to resolve any financial crisis[27]:

a. Tight monetary policy to reduce initial speculative pressure and contribute to exchange rate stability and to control inflationary pressure.

b. A comprehensive financial sector restructuring to retum the banking system to financial viability and to ensure proper lending in future.

c. Fiscal policy needs to take into account the objective of protecting social expenditures and expanding the social safety net while remaining mindful of the impact of the economic slowdown on revenues.

d. Limited capital controls which are not allowed to persist over a long period.

e. A feasible policy framework which could be adapted to changing circumstances.

5.17 Notwithstanding the inherent logic of some of policies proposed for crisis resolution, it needs to be borne in mind that in actual practice tight monetary policy using very high interest rate and strict control on credit expansion have virtually crippled the real sector in most affected economies. As a result, most of the economies have drastically contracted and would not achieve economic turnaround unless suitable measures to balance the tight monetary policies are adopted.

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27 See Kochhar et.al. [35]

5.18 Monetary and financial tightening if applied across the board leaves little scope to promote those sectors which may be otherwise efficient but were hit equally by the liquidity constraints. Examples of such sectors could be small enterprises and the agricultural sector in Indonesia or small housing sector in Malaysia for which demand has continued to be active despite general slowdown in the property sector.

5.19 Adverse social effect on education, health, food security, and unemployment if they go beyond a limit, as they seem to have already reached in some of the affected countries, may not allow the continuation of tight monetary policy due to social tension and strives.

5.20 While implementing crisis resolution measures, it needs to be kept in view that the corporate and financial sector restructuring is not a routine task. If the social fallout of such exercises are not adequately contained, it could lead to major social and political tension.

Major Lessons For IDB Member Countries

5.21 Countries targeting for high growth under open trade and investment policies have to accord high priority to financial sector development and institutional capacity to deal with sharp market fluctuations. High growth strategy is still viable provided it is based on sound economic strength rather than on popular sentiments.

5.22 Investment policy should be used to reorient the role of foreign direct investment (FDI) in the process of development. The flows of FDI should be directed according to the national development priorities which in the case of most IDB member countries lie in the development of infrastructure, agro-based activities, and the social sector.

5.23 Allowing the free convertibility of the currency and free flow of capital are desirable long run objectives. However, for countries where public and private institutions including the financial institutions are not well-developed and resource bases are not strong, capital movements should not necessarily be the first to be liberalized. A more prudent approach would be to link such liberalization to some extent with the progress in trade and foreign exchange resources and the development of the financial sector.

5.24 In general, fiscal management in which deficits are not allowed to persist, prudent monetary policy, financial sector which follows internationally accepted sound practices, and greater exchange rate flexibility could minimize

the risk of market instabilities. However, it is the strength of the financial sector which could be the most important deterrent against the financial crises. Without enhancing the international competitiveness and internal efficiency of the banking sector, integration with the global capital market would not be smooth.

5.25 Greater use of non-debt financial investments could help in insulating the banks from financial shocks. Promotion of such instruments would be desirable option for minimizing the risk of future financial crises.

5.26 The role of the government in implementing macroeconomic policies would be effective only if it is accompanied by sound corporate practices and governance.

5.27 The government sponsored production activities when necessary could be sustainable if:

(a) Their economic and social objectives are well defined;

(b) They are meant to generate opportunities for those who otherwise might be left out;

(c) They are run efficiently; and

(d) They encourage private sector partnership wherever possible.

5.28 The growth experience of countries like Indonesia shows that skewed and narrowly based growth is likely to be more unstable. It is therefore extremely important that some sectoral balance in the sources of growth is maintained even if it amounts to marginal adjustment in growth targets. Similarly, due emphasis should be placed on small and medium enterprises (SMEs) which depend on local material and have export potential to provide a more stable base for long run economic growth.

5.29 At times of uncertainty and instability, economic decisions are influenced equally by instinct and perception. In such situations, public policy pronouncements need to keep in view the psychological reactions of the investors besides their economic behaviour.

5.30 In case an economy is hit by sharp economic fluctuations, or observes early signs of a crisis, it should not delay corrective measures as such delays could be costly, usually complicate the crisis, and make recovery more difficult.

5.31 While trying to achieve macroeconomic discipline for avoiding any financial instability, it is equally important that discipline is implemented at the sectoral level and, to the extent possible, at the enterprise level.

5.32 For effective extemal debt management, there is a need to maintain some balance between total debt liabilities (i.e. both public and private) and total foreign reserves. Using official reserves as a measure of financial viability of the country is not appropriate any more as there should be other sources of reserves to meet the private debt liabilities.

5.33 In order to avoid the problem of moral hazards in the financial and corporate sectors, risk assessment and management need to be given central importance in the financing activities.

Chapter Six

EFFORTS REQUIRED TO AVOID AND OVERCOME FINANCIAL CRISES IN IDB MEMBER COUNTRIES

6.1 The economic and financial stability of a country essentially depends on the strength of its macro-economic indicators, level of political stability, nature of development strategy, quality of govemance, and institutional capabilities to implement economic programmes and respond to market fluctuations. The major responsibility to meet these requirements lies with the country concemed. However, given the inter-dependence of economic activities which have radically increased with the globalization of capital market, no country in the developing world in particular can prevent or overcome financial crises based only on its own resources and efforts. Intemational efforts and cooperation are unavoidable for this purpose. Some of the key areas where such efforts need to be focussed at the national and international levels to avoid financial crises in IDB member countries are identified below.

National and Multilateral Efforts to Avoid and Overcome Financial Crises in IDB Member Countries[28]

6.2 It seems quite clear form the Asian financial crisis that achieving orderly flows of foreign private capital cannot be achieved without intemational cooperation on managing such flows. Thus, beside the national efforts, some understanding at the intemational levels may be required to regulate the rapid capital and currency flows and influence the composition of such flows.

6.3 The intemational dimensions of speculations have created serious difficulties for national policy formulation. Therefore, there is a need for international cooperation to regulate the speculative behaviour. This could be done with the cooperation of the banking sector and other intemational financial intermediaries.

6.4 Proposal to establish regional level stabilization funds with contributions from national and intemational sources in IDB member countries need to be studied for possible implementation. One of the objectives of such funds should be to promote capital market development in member countries.

6.5 The imperfections in the intemational capital market due to the

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28 Since most of the efforts identified have both national and multilateral dimensions, they have been placed under one heading rather than classifying them separately.

involvement of a few large fund managers could be overcome through international cooperation to check collusive behaviour and other corporate malpractices.

6.6 A suggestion has been made to promote the use of regional currencies to finance intra-trade rather than relying on international reserve currencies such as US dollar or British Pound. While this suggestion has some intrinsic merit, in reality it would be more effective if the share of intra-trade in total trade is large. As far as IDB member countries are considered, the current intra-trade level is around 10%. Therefore while it might be desirable to implement this proposal in some regions, further efforts at different levels need to be made to achieve a major increase in intra-trade.

6.7 The ASEAN region has already agreed to set up a financial monitoring system for the purpose of early warning about the financial disturbances in the region. This arrangement which would require sharing corporate and financial data with all concerned could go a long way in developing timely responses to instabilities and avoiding financial crises. Multilateral efforts, including those of IDB, would be required to establish such Early Warning System (EWS) in different regions.

6.8 The role of international rating agencies to influence capital flows is well-recognized. There is a need to create such agency at the level of OIC member countries with a view to facilitate and promote intra-OIC member countries investment.

6.9 It has been observed that during the Asian financial crisis, Islamic banks in the region remained largely unaffected. It could be argued that this happened because of their limited exposure of foreign borrowed capital. However, an important fact that Islamic banks usually deal with the real sector and are not allowed to finance speculative activities make them more stable. Expansion in their operations could therefore improve the overall economic and financial stability in a country.

6.10 There is a need to develop a variety of non-interest based financial instruments which could be used to meet the capital requirements of a growing economy. The Asian financial crisis has created the right psychological environment for greater acceptability of Islamic banking in general and in member countries in the region in particular. Efforts to promote such banking and disseminate information about the Islamic modes of financing therefore need to be enhanced both at the national and multilateral level in IDB member countries.

6.11 Most of the efforts to attract investment to Indonesia and Malaysia have been targeted at the conventional sources in the region and in the industrial countries. Perhaps, it is time that other sources including, in particular, the Islamic financing institutions are mobilized to strengthen the process of economic recovery and promote economic growth in member countries directly affected by the Asian financial crisis. The facilities of the institutions like the Islamic Corporation for the Insurance of Investment and Export Credit (ICIEC), an affiliated body of the IDB, could be availed to arrange necessary insurance coverage for investment in these countries.

6.12 As the instability associated with the Asian financial crisis is threatening to spread to other parts of the world, it is feared that there may be a second round of repercussions on the countries already affected and other developing countries. This requires efforts at the international level to pool more resources including private sector back-up facility to recapitalize the economies already affected by the crisis and support those which have been threatened by instability mainly because of inadequate international support.

6.13 The IDB has recently taken very important steps by significantly enhancing its catalytic role of mobilizing funds to support its member countries. These steps are quite in line with the expectations which economic events such as the Asian crisis could raise about institutions like the IDB. This role needs not only to be consolidated but also further enhanced by greater cooperation among national and multilateral financial institutions in IDB member countries.

6.14 Due to recent slowdown in capital markets, investors from IDB member countries outside the Asian region have also suffered huge losses on account of the funds invested in stock markets in different parts of the world. This is going to increase aversion to risky investment. Therefore, perhaps it is a suitable occasion to create investment opportunities within member countries to attract some of these funds. For this purpose, special attention needs to be paid to create enabling environment for foreign direct investment with emphasis on private sector to attract investment in member countries facing capital constraints. National and multilateral institutions could take advantage of this development by offering Shariah-compatible financial products.

6.15 Innovative ways need to be found to develop capital markets in member countries to avoid undue speculations and promote real sector growth. Trading norms and rules and financial products need to be designed accordingly.

6.16 Affected IDB member countries continue to face uncertain recovery prospects. However the investment opportunities are enormous as the level of infrastructure, human resources development, and overall business environment are quite conducive for real investment activities. Indonesia, for example has a rich natural resource base and has also recently opened a number of agro-based activities for foreign investment. Similarly in both Indonesia and Malaysia, there are industries which are otherwise viable but have been closed due to liquidity constraints. Investors from IDB member countries need to be encouraged to invest in such activities.

Annexations

Annex 1

Major Economic and Financial Indicators of Economies Directly Affected by the Asian Financial Crisis

(percentage)

	Indonesia			Korea			Malaysia			Philippines			Thailand		
Item / Year	**91-95**	**96**	**97 (e)**	**91-95**	**96**	**97 (e)**	**91-95**	**96**	**97 (e)**	**91-95**	**96**	**97 (e)**	**91-95**	**96**	**97 (e)**
GDP growth	7.8	8.0	5.0	7.5	7.1	5.3	8.7	8.6	7.3	2.2	5.7	5.1	8.6	5.5	-0.4
Inflation	8.9	7.9	6.6	6.1	4.9	4.5	3.6	3.5	2.7	10.5	8.4	9.0	4.8	5.9	5.6
National saving as % of GDP	28.6	28.8	27.1	35.2	33.3	34.8	31.8	36.6	38.0	18.2	18.8	18.7	34.5	33.7	32.9
Investment as % of GDP	31.0	32.1	29.5	36.7	38.2	35.8	38.8	41.5	42.3	21.9	23.3	23.9	40.9	41.7	35.0
Export growth rate in US$ %)	11.3	9.2	7.3	14.6	4.1	7.2	10.2	7.1	1.3	16.6	17.3	22.8	18.5	-1.9	3.5
Current Account % of GDP	-2.4	-3.3	-2.4	-1.5	-4.7	-1.9	-7.0	-4.9	-4.3	-3.6	-4.5	-5.2	-7.7	-8.8	-3.2
Fiscal balance as % of GDP	-0.2	1.2	0.8		0.3	0.0.	0.3	1.1	9.6	-1.6	-0.4	-0.9	2.6	2.4	-1.0

Source: Partially adopted from Kochar,K. et al. [35]

(e): These were early estimates of IMF. Recent figures show significant deterioration in most indicators of these economies. For some recent figures on GDP, see Table 2.5 and World Bank [55].

Annex 2

Trends in Values of East Asian Currencies: June 1997-September 1998

Country	LC/US$ US$ 15/6/97	LCUS$ 30/12/97	LC/US$ 15/6/98	LC/US$ 9/9/98	Depreciation 15/6/97 to 30/12/97 (%)	Depreciation 15/6/97 15/6/97 (%)	Depreciation 15/6/97 9/9/98 (%)
Indonesia	2432	5570	14699	11700	56.3	83.5	79.2
South Korea	888	1635	1436	1362	45.7	38.3	34.8
Malaysia	2.52		3.89	3.8	35.2	38.5	33.7
Philippines	26.4	40.5	42.4	43.9	27.9	37.7	39.9
Thailand	25.3	49.0	43.8	41.0	46.2	42.2	38.3
Singapore	1.43	1.68	1.75	1.74	14.9	18.3	17.8
Taiwan	27.9	32.6	34.9	34.6	14.4	20.1	19.4

LC/US$: Local Currency per US Dollar

Source: Calculations based on data from The Economist, Various Issues.

Annex 3

Trends in East Asian Stock Markets 30/12/96 to 9/9/98

	Stock Market Index			% Change		Change in US Dollar Terms 1996 to 1997 (%)
Country	30/12/96	30/12/97	9/9/98	1996 to 1997	30/12/97 to	
Indonesia	637	401	326	-37.0	-48.9	-73.3
South Korea	651	376	329	-42.2	-49.4	-70.2
Malaysia	1238	589	390	-52.4	-68.5	-69.1
Philippines	3171	1869	1157	-41.1	-63.5	-61.7
Thailand	832	366	214	-56.0	-74.3	-75.9
Hong Kong	12906	10755	7906	-16.7	-38.7	-20.4
Singapore	1995	1515	886	-31.7	-55.6	-43.1
Taiwan	6720	8146	6895	+21.2	+2.6	-0.9

Source: Calculation based on data from The Economist, Various Issues

Annex 4

Changes in Exchange Rates relative to US Dollar and Local Currency Stock Market Indeces in Selected Countries Outside East Asia (Year ending June 1998)

Sr. No.	Country	Exchange Rate[1]	Stock[1] Market (year ending 1998)	Exchange[2] rate (24/6/98 to 9/9/98)	Stock Market[2] (24/6/98 to 9/9/98)
1	**Argentina**	-0.1	-17.7	0.0	-37.3
2	**Australia**	-17.3	1.6	-	-
3	**Brazil**	-6.9	-23.0	-1.7	-42.6
4	**China**	0.1	-50.0	0.0	-14.9
5	**Hungry**	-14.1	14.9	-2.2	-35.3
6	**Japan**	-17.5	-23.2	-	-
7	**Mexico**	-11.5	-3.9	-14.1	-27.7
8	**Newzeland**	-23.4	-21.5	-	-
9	**Poland**	-5.5	3.7	-4.14	-17.2
10	**Russia**	-7.3	-61.9	-64.7	-65.4
11	**South Africa**	-23.2	-8.7	-12.8	-28.4

Source: (1) International Institute of Finance, Monthly Economic Review, July 10, 1998

(2) Calculations based on data from The Economist,various Issues

Annex 5

Compositionm of Net Private Capital Flows to Five Economies Directly Affected by Asian Financial Crisis 1982 to 1996 Selected Years *

(%)

S. No.	Nature of Flows	1982-90	1994-96
1.	Foreign Direct investment	19	47
2.	Portfolio Equity Flow	0	18
3.	Portfolio bond flow	4	13
4.	Bank and trade related	77	22

* Affected economies are Indonesia, South Korea, Malaysia, Philippines and Thailand.

Source: Rhee [49], Asian Development Bank, Manila, Philippines, March 1998

Annex 6

Private Sector External Debts by Debtor Classification, June 1997

Country	Total	Non-Bank Private Sector	Banks	Public Sector
Indonesia	100	35.2	10.8	54.1
Korea	100	22.4	77.6	-
Malaysia	100	20.8	24.6	54.6
Philippines	100	21.7	20.5	57.5
Thailand	100	39.3	39.4	21.2

Source: Rhee [49], " What Went Wrong in Asia? Achronology of Developments". Asian Development Bank, Manila, Philippines, March 1998

Annex 7

Foreign Debt Position and Composition, June 1997

S. No.	Country	Total Foreign Debt as % of GDP	Total Short-Term Debt as % of Foreign Exchange Earnings
1.	Indonesia	37	190
2.	South Korea	26	350
3.	Malaysia	31	75
4.	Philippines	19	85
5.	Thailand	48	180

Source : The Economist, March 7-13, 1998

Annex 8

IMF Programme: Macroeconomic Targets

Programme for 1998	Indonesia	Korea	Thailand
Initial (date)	**Nov. 5. 1997**	**Dec. 3. 1997**	**Aug. 20. 1997**
GDP growth	3.0%	3.0%	3.5%
Consumer price Inflation (end of period)	10.0%	5.0%	5.0%
Fiscal balance (% of GDP)	1.0%	0.0%	1.0%
Money growth rate (M2)	N/A	Consistent with inflation target below 1%	11.0%
Current account balance (% GDP)	-2.0%		-3.0%
Revised (date)	**Jan. 15. 1998**	**Dec. 24. 1997**	**March 4. 1998**[1]
GDP growth	0.0%	same as initial program	-3.0 to -3.5%
Consumer price Inflation (end of period)	20.0%	same as initial program	11 to 12%
Fiscal balance (% of GDP)	-1.0%	same as initial program	-2.0%[2]
Money growth rate (M2)	16.0%	same as initial program	5.1%
Current account balance (% GDP)	Small surplus	same as initial program	3.9%
Exchange rate, March 20, 1998	10,250.0	1,448.0	40.05

[1] Second revision (first revision: November 25, 1997).
[2] Excludes 3 percent of GDP interest costs of financial sector cleanup.
Source: International Institute of Finance [23].

Annex 9

Indonesia: Selected Key Indicators, 1990 - 1997

(in percent of GDP, unless otherwise indicated)

	1990	1994	1996	1997 (e)
Real GDP (% of growth rate)	9.0	7.5	7.8	5.0
Consumption	63.3	65.6	66.0	-
National Saving	27.5	28.4	29.3	27.1
Investment	30.1	30.3	32.7	29.5
Real GDP (% of growth rate)	9.5	9.2	6.5	6.6
Fiscal Balance	0.4	0.1	0.2	0.8
Current Account Balance	-2.8	-1.7	-3.7	-4.0
Net Capital Inflows	4.9	2	5.0	-
Of which:				
Net Portfolio Investment	-0.1	2.2	n.a.	-
Net Direct Investment	1	0.8	n.a.	-
Other Capital	3.3	-0.9	n.a.	-
Reserves (in months of imports)	4.7	88.8	5.1	-
Ratio M2 to Reserves (%)	514.0	34.2	633.3	-
Total External Debt	65.9	88.8	131.4	140
Private Stock of Debt	-	34.2	55.5	-
Total External Debt (in percent of Exports of Goods and Services)	222.0	195.8	194.0	-
Short Term Debt (in percent of Total External Debt)	15.9	17.7	24.8	
Private Short Term Debt (% of total private debt)	-	61.8	61.7	59.0
Debt-Service Ratio (in percent of Exports of Goods and Services)	30.9	30.0	33.0	34.0
Exports Goods & Services (in percent of GDP)	26.6	26.0	26.2	-
Exports of Goods (% of growth rate)	15.9	8.8	9.7	7.3

Sources: Data for 1990, 1994 and 1996 are mainly adapted from Nusition [41]. The original source of data are:

IMF, International Financial Statistics, various issues. IMF, Annual Report, 1996 and 1997.

World Bank, World Debt Tables: External Finance for Developing Countries 1996.

World Bank, World Development Indicators, various issues.

Data not available.

(e) Early estimates.

Annex 10

Indonesia: Monetary Survey

(in billions of Rupiah, unless otherwise indicated)

Assets				
Foreign Credit	10659	24390	50912	67985
Domestic Credit	95898	193458	288788	407301
Claims on Government (Net)	-12024	-14292	-20922	-45543
Claims on Official Entities	7709	6874	9248	20612
Claims on Private Sector	100214	200876	300462	432232
Liabilities				
Money	23819	45374	64089	78343
Quasi-Money	60811	130280	224543	277300
Import Deposits	1074	1541	2099	1419
Other Items (Net)	20852	40970	48968	118224
Rate of Growth Money Supply (% per year)				
	15.9	23.3	21.7	22.2
M 1 (Narrow Money)	44.6	20.1	28.9	23.2
M 2 (Broad Money)				
Rate of Growth Bank Credit (% per year)	54.2	25.7	24.9	29.1
	35.2	11.8	16.5	40.7
State Foreign Exchange Banks	88.1	42.8	34.3	12.5
Private National Banks	98.3	24.7	13.3	76.2
Foreign & Joint Venture Banks	41.7	18.2	23.2	16.8
Regional Dev. Banks				

Source: Nasution [41]. Original data from Bank of Indonesia, Indonesia Financial Statistics Based on data from various Issues.

Annex 11

Indonesia: Share of Gross Domestic Product by Industrial Origin

Total	1985	1995
Total GDP (Trillion Rupees)	173.2	452.4
Total %	100	100
Agriculture, Livestock, Fisheries	22.6	16.1
Mining and Quarrying	18.2	9.3
Manufactured Industries	15.8	23.9
Electricity, Gas, and Water Supply	0.4	1.1
Trade, Hotel and Restaurant	14.6	16.7
Transport and Communication	5.3	7.2
Financial Ownership and Business	6.4	9.0
Services	11.3	9.2

Source: Based on data from Nasution [41].
Original data from Indonesia: Central Bureau of Statistics, Economic Indicators, Various Issues.

Annex 12

Disaggregated Distribution of External Debt of Indonesia by Category of Debtors, March 1998

Debtor	Amount
Public Sector	65.56
Government	54.39
State Enterprises	11.18
Corporate	5.61
Private Sector	5.57
Private Banks	72.46
Corporate	8.00
Total External Debt	138.02
Debt owed by:	
Corporates b/	70.03
Bank Credit (%)	64.60
Domestic Securities (%)	5.43
Banks	13.61
Interbank Lines (%)	12.83
Domestics Securities (%)	0.78

(a) Figures valid till July 8, 1998.
(b) Includes state enterprise debt

Source: Adapted from the World Bank [53]. Original data from Bank Indonesia.

Annex 13

Major Economic Indicators of Malaysia, 1994-1998

	Indicators	1994	1995	1996	1997-P	1998f
1	Real GDP (RM billion	109.9	120.3	130.6	140.9	144.4
2	Real GDP Growth (%)	9.2	9.5	8.6	7.8	2-3
3	Nominal GDP (RM bill)	180.9	208.2	237.9	263.1	279.4
4	Nominal GDP (% growth)	-	15.1	14.3	10.6	6.2
5	National Saving as % of GNP	-	35.2	38.5	40.0	40.7
6	Export (Fob)	149.3	179.5	193.1	218.7	298.8
7	Imports (Fob)	144.0	179.4	183.0	207.6	271.2
8	Current Account balance Net (% of GNP)	-	-10.5	-5.1	-5.1	-0.5
9	Bank Negara Reserves (% change)	-	63.8	70.0	59.1*	-
10	Price (% change) 1999=100	-	3.9	2.3	2.7	12- 13
11	Unemployment as % of labour force	-	2.8	2.5	2.7	-
12	Net External Reserves (1) (US$ billion)	-	25.3	27.8	22.0	21.0

Source: Bank Negara Malaysia, [12]

* Does not include exchange rate revaluation gain of RM 24.6 billion

P= Preliminary estimates

f= Forecast by Bank Negara Malaysia

(1)= Data from IIF Monthly Economic Review August 1998

Annex 14

Financial and Monetary Indicators of Malaysia, 1994-1997

	Indicators	1994	1995	1996	1997
1	Public sector surplus (% of GNP)	-	3.4	4.2	3.4
2	External debt (RM billion)	73.4	85.0	98.8	166.2
3	External Debt (yearly change %)	6.1	15.8	16.3	68.2
4	Debt Service Ratio (% of Exports)	-	6.5	6.1	5.7
5	Money Supply (M3), yearly change (%)	-	22.3	21.2	18.5
6	Domestic credit expansion (yearly % change)	16.5	28.3	27.8	26.5
7	Short-term capital flows (yearly % change)	- 8.5	2.5	10.3	-14.2
8	Share of property sector in Banking Sector loans	-	26.4	43.1	40.0
9	Interest Rate: (Average base lending rate)	-	8.3	9.18	10.33
10	Ratio of private credit to Nominal GDP	116	130	143	161
11	Stock Market Capitalization (%) yearly change)	17.9	11.2	42.6	-53.4
12	Real effective exchange rate (yearly change against US dollar %)	-	0.7	0.5	-35.0

Source: Ariff [7] and Bank Negara Malaysia [12]

Annex 15

Major Economic and Financial Indicators of Pakistan, 1992-98, selected years

	FY 92	FY 94	FY 96	FY 97	FY 98*
GDP (% Growth p.a) 1980-81 prices	7.7	4.5	4.6	3.1	5.0
GDP Market price (US$ bill)	49.27	52.27	64.5	63.58	-
GDP per capita (US$) at mp	420	420	490	470	-
Agriculture growth %	9.5	5.2	5.6	0.7	5.1
Manufacturing growth %	8.1	5.4	4.4	1.8	7.2
Large Scale %	7.9	4.1	2.6	-1.4	6.5
Small Scale %	8.4	8.4	8.4	8.4	8.4
Services growth %	6.8	4.2	4.8	4.1	5.9
Inflation (CPI) (%) (1990-91=100)	10.6	11.3	10.8	11.8	9.0
Fiscal Deficit (% of GDP mp)	7.4	5.9	6.3	6.2	5.0
Exports (US$ bn)	6.762	6.685	8.311	8.90	-
Exports growth (%)	14.6	-1.4	7.1	-2.7	15.0
Imports (US$ bn)	8.998	8.685	12.015	11.418	5.0
Imports growth (%)	7.3	-13.6	16.7	-5.0	-
Trade balance (US$ bill)	-2.236	-2.000	-3.7704	-3.328	-
Current account deficit (% of GDP)	-1.9	-3.8	-7.1	-6.5	-5.3
Forex reserves (US$ bn)	1.012	2.305	2.065	1.219	1.673
External debt (US$ bn)	19.629	24.482	28.852	29.617	35.0
Total Debt servicing / exports (%)	42.2	54.0	52.3	61.8	-
Foreign debt servicing/Exports (%)	21.9	25.7	24.5	27.2	27.9
Money supply (M2) growth (%)	76.7	20.3	-6.1	0.6	-
Rs./US$ exchang e rate - average	24.84	30.16	33.57	38.99	46.0

Source: Adopted from Salman Ali [4] with some addition. Original data from ABN Amro Bank and Pakistan Economic Survey 1997-98

* Estimated or Targetted - Data not available

(1) Official rate. Open Market Rate was around Rs. 57/US$ in September 1998

Annex 16

Relative Size of Financial Sub-sectors by Amount of Funds Mobilized in Pakistan

Amount in Rs.Billon (%)

	1994-95	1995-96	1996-97
Banks	108.797	117.7	121.9
	(57.7%)	(62%)	(61.9%)
NBFI / NDFIs	43.74	61.164	74.418
	(23.2%)	(32.2%)	(37.8%)
Stock Market, new capital raised	35.9993	10.9132	0.55
	(19.1%)	(5.7%)	(0.28%)
Informal sector	na	na	na

Notes:

1. Amount for Banks is on calendar year basis where amounts for NBFIS, Stock market etc. are on the basis of fiscal year (July to June).
2. Figures in parenthesis are percentage share in total fund mobilization excluding the informal sector.
3. na = not available

Source: Salman Ali [4] original data from Pakistan Economic Survey, 1996-97 & 1995-96 and Annual Report, State Bank of Pakistan, 1996-97 & 1995-96

Annex-17

Shares of Pakistan's Exports and Imports from Asian Countries plus South Korea and Japan

(percentage of total exports/imports)

(1) Years	(2) Malaysia	(3) Indonesia	(4) Thailand	(5) Philipines	(6) South Korea	(7) Japan	(8) Total of 2 to 7
Exports	0.7	0.5	0.8	0.4	3.0	8.0	13.4
1993-94							
Imports	5.5	1.3	0.7	0.03	3.7	11.8	23.0
Exports	0.6	1.1	0.6	0.4	3.0	6.7	12.4
1994-95							
Imports	8.8	1.2	0.8	0.02	3.2	9.5	23.5
Exports	0.5	1.8	1.3	0.6	3.0	6.6	13.8
1995-96							
Imports	7.2	1.1	1.1	0.07	2.8	10.7	23.0
Exports	1.4	0.8	0.3	0.5	2.5	5.7	11.2
1996-97							
Imports	4.7	1.38	1.17	0.1	2.5	8.6	18.5
Exports							12.7
Average							
Imports							22.0

Annex 18

Some Key Features of Stocks and Bonds Markets in Turkey, 1986-1997, Selected Years

	Stocks (Istanbul Stock Market)			Bonds and Bills	
	Index Composite		Market Capitalisation US$ bill.	Volume Traded (billions)	
Years	TL	US $		TL	US $
1986	171	132	0.94	-	-
1990	3.256	643	18.74	1.5	0.312
1994	27.257	413	21.79	270	8.83
1996	97.589	534	30.33	2711	32.74
1997	3.451	982	61.35	-	-

Sources: Based on data reported in Oksus [43]. Original data from ISE, Istanbul Stock Market (ISE)-Monthly Bulletins and Factbook; Undersecretariat of Treasury, Main Indicators of the Turkish-Financial System, December 1996 and TCMB, Annual Report, 1997.

1. IIF, "IMF-Supported Adjustment Programmes in the East Asian Financial Crisis", IIF Research Paper No. 98-1, May 1998.

Annex-19

Main Features of the Indonesian Debt Restrictions Agreement

The Indonesian debt restructuring agreement reached in Frankfurt on June 4, 1998 comprised three components -- corporate debt, interbank lines and trade finance.

Corporate debt

* Coverage: Foreign currency debt of corporations to nonresident creditors.

* Voluntary scheme, requiring the agreement of both creditor and debtor.

* Minimum terms of restructured foreign debt: three years of grace and eight years to maturity.

* Period during which the scheme is open for entry: Likely to be August 1, 1998 to June 30, 1999.

* Cap on interest rate on the renegotiated foreign loan: LIBOR plus 3 percentage points.

* Exchange rate risk guarantee: will be provided for the initial conversion of foreign debt into rupiah debt.

* Payment terms on the rupiah loans: The rupiah loans will be indexed stay constant in real terms.

* Terms on rupiah loans: 8 years' tenor, real interest rate of 5.5 percent.

* Accelerated payment option for rupiah loans: five years' tenor, real interest rate of five percent.

* "Buy down" option: Debtors can "buy down" (appreciate) the account exchange rate by 10 or 20 percent if they agree to pay a real interest rate that is higher than the base real interest rate by 2.9 percentage points and 6.4 percentage points respectively.

* "Early bird" incentive: The interest rate for the first two years will be reduced by 0.5 percentage point if firms enter in the early part of the entry period.

* Default by the corporate borrower: If the borrower defaults on three consecutive monthly payments, INDRA is no longer obligated to pay the creditor.

* Termination value: In the event of default or voluntary withdrawal, INDRA will refund any balance that has been accumulated with it, minus an accumulated premium of 1 percent per annum on the outstanding balance of the rupiah loan, which INDRA will retain. During the grace period the termination value will be reduced.

* Eligible debt: Estimated at US$ 64 billion (of which, however, substantial amounts are expected to be written off, refinanced, or restructured independently).

<u>Interbank debt</u>

* Modalities and coverage: Exchange for new loans of existing obligations of Indonesian banks to foreign banks maturing by March 31, 1999 (including most derivatives).

* Tenor and interest rate of new loans, and maximum/minimum proportion of loans that any foreign bank can exchange for new loans of each maturity will be:

  1 year, LIBOR + 275bp, maximum 15 percent;
  2 years, LIBOR + 300 bp, maximum 30 percent;
  3 years, LIBOR + 325 bp, maximum 45 percent;
  4 years, LIBOR + 350 bp, minimum 10 percent.

* Dollar guarantee: New loans to benefit from a dollar guarantee from Bank Indonesia.

* Arrears on interbank debt and trade credit to tendering banks to be cleared before the exchange.

* Rollover: In the period before the exchange, informal rollover agreement reached in Tokyo will be in effect.

* Estimated amount eligible: approximately US$ 9 billion (there is some uncertainty on the amount eligible for derivatives and the amount owed by foreign subsidiaries).

<u>Trade Credit</u>

* Modalities and coverage: Individual foreign banks to undertake, by means of a letter to Bank Indonesia, to use best efforts to maintain their level of trade credit provision as at end-April, 1998.

* Term of facility: One year.

* Dollar guarantee: Eligible debt to benefit from dollar guarantee from Bank Indonesia.

* Arrears on trade credit to banks involved to be cleared before undertakings entre into effect.

* Reporting requirements: Monthly reporting to Bank Indonesia and creditor bank's own supervisory authority.

* Rollover: In the period before the formal commitments enter into force, information rollover will be in effect in accordance with agreement reached in Tokyo.

* Estimated amount eligible: US$ 4-6 billion (data discrepancies remain to be ironed out).

Source: The World Bank [53]

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