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THE ASIAN FINANCIAL CRISIS
Causes, Cures, and Systemic Implications

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Introduction

The turmoil that has rocked Asian foreign-exchange and equity markets since June 1997 and that has spread far afield is the third major currency crisis of the 1990s. Its two predecessors were the crisis in the European Monetary System (EMS) of 1992–93 and the Mexican peso crisis of 1994–95.

At the meeting of heads of state of the Asia Pacific Economic Cooperation (APEC) forum in Vancouver in November 1997, US President Bill Clinton first characterized the Asian crisis as "a few small glitches in the road"—a description that has given way to less rosy scenarios as evidence of the depth and breadth of the crisis has accumulated. As shown in tables 1 and 2, currency and equity markets in emerging Asia recorded huge falls—on the order of 30 to 50 percent—in the second half of 1997 (as measured from the end of June, just before the floating of the Thai baht). Developments during the first four months of 1998 have been mixed: on the positive side, there have been some rebounds in exchange rates in Thailand and South Korea and in equity prices in the Philippines; in the negative column, the downward slide in the Indonesian rupiah has accelerated, and even where currency and equity prices have rebounded, the cumulative decline over the crisis period as a whole remains very large.

Moreover, forecasts of 1998 economic growth in the region—which stood in the 6 to 8 percent neighborhood prior to the crisis—have been sharply marked down since then (see table 3).[1] Thailand, Indonesia, and

1. Goldstein and Hawkins (1998) show that these downward revisions of 1998 growth forecasts for the Asian emerging economies represent some of the largest downward revisions (over a 6-month period) of the 1990s.

Table 1 Exchange rates, 30 June 1997 to 8 May 1998

	US dollars per 100 local currency 6/30/97	US dollars per 100 local currency 12/31/97	Percentage change 6/30/97-12/31/97	US dollars per 100 local currency 5/8/98	Percentage change 1/1/98-5/8/98	Cumulative percentage change 6/30/97-5/8/98
Thailand	4.05	2.08	–48.7	2.59	24.7	–36.0
Malaysia	39.53	25.70	–35.0	26.25	2.1	–33.6
Indonesia	0.04	0.02	–44.4	0.01	–53.0	–73.8
Philippines	3.79	2.51	–33.9	2.54	1.3	–33.0
Hong Kong	12.90	12.90	0.0	12.90	0.0	0.0
Korea, South	0.11	0.06	–47.7	0.07	21.9	–36.2
Taiwan	3.60	3.06	–14.8	3.10	1.2	–13.8
Singapore	69.93	59.44	–15.0	61.80	4.0	–11.6

Sources: Bloomberg; *Financial Times* (various issues).

Table 2 Stock markets, 30 June 1997 to 8 May 1998

	6/30/97	12/31/97	Percentage change 6/30/97-12/31/97	5/8/98	Percentage change 1/1/98-5/8/98	Cumulative change 6/30/97-5/8/98
Thailand	527.3	372.7	–29.3	386.4	3.7	–26.7
Malaysia	1,077.3	594.4	–44.8	580.1	–2.4	–46.2
Indonesia	725.0	401.7[a]	–44.6	434.7	8.2	–40.0
Philippines	2,809.0	1,869.2[b]	–33.5	2,210.0	18.2	–21.3
Hong Kong	15,197.0	10,722.8	–29.4	10,060.4	–6.2	–33.8
Korea, South	745.4	376.3[b]	–49.5	373.0	–0.9	–50.0
Taiwan	9,030.0	8,187.3	–9.3	8,210.8	0.3	–9.1
Singapore	1,988.0	1,529.8	–23.0	1,420.8	–7.1	–28.5

Note: All stock market indices are local indices. The Hang Seng index is used for Hong Kong and the Straits Times for Singapore.

a. As of 12/30/97.
b. As of 12/29/97.

Sources: Bloomberg; *Financial Times* (various issues).

Table 3 Real GDP growth and growth forecasts, 1996-98 (percentages)

			IMF forecasts			Consensus forecasts		
	1996	1997	1998 (as of May 97)	1998 (as of April 98)	Change in 1998 forecast	1998 (as of June 97)	1998 (as of April 98)	Change in 1998 forecast
Indonesia	8.0	5.0	7.4	-5.0	-12.4	7.6	-6.3	-13.9
Thailand	5.5	-0.4	7.0	-3.1	-10.1	5.9	-4.1	-10.0
Korea, South	7.1	5.5	6.3	-0.8	-7.1	6.1	-1.6	-7.7
Malaysia	8.6	7.8	7.9	2.5	-5.4	8.0	1.1	-6.9
Philippines	5.7	5.1	6.4	2.5	-3.9	6.3	2.2	-4.1
Singapore	6.9	7.8	6.1	3.5	-2.6	7.3	2.7	-4.6
Hong Kong	4.9	5.3	5.0	3.0	-2.0	5.5	3.0	-2.5
China	9.7	8.8	8.8	7.0	-1.8	10.4	7.8	-2.6
Taiwan	5.7	6.9	6.3	5.0	-1.3	6.5	5.9	-0.6

Sources: IMF, *World Economic Outlook* (various issues); Goldstein and Hawkins (1998); Consensus Economics, Inc., *Asia-Pacific Consensus Forecasts* (June 1997 and April 1998).

South Korea are now expected to suffer recessions this year, and growth in Malaysia and the Philippines is likely to be only about a third of what was anticipated prior to the crisis. Excluding China, growth in emerging Asia is now expected to be only marginally positive (1 to 2 percent) this year.

Moving outside the region, it becomes more hazardous to link changes in 1998 growth forecasts solely to the effects of the Asian crisis, because other factors have also changed. Nevertheless, it is relevant to note that in April 1998 the International Monetary Fund (IMF) (1998b) revised its 1998 global growth projection to 3.1 percent—down from 4.3 percent in October 1997, and (roughly) two-thirds of that downward revision might be attributed to slower growth in developing Asia. Turning to growth in the largest industrial countries, there is a consensus that Japan has been hardest hit by the Asian crisis, with its impact exacerbating Japan's serious homegrown problems.[2] In the United States, the contractionary impact of the Asian crisis has so far been more subdued, and the IMF's latest (1998b) forecast for 1998 growth is in fact now higher than it was before the crisis.[3]

My aim in this book is threefold: first, to explain how the Asian financial crisis arose and spread; second, to outline the kinds of corrective policy measures and reforms that would help to end the crisis; and third, to suggest a package of improvements in the international framework for crisis prevention and crisis management.

Chapter 2 discusses the three main interrelated origins of the crisis, namely: *financial-sector weaknesses* in Asian emerging economies cum easy global liquidity conditions; mounting concerns about *external-sector problems* in these economies; and *contagion* from Thailand—first to three larger economies of the Association of Southeast Asian Nations (ASEAN-4) (Indonesia, Malaysia, and the Philippines), then to North Asia (South Korea, Taiwan, Hong Kong, and Japan), and finally to other countries (ranging from Brazil to Russia and, more briefly, to equity markets in some major industrial countries).

Chapter 3 turns to proposals for fixing the crisis. Here, I take up restructuring and reform of financial sectors and prudential supervision in the ASEAN-4 economies and South Korea, exchange rate policies in Asia, fiscal and financial-sector policies in Japan, competitive depreciation pressures facing China, and the design and effectiveness of IMF-led official rescue packages.

2. IMF forecasts for 1998 growth in Japan have fallen from 2.9 percent in the May 1997 *World Economic Outlook* to zero in the April 1998 edition. The IMF (1998b) argues that while the Asian crisis added to the toll, the faltering of Japan's recovery in 1997 primarily reflected problems of its own making, including the large withdrawal of fiscal stimulus when the recovery was not yet firmly established, the bad loan problem cum more generalized financial-sector weaknesses, and delays in the implementation of structural reforms. Posen (forthcoming 1998) comes to a similar conclusion. Liu et al. (1998) also find that Japan's real GDP is more adversely affected by the Asian crisis than either the United States or Europe but emphasize that the outcome is heavily influenced by how one treats the depreciation of the yen vis-à-vis the US dollar and European currencies over the period and by how one accounts for the real absorbtion effects of exchange rate changes. As argued in chapters 2 and 3, Japan's problems have also been an important element in the origins of the crisis and have made recovery from the regional crisis more difficult.

3. In May 1997, the IMF was projecting 1998 growth in the United States to be 2.2 percent; the April 1998 *World Economic Outlook* envisages US growth of 2.9 percent in 1998.

In chapter 4, I put forward a set of "Halifax II" reforms to strengthen what US Treasury Secretary Robert Rubin (1998) has recently called the "international financial architecture."[4] These proposed reforms are grouped under the following five headings: (1) reducing moral hazard and bringing more order and flexibility to private debt rescheduling; (2) strengthening prudential standards in developing countries and making it more attractive for countries to implement these standards sooner; (3) improving transparency and disclosure in international financial markets; (4) giving IMF surveillance more punch; and (5) shoring up risk management in global financial institutions.

Finally, chapter 5 outlines 10 lessons from the crisis and offers some brief concluding remarks about the future role of the IMF.

4. The G-7 Economic Summit in Halifax, Canada in June 1995, following the Mexican peso crisis, paid considerable attention to supervisory and global financial-architecture issues.