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FROM MIRACLE TO CRISIS: The Role of Domestic and International Money

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The still unfolding financial crisis in Asia caught almost everyone by surprise. Economists and analysts are now heatedly debating about its causes. We are probably too close to history to pass an objective, not to say definitive, judgement. What I intend to do today is to discuss what I think were the crucial factors and the chain of events leading to the crisis. I do not subscribe to the view that the whole thing was a result of a grand conspiracy. Instead, different parties made various mistakes or moves which turned out to be incompatible with each other. Pressures accumulated and finally the situation exploded. Although it might be a bit early, I shall try to draw several "lessons" before I end my presentation. They are all about the volatility of money in open economies such as ours. As the saying goes, money can really "make or break".

The "miracle" eulogized and the herd rushed in

The Asian story started out as a happy one. The idea of a "Pacific century" first emerged in the 1970s. It gained further currency in the 1980s when East Asia became a powerhouse of economic growth. Japan began to "say no", even to the US, before behaving like "number one" in the world. However, the watershed year must be 1993, when the World Bank launched its report *The East Asian Miracle: Economic Growth and Public Policy*.

The report was not very accurate in explaining the success story of East Asia: we were then less "market-oriented" and "liberalized" than the report made us look. On the other hand, we were not as successful as it thought, although we were undoubtedly the fastest growing area of the world.

In any case, the endorsement of the East Asian "economic miracle" by the world's top financial institution generated a tidal effect, which was felt even by a humble being like myself. In the year that followed, I was invited in Hong Kong to many lunches by international brokers and fund managers. Carrying with them huge portfolios of billions of dollars, they were so eager to invest in Hong Kong, China, and the East Asian region. I remembered being asked a question by a fund manager from North America while I was having my soup, and I nearly choked. "How large is the population of Shanghai? Three million?" he inquired. He was thinking of investing in the B-share stock market in China's largest metropolis, which then had a population of over 13 million.

That is international money, looking for quick returns, but not really having the right amount of knowledge and information. No wonder fund managers behave like herd. Add on top of that international institutions like the World Bank and the IMF which are entrenched in the economic orthodoxy of the west, and are therefore not particularly sympathetic to "non-west" problems, constraints, and difficulties, periodic crises seem almost unavoidable.

What caused the crisis?

Some commentators already spotted serious macroeconomic imbalances in some East Asian countries such as Thailand and Indonesia in 1996. But the ferocity and the spread of the currency crisis across the region since summer 1997 have admittedly exceeded the expectations of even the most skeptical. Why has it occurred? Hindsight is always easy, but not necessarily right. And we better get it right this time.

In the economics literature, there have been two "generations" of models trying to explain "currency crisis" (for the first generation, see Krugman (1979); for the second, see Obstfeld (1994)). But they are too narrowly focused and therefore not useful for explaining the present crisis in East Asia. A "third generation" of models is emerging, but they are as yet too diversified for a quick summary. Nevertheless, the following factors have been cited by various authors as "causing" the crisis.

Deteriorating CADs and excessive investments

First is the widely observed phenomenon of current account deficits in the region. A Current Account Deficit (CAD) is the amount by which a country imports more goods and services than it exports (plus other minor items). In that situation, the country owes the rest of the world some money. A CAD in excess of 5% of GDP is internationally regarded as worrying. In this regard, several countries showed persistently huge CADs in the 1990s. Thailand had an average annual CAD of 7.8% in 1990-1996, while the actual deficit stood at 9.2% in 1996 (in terms of national income accounting---NIA, the same below). The figures for Malaysia were 8.1% and 6.0% respectively, and 4.8% and 5.9% respectively for Philippines. In 1996, Indonesia's CAD was 3.4% of GDP. On the other hand, Hong Kong and China had a roughly balanced current account in that year, while Singapore even managed to have a *surplus* of 16.26% of GDP! Taiwan's surplus was less impressive, but the ratio still stood at about 5%.

I shall have more to say about why even apparently healthy economies like Singapore, Hong Kong and Taiwan have been subject to currency attacks. It has something to do with the so called "contagion effect". Let me first concentrate on the deficit countries first. One would immediately want to ask what actually caused those CADs, how they were financed, and whether they were sustainable (or actually why they were *not* sustainable, now that the currency attacks and huge devaluation of exchange rates have taken place).

Simple accounting rearrangement can show that a CAD is also equal to the amount by which national investment exceeds national savings. In that case, a country needs to borrow or attract money from the rest of the world for its shortage in savings. Therefore, a CAD can emerge as a result of excessive investment, or insufficient savings, and both can occur in the public sector or the private sector. In East Asia, the saving rate is among the highest in the world, thanks perhaps to "Asian values". Most countries and territories in the region showed a saving rate of over 30% of GDP. Even below-average performers like Indonesia and Taiwan had a rate of 28.7% and 28% respectively in 1996. Philippines is perhaps the only exception with only a saving rate of 18.3% in 1996. But at the same time, Philippines also has one of the lowest national investment rate in the region: it was only 24.2% in the same year.

Moreover, the public sector in East Asia can hardly be blamed for lacking fiscal discipline. All of the countries and territories, which have suffered currency attacks, were either having huge fiscal surpluses (like Hong Kong and Singapore) or roughly balanced budgets. Even in Indonesia, a country that is still suffering from financial turbulence, the fiscal surplus in 1996 represented 1.2% of GDP.

Speculative asset price bubbles: the roles of domestic and international money

Hence the problem seems to lie with excessive investments. Of course, East Asia has had the highest investment rates in the world for many years, but what is interesting is that investments in the 1990s seem to have concentrated on the "wrong" sectors. No doubt the huge inflow of foreign capital into the region, helped in no small measures by the World Bank *Miracle* Report, has contributed to such a structural problem.

There has been evidence that investments in several countries have centred on the non-traded sectors, in particular in real estate and other forms of infrastructural construction. Moreover, a significant portion of the financing obtained (from both the local and the international markets) did not go into new investment projects that would have produced new capital goods. Instead, the loans and bonds were used to finance the speculative demand for existing assets. Hence speculative asset price bubbles were formed in Thailand, Malaysia, Indonesia, as well as Singapore and Hong Kong (both of which however did not have CAD problems).

Here the roles of both domestic and international money are important. I have talked about the herd-like behaviour of international money at the beginning. This is however not necessarily a "western" problem. A top investment bank in Hong Kong, the Peregrine, went under early this year because it issued huge amounts of "junk bonds" and loans to Indonesia, which did not seem to have been supported by careful analysis and risk assessment.

As for domestic money, i.e., the financial system within a country, economists now point to a problem called "moral hazard" (Krugman 1988). That is, given the close relationship between the domestic banking system (at least the top banks) and the government, so that a bail-out by the government in the case of bad debts or even insolvency seemed assured, some East Asian banks engaged in reckless lending that fuelled the asset bubble. Commentators have suggested that the problem was quite serious in South Korea, Thailand and Indonesia.

However, there is another version of the story, which also involves international money. Encouraged by the World Bank and the International Monetary Fund (IMF), many East Asian countries embarked on a process of financial deregulation and privatization, but without careful monitoring. Given newly found freedom, many banks and non-bank financial institutions (NBFIs) became intermediaries that channelled foreign capital into the local system. However, many of them, in particular the financial trusts in Thailand, were under-capitalized. In other words, their owners had everything to gain by borrowing locally and aboard and re-lending the money to domestic investors and speculators, but had little to lose themselves if things went wrong. That was a result of carelessly following the *laissez faire* ideology and the lack of proper prudential supervision by the government.

Explicit and implicit fixed exchange rates

All the above factors would have caused serious problems, but probably not crises or disasters of the kinds that we have witnessed in the past six to nine months. Since they took the form of a financial storm in general, and attacks on national currencies in particular. We have to look at the exchange rate more closely.

In the region, only Hong Kong formally pegs its currency to the US dollar at the rate of HK$7.80/US$, under the so called linked exchange rate system, or the "link". The system is actually a variation of a genre called "currency boards" (Tsang 1996a, 1996b). Most other countries explicitly pegged their exchange rate to a basket of currencies, including the US dollar. But one could observe that before the present crisis, the exchange rates of most East Asian currencies did not move much against the US dollar, some in nominal terms, others in real terms. Hence the weight of the US dollar in the basket must have been very large or overwhelming. In effect, East Asian countries were practicing *implicit nominal peg* or *implicit real peg* to the US dollar.

Hence when the US dollar started its relentless strengthening against all major currencies in 1996, because of the unexpectedly sound US economy, international speculators smelt blood in East Asia. With the implicit peg to the US dollar (or explicit peg in the case of Hong Kong), East Asia faced the loss of competitiveness against the rest of the world, exactly at a time it could ill-afford to. Given the CADs and the emerging financial problems, the region's ability to export goods and services, and therefore to earn sufficient foreign exchange to service the financial liabilities that had been built up, was dealt a serious blow.

Hence international speculators flocked in and sold the East Asian markets short. I do not think that there was a grand conspiracy coordinated among a few George Soros's, but several large international funds did have some market power or the ability to ignite a trend, given also the right "fundamentals". Those funds which had already been locked in then panicked, and along with domestic units and agents, ran for cover. The Bank of Thailand put up a fight for the Thai baht by pushing up interest rates and selling the US dollar in the forward market, but then had to yield because of a shortage of foreign exchange reserves, which unfortunately was not fully revealed to the public. When reality transpired, confidence in the Thai baht was suddenly and severely shaken. The meltdown then began.

Competitive devaluations and the contagion effect

In a speech in Hong Kong, the Nobel laureate in economics, Merton Miller (1998) from the Chicago University, accused Japan as the "culprit" of starting the crisis in East Asia, because it allowed the Yen to depreciate sharply against the US dollar, in a bid to export herself out of her six-year old recession. The other side of the coin was of course the rapid strengthening of the US dollar, to which most East Asian currency pegged, as I said.

However, why did the crisis spread to Taiwan, Singapore and Hong Kong, economies with balance of payments surpluses, and huge fiscal and foreign exchange reserves? Fred Bergsten (1998), a former undersecretary of the US treasury and now Director of Institute of International Economics, criticized the Taiwanese authorities which "chose to let its currency join the decline after a minimal defensive effort" and therefore spread the crisis to the "strong center" economies of Hong Kong and Singapore. "On every measure, its (Taiwan's) competitive position remained very strong even after the depreciations in southeast Asia and Korea. Hence its action was totally unnecessary and violated every norm of international cooperative behaviour."

I do not want to judge who is the real culprit here. The "contagion" effect is a phenomenon which is difficult to understand. Market psychology sometimes does feed onto itself, and creates herd-like or panic behaviour that spreads afar.

Three lessons to learn about money

Some say that the worst is over for the East Asian currency crisis. Others predict that the worse is yet to come. My honest answer is that I do not know what the future holds. Many who said the turbulence would die down by Christmas 1997 were embarrassed by the Indonesian crisis in January 1998.

In any case, I think that there are three lessons about money that we in the region should learn.

The first lesson is that governments and enterprises should use money carefully and wisely. They should avoid investing borrowed money in projects or speculative ventures that do not generate sufficient real returns which would enable them to service their debts. No matter how optimistic the future may look, no countries or territories are exempted from the law of financial gravity: what goes up must come down (or what shoots up must then plunge).

The second lesson is that monetary institutions are beset with the problems of "moral hazard".

Financial liberalization should be pursued with care to ensure proper monitoring and supervision. This is an inescapable responsibility of a government.

The third lesson is that the international monetary order is in a mess. On the one hand, international institutions such as the World Bank and the IMF are lamentably lacking in funds and authority that enable them to serve as genuine global central banks. Even if they had, we would be wary of whether their decision making could truly reflect the diverse situations and needs in different parts of the world. On the other hand, there are all these private funds seeking quick returns on the basis of incomplete information, or worse, hearsay. The other side of the coin for over-borrowing is over-lending: moral hazard cuts both ways. International investors should themselves be more disciplined.

The East Asian currency crisis is a typical case of international market failure and the lack of effective international governance as a public good. In such a messy environment, any nation or territory must act with extra caution.

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