Chapter 4

Measures and Policy Responses

4.1 Introduction

It is well known that, prior to mid-1997, East and Southeast Asian economies sustained high economic growth. There was no indication that these economies are facing some problem. Economist as well as policymakers did not actually anticipate the East and Southeast Asian crisis that started through floatation of Thai baht. Even though the debate on the causes are still going on among economists and policymakers, but the consequences of the crisis have been worst. Various policies were adopted by affected countries to recover from the economic instability. For this purpose, Thailand, Korea and Indonesia have sought assistance from the International Monetary Fund (IMF), whereas, Malaysia decided not to be under IMF program however it adopted a few measures that were suggested by the institution.

In this chapter, the role of IMF in the East and Southeast Asian financial crisis, the measures taken by Malaysia and other suggested measures to avert future crisis will discussed in depth.

4.2 The IMF's Role in the East and Southeast Asian Financial Crisis

Since the East and Southeast Asian financial crisis broke out in mid-1997, the International Monetary Fund was approached by the affected countries for financial assistance. However there is a growing concern that IMF policies are not helping to restore market confidence. Thailand, South Korea and Indonesia which have sought the IMF assistance in the wake of currency crises, finds their economy are getting worst after using IMF policy prescriptions. In this regards, many prominent mainstream economists have criticized the IMF programs of fiscal austerity and the tight money, arguing that, while these policy prescription could be appropriate under conditions of monetary and fiscal imbalances, but it is not applicable in the case of East and Southeast Asia countries (Yilmaz Akyuz,1998).

During August-December 1997, the IMF signed three emergency lending agreements with Thailand, Indonesia and South Korea. These programs established packages of international financial support at an unprecedented cumulative sum of approximately $110 billion, based on the financing commitments. The underlying concepts of these programs is that, the IMF envisioned that the immediate objective was to re-establish financial market confidence by stabilizing the exchange rates. Exchange rate stabilization was to be based on a combination of macroeconomic discipline (fiscal balance, high interest rates, and tight credit), the increased availability of foreign exchange reserves and confidence that the fundamental reforms of the economic system were moving forward. These reforms, in turn, would be signaled by decisive actions at the start of the program to close or suspend loss-making financial institutions, as well as the announcements of a strict schedule of longer-term reforms regarding financial markets, corporate governance and increased market competition in various areas (Radalet and Sachs, 1998).

4.2.1 Thailand

Thailand received US$17.2 billion standby assistance from IMF. With conditions that, Thailand reduce its current account deficit to 5 per cent of the GDP in 1997 and 3 per cent of the GDP in 1998 and also must achieve a fiscal surplus of at least 1 per cent of GDP in 1998. The value added tax (VAT) rate is to go up from 7 to 9 per cent. Price of utilities and petroleum products are to go up as well. Government should stop assisting unviable financial institutions and finally, foreign exchange reserves should be augmented and the financial sector has to be restructured.

Government implementation started as soon after the conclusion of the agreement. The authorities suspended 58 finance firms and latter closed 56 of the suspended firms. Rehabilitation plans where initiated through establishment of Financial Restructuring Agency (FRA) and Asset Management Corporation (AMC). In additions, financial sector legislation was revised in order to modernize the regulatory framework for central bank operations and to facilitate implementation of the financial restructuring framework. To meet the IMF's targets of a 1 per cent fiscal surplus, the government increased its duties on import and luxury items and adjusted certain utility and state enterprise charges to reflect the larger baht depreciation. On the expenditure side, investments in utility programs were reduced and privatization efforts are stepped up (Bhanoji Rao, 1998).

4.2.2 South Korea

The Korean standby agreement was signed in early December, which involved $57 billion, the largest ever bailout. The conditions of the rescue package is that, any banks that falls below the capital adequacy standards (enough capital to cover any bad debts) of the Bank of International Settlements (BIS) will be taken over or will be closed. In this respect, Korea agreed to shut 9 of 30 finance companies if it fail to achieve the standards.

Other loan conditions include tougher loss provisioning that will compound write-off of bad loans and further depleting capital. Moreover, foreign banks would be allowed to set up shop in Korea, in which, joint venture and foreign banks will be allowed to open affiliates. At the same time individual investors will be permitted to own up to 25 per cent of Korea banks compared to 4 per cent previously. However, the first agreement was ineffective to pull out South Korea from the economic crisis. The Korean government and IMF signed a second agreement. In this second agreement IMF and US government insisted on the comprehensive debt rollover as a condition for further disbursements of the IMF lending packages. Consequently, the fall in the value of won and the stock markets has been reduced.

4.2.3 Indonesia

Indonesia signed an agreement with IMF on 31 October involving assistance of $40 billion. Following the agreement, the Indonesian government announced a package of measures to shore up confidence in the ailing financial sector. Since the first agreement failed to show some positive responses, on Jan 15 second agreement was signed with the IMF. However, the Indonesia government was very disappointed with the arrangements because it did not reflect any new strategy. Once again the IMF package failed to achieve its objective of restoring confidence in the economy. Moreover, rupiah plunged further after the announcement of the package. In mid-February, Indonesia proposed to establish a currency board system to stem speculative activities and stabilize the rupiah. However, the US government and IMF opposed the move and threaten to withdraw its financial assistance if Indonesia proceeds with the implementation of currency board. Following this, a third agreement was signed between IMF and Indonesia government, which included provisions on restructuring private sector foreign debt and a more comprehensive strategy for the commercial banks. It also eased requirements on fiscal restraint and the schedule for removing subsidies. The market reacted positively to the new agreement in which the rupiah appreciate 6 per cent (Radalet and Sachs, 1998).

4.2.4 Conclusion

As a whole, it is noted that during the period of August to December, the IMF programs fails to meet the objective of restoring market confidence in which, this was reflected by the downward movements in the exchange rate and stock markets in the aftermath of the IMF agreements. This also implies that, foreign investors remained unconvinced about the debt servicing capacity of the private debtors despite the announced availability of IMF loans, and they continued to demand for the repayment of short-term loans as they fell due. On the other hand, it is found that, the achievement of currency market stability across the region during the first quarter of 1998 came in conjunction with a relaxation of the IMF's fiscal targets. Initially, IMF relented on its goal of a fiscal surplus in all three countries. But in the revised programs, Indonesia, Korea and Thailand will aim for modest fiscal deficits.

4.3 Malaysian Way of Handling the Economic Crisis

The big question mark hanging over the fate of Malaysia's economy since it was brought down by the contagion effect of the Asian economic crisis is various policy measures that were implemented in reviving the economy. Initially Malaysia adopted IMF-type of strategy to deal with the economic crisis without seeking IMF money. As it is well known, the IMF-type programs prescribed tight monetary and fiscal policy, which involves high interest rates, fiscal restraint and financial sector restructuring. In the initial stage, interest rate was raised to stop further depreciation of ringgit and also to with hold the massive outflow of short-term capital. In terms of financial restraint, Federal government expenditure was cut by at least 18 per cent in 1998 with an immediate 10 per cent cut across the board of both operating and development expenditure and 8 per cent on a more selective basis (Economic Report, 1997/1998).

Moreover, a number of mega projects have been postponed. Reverse investment also reduced and only those investments, which have strategic and productive linkages with domestic economy were encouraged. On the other hand, IMF-type of strategy also insisted on financial restructuring which involves institutional changes to strengthen financial regulation and supervision and increase transparency. As a result, banking institutions were required to disclose in the financial statements, the information on non-performing loans, loan exposure by sectors and movement in their provisions for bad and doubtful debt. Moreover, the central bank merged 39 local finance companies into eight and insisted local banks to reduce lending.

It is believed that this strategy has its benefits because, first, policymakers can function relatively more freely without supervision reports and press conference as well as unsolicited advice that comes from some of the countries that are major stockholders in the Fund. Second, there is no loss of national pride. Finally, fine-tuning of the measures and policies can be accomplished within a time frame convenient to the domestic policy and not at the behest of some IMF experts in a hurry. However, since the implementation of the IMF type of policies, the situation became worst that the Government decided not to use it anymore.

We were fortune enough that Thailand got hit first, so to some extent we were able to anticipate the necessary measures to be taken. We were able to analyze the steps Thailand took and we found out before hand which worked and which did not work. Instead of drastic hike in interest rates, which the analyst describes as the usual textbook response but Bank Negara has opted for measures that would not jeopardize growth, which the Malaysian economy needs to maintain at slower pace.

4.3.1 Strategic measures to strengthen the economic and financial stability

Given the severity of the impact of the currency crisis on Malaysia economic performance, on 8 December 1997, Government leadership introduced some measurement to cut government spending, squeeze credit growth and restore confidence in the financial system. In the 1998 Budget, Finance Minister announced a package of measures to restore confidence and strengthen economic fundamentals as well as to stabilize the financial market. The Government plan was aimed at cutting federal government spending by 18 per cent in 1998 to ensure that the country can finance investment without turning to external sources. Imports of ships and aircraft by Malaysian International Shipping Corporation and the Malaysian Airlines have been deferred. On the other hand, several major projects such as Northern Region Airport in Kedah, the Kuala Lumpur Linear City, further phases of the Putrajaya project and the Bakun Hydroelectric dam have been postponed.

among themselves, in the hope that this will reduce the amount of US dollars normally used in such transactions and at the same time create more market demand for the three currencies.

However, according to Mohamad Ariff (1998), it is unlikely that the mechanism will work to boost trade and improve their balance of payment problem. He further argues that the very nature of ASEAN economies and the intra-Asean trade, coupled with currently volatile regional currencies, it would be detrimental to use local currencies for trade with neighboring countries. He mentioned that this kind of mechanism could only work for countries with very little extra regional linkages that just trade among themselves and do not import anything from elsewhere (Investors Digest, June 1998). Since the characteristics of the ASEAN economies (Singapore, Thailand, Malaysia and Indonesia) is their openness, high level of trade and financial links to the non-ASEAN world, it is believed that using local currencies for trading is quite impractical to be implemented. As the impact of crisis deepens, National Economic Action Council (NEAC) was formed to initiate measures to nurse the sliding economy to recovery path. With realisation the importance of restoration of investor's confidence in our macroeconomic stability, most of measures that are implemented gives emphasis on confidence restoration. Thus, the crisis of confidence that triggered by real or perceived factors, which has been shackling the economy since the first speculative attacks on the currencies in the region, needs to be resolved expeditiously. Rightly so, the NEAC identifies six key areas for action, that is:

* stabilizing the ringgit
* restoring market confidence
* maintaining financial stability
* strengthening economic fundamentals
* continuing with equity and socio-economic agenda
* restoring adversely affected sectors

On 13 July, details of the fiscal stimulus package for 1998 was announced and at the same time it was acknowledge that the economy was expected to contract by one to two per cent. This measure was seen as part of the National Economic Recovery Plan (NERP) with priority given to reforming and strengthening the banks. For this purpose, the Asset Management Company (AMC) and Special Purpose Vehicle (SPV) was initiated to nurse financial houses back to a reasonable level of good health. The main objective of this special agency is to strengthen the banking system through capital injection. The government has allocated RM2250 million to the Dana Pengurusan Harta (AMC) to buy the non-performing loan of banks and install confidence in financial sector.

On September 1998, the government introduced exchange rate control (capital control). Under the exchange controls rules, the Government banned the trading of ringgit in overseas international markets, which effective immediately, by freezing the country's external account (the pool of ringgit owned by foreigners, including currency traders and stock market investors). Any transfer of funds in the external account will need prior approval from Bank Negara and moreover, all settlement of exports and imports will be made in currencies other than US dollar and restriction are made on the amount of foreign currencies that can be hold by Malaysians. It is expected that with banning trading in the ringgit outside the country, interest rates would be lowered and this will encourage domestic business community. This exchange rates control policy, explicitly shelter the economy from the currency crisis.

Even though there is some merits and demerits regarding the adoption of capital controls but according to Malaysian Prime Minister this capital controls only a temporary measures to rebuild the banking and financial systems. He also did ruled out the possibility of using the measure for longer time period but depending on how the global market are reacting to his proposal that currency trading are regulated. On the other hand, some economists expressed their dismay with the implementation of exchange controls by Malaysian. This is because they believed that capital controls would frighten away foreign investors in Malaysia's stock market and threaten badly needed new direct foreign investment. Moreover, currency traders expressed that banning ringgit transactions could ignite billions of dollars in legal disputes between parties with outstanding currency contracts (Asian Wall Street Journals, September 2, 1998).

To sum up, it is believed that no economic prescription is testable in advance. But with hard work, sacrifice and faith we can avoid a protracted period of poor economic performance. For this purpose, two of the recommendations to restore market confidence stand out. One is improving transparency and the regulatory environment. No doubt that people's primary concern in this downturn is the health of banking system. The measures to strengthen the banks and the assurance that Malaysia has the internal resources to recapitulates them should go a long way to instill confidence. On the other hand, imprudent lending and abuses by the lenders and borrowers are major reasons for the massive losses experienced by many banks in the country. The best way to protect the bank's integrity is through prudent banking practices and tight regulations. The other significant recommendations are that weaknesses existing in the system should be openly acknowledged by the relevant authorities, which should demonstrate the determination to rectify them.

Regional cooperation also should be given due consideration to uplift the ailing economies in the East and Southeast Asian region. It is believed that if all the affected nations in the East and Southeast Asia adopt a regional type of policies, there is possibility that the financial crisis can be overcome within few years. The wide ranging policy measures introduced by the government recently have already borne the desired results.

4.4 Suggested Remedies to Avert Future Crises

4.4.1 Financial Sector Reform

Every commentator on the East Asian crisis has noted the urgent need for implementing banking and financial sector reforms. This is because; the sector has a built-in gravity for possible crisis. Many empirical studies have shown that, over the period of 1980-1996 at least two-thirds of IMF member countries have experienced significant banking sector problems and that the incidence of banking crisis in the 1980s and 1990s has been significantly higher than in the 1970s (Bhanoji Rao, 1998).

There are many factors that are identified as main contributors to the banking crisis in the emerging economies. Of all the factors, macroeconomic volatility, both external and domestic, is an important factor. Macroeconomic volatility on the external front may be caused by terms of trade deterioration or volatility in the interest rates or exchange rates. On the other hand, macroeconomic volatility on the domestic front may due to volatile economic growth and inflation rates. It is claimed that one of the early-warning signals of financial crises is that sharp contractions in economic activity. Another view is that imprudent lending practices also have led to banking crises.

Thus, there has to be mechanisms in place to ensure that there is always stability in the financial sector. It is crucial to have financial sector reform in a dynamic way. In order to have a crisis free banking system, few things should be given due considerations, that is, it should contain inflation controls, exchange rate stability within the context of flexibility, strong banking system and effective supervision and regulation.

4.4.2 Initiatives to Curb Speculation

It was widely known that currency traders have actually contributed to the contagion effect of the currency crisis in the East Asia region. Malaysian Prime Minister had consistently blamed the currency speculators for the downfall of the currencies as well as the economy in the East and Southeast Asian region. He claimed that currency speculation is 'unnecessary', 'unproductive' and 'totally immoral' activity, which should be regulated or made illegal. He also called for a set up of regulations to curb the unfettered and chaotic side of currency trading and ensure a more transparent and stable system.

According to some economists, it is quite difficult to implement restrictions on currency speculation as it imposes some major problems. Any agreement on regulations will be difficult to achieve because major institutions in world financial market dealing in stock investment and hedge fund might not participate in the agreement. Another view is that the increasing sophistication of the financial markets allows speculators to bypass the foreign exchange markets and yet take speculative positions. There was also suggestion to tax speculators. However, it is found that the tax will not only affect the speculators but also traders and investors. Moreover, taxation will raise transaction costs.

4.4.3 Other International Initiatives

Since our global economy are very much integrated, in which almost all nations of the world are part of one global economy and they are all subjected to vagaries of the international financial markets. According to some mainstream economists, in the global level it is quite difficult to contain the flow of crisis, as the nature of global economy is very interrelated. Thus, at the international level some new mechanisms are needed to prevent future financial crisis of regional or global proportions.

Colaco (1997) suggests an international mechanism for emerging market economies that can take concerted action like G-10 and Bank of International Settlements (BIS) to stabilize currency parities. It is believed that such mechanism will be especially useful to prevent contagion effects. It would requires a combined of rapid financial assistance with domestic economic policy and structural measures. Thus, it would serve to dampen the effects of overshoots provoked by the herd instincts present in financial markets, and significantly reduce economic disruptions.

Meanwhile, Krugman suggests restrictions on capital movements as an alternative. In particular, he said that there should be limits on foreign currency debt by domestic residents, despite some unavoidable costs of such controls. On the other hand, Soros proposed for establishment of an international credit insurance corporation as an adjunct of the IMF that would charge a small fee on every international loan and use the proceeds to finance any needed bailout (Bhanoji Rao, 1998).

4.5 Conclusion

It is almost more than a year since the onset of East and Southeast Asia financial crisis, and various type of policy was prescribed to the ailing nations in the East and Southeast Asia, but somehow the policies seems to be ineffective. A few countries sought the assistance of International Monetary Fund (IMF) to help their country recover from the economic crisis. However, it is believed that the only way in which those ailing economies in East and Southeast Asian could come up from the crisis is with the cooperation and financial assistance of international community. Furthermore, appropriate domestic policy measures also should be given due consideration in every country recovery plan.