Chapter 1

INTRODUCTION

1.1   Issues

Since the bursting of her property bubble in March, Thailand has experienced one of the worst economic crises. Frenzy lending in huge amounts by the financial sector to the property sector has seen the latter's failure to repay loans when the property glut set in. On July 2, the Thailand government was forced to release the peg on the baht to the US dollar as she can no longer withstand to the baht selling pressure. The baht has since then slided continuously against the greenback.   At the same time, a contraction in exports is experienced. The current account deficit rose to the height of 8% of GNP. Besides this, Thai faced political upheaval to seek for a more viable government.

Given these situations, it would be understandable on the sources of Thailand's economic woes. But how do one explain the spreading of the Thailand crises to the rest of South East Asia and eventually to East Asia? Conventional economic fundamentals are said to be in good shape. It must be more than just a contagion effect. If it is a contagion effect, sound economic fundamentals will eventually speak for themselves and thus regaining the confidence back into these South East Asia countries.

Malaysia, Indonesia and Thailand have been deemed as the South East Asia's economic miracles. The World Bank praised these countries for their good fundamentals as a result of good macroeconomic management. One wonders what happen to these 'miracles' when these countries floundered with little resistance in the current economy woes. Among the four countries analyzed, Singapore has proved that it is able to stand up well to currency attacks. However, Malaysia has not been so fortunate. Indonesia seemed

to be the worst affected. The issue here is what makes a country being able to ward off currency attacks and another that is not as successful.

As the world comes closer together in the age of progressive technology and liberalization, conventional economic fundamentals such as high growth rate, low inflation rate and low unemployment rate will not be sufficient to judge the soundness of an economy. Thus the issue here is "what are the indicators that economy agents seek to maintain stable confidence in an economy?" The indicators that will be looked into are:

1) Percentage of bank loans to the property sector and percentage of bad debts

2) Current Account Deficit

3) Macroeconomic indicators such as GDP growth, inflation rate, M2 and M3 growth, consumption growth, gross national saving, gross fixed capital formation, export to GDP ratio, trade balance and foreign exchange reserves.

How did the foreign capital inflow play a part in influencing those indicators? To what extent are these indicators relevant in supporting a country to stand the test of time? In other words, how important are these indicators? How did all the countries fair in these indicators? Are countries in South East Asia just victims to currency manipulators?

1.2 Objectives

The objective of this study is to compare economic environment of Malaysia, Singapore, Thailand and Indonesia that might shed some light into the different performances of these countries in the wake of the current financial turmoil. This is done through:

1) The analysis of the amount of capital inflows since 1990 and the way they affected the local economies.

2) The analysis of the strength of the financial institutions in these four countries through their lending to the property sector and the percentage of debts that mounted over the years.

3) The performance of the current account - the percentage of the current account deficit with respect to GDP

4) The analysis of other macroeconomics indicators.

It is hoped that with this research, the necessary and essential factors will be identified for an economy to sustain its growth. It is not the objective of this research paper to predict the direction of the future economic movement of these countries. The effects of the financial crises will also be touched on.

1.3   Methodology

Four countries are chosen for this study. They are Malaysia, Thailand, Indonesia and Singapore.

Materials for the research will be obtained from journals, reports, magazines, compact disks, Reuters Online News Services and the Internet. Exchange rates and the various stock exchange indices will be used as indicators of confidence in the economy. The data on the exchange rates and stock market indices are available from the Extel CD-Rom. Other macroeconomic data are obtained from the respective countries' central bank reports, the International Financial Statistics reports published by the International Monetary Fund, the Asian Development Bank and other reading materials.

Data will be analyzed using tables and graphs from the year 1990 as this is the year when surge in capital inflows, rapid liberalization and growth takes place within the Asian countries.

1.4   Hypothesis

Conventional macroeconomic indicators such as high GDP growth, low inflation rate and high employment rate are no longer adequate forms of indicators on the health of the economy. This has already been proven with the vulnerability of South East Asia countries to currency attacks even when their economic fundamentals are in good shape (high economic growth, low inflation rate and low unemployment rate). They are now more of a supportive role than a main role in an increasingly global economy. Rapid liberalization of the financial system lead to massive short-term capital flow into the economies. These has not always been used wisely, leading to rapid credit growth in non-productive sectors, high consumption growth and high investment that in turn resulted in current account deficits. Effectiveness of regulatory policies is thus greatly eroded by rapid liberalization of the financial system. The followings which are affected by capital inflows, are important in determining the economy's health:

1)   Cautious and viable lending as well as borrowing are important for maintaining a sound and resilient financial sector in the even of any shocks in the economy;

2)   Current account balance must be sustainable to avoid any crises;

3)   Inflation rate, M2 and M3 growth, consumption growth, gross national saving, gross fixed capital formation, export to GDP ratio, trade balance and foreign exchange

reserves are vital factors to monitor because they will indicate whether the economy is overheating, which can cause unrealistic asset price increment (price bubble) that form the illusion of a overly rosy economy. Thus, economies with healthy indicators will be able to fair better in times of crises.

It is hypothesized that countries that do not ensure the above will have a greater degree of impact from the financial crises. The performance of the foreign exchange, stock market and gross domestic product growth will depend on how strict the above three points are adhered to.

1.5   Literature Review

1.5.1   Studies related to Asian Crises

According to Paul Krugman (1998), because Asian governments often implicitly guarantee depositors' money in poorly regulated financial institutions, moral hazard looks attractive to bankers. This implicit guarantee is reinforced by the fact that most financial intermediaries have strong political links. Bankers know that they can then invest these funds into more risky ventures that often bring higher rate of return than safer ventures. If these risky ventures do fail, bankers have nothing to lose because the government implicitly guarantees their liabilities but if they succeed, bankers stand to benefit a lot.

Huge risky investments in speculative sectors such as property and share often fuel unrealistic price increment. In turn, this made the financial condition of the financial intermediaries seems sounder. This condition was made more intense in the 1990s when Asian countries had easier access to foreign capital. When the asset bubble bursts, falling asset prices made the insolvency of intermediaries visible, forcing them to cease operations,

leading to further asset deflation. As the real economy still needs efficient financial intermediaries to survive, it is also affected when intermediaries go into trouble. Depositors start to withdraw money in numbers. Confidence trails off and investors flee. The depreciation of the currency therefore is more of a symptom than a result of the crises.

In Jeffrey Sach's (1997) opinion, financial panic is the main cause of the crises. Much of the panic is a self-fulfilling outflow of capital, made easier by the vulnerability to a huge amount of short-term debt that can flow out easily when there is a panic. If there is not enough foreign exchange reserves to offset this movement, then doom will occur. Although the economies were fundamentally healthy at the start of the panic, nobody wants to be the last one out when currencies and banks are weakening. Corruption and mismanagement do exist but these themselves do not explain the intensity and speed of the crises. No economy can easily weather a panicked withdrawal of confidence and this seems a more plausible explanation. There were of course weaknesses in the Asian economies, but far from fatal. The deeper strengths - high savings, budget surpluses, flexible labor markets, low taxation - remain in place, and long-term growth prospects are solid.

This crisis mainly originated from the private, albeit under-regulated, financial markets that went on a lending freeze. Short-term borrowing from abroad was used, unwisely, to support long-term investments in real estate and other non-exporting sectors.

According to Ghosh, Sen and Chandrasekhar (1998), at the time of the Asian crises, the Asian countries have substantial economic performance differences. Thailand was facing a sharp reduction in exports, huge current account deficits and reduction in foreign direct investment. Malaysia also has a current account deficit that was financed by hot money. Excess resources were directed to the real estate. Indonesia has a lower current account

deficit but did not face the problem of reduced export. South Korea's real economic strength was unquestionable, having winning a place as a member of the Organization for Economic Cooperation and Development (OECD). These differences, according to the writers, suggest that the same economic fundamentals could not have led to the crises. Instead the globalization of financial system has been pinpointed as the crux of the problem.

What is in common is the growing exposure to international finance in the wake of financial liberalization. With the financial markets becoming more mobile and the existence of investors that are out for quick profits, seeking new investment markets and pulling out in a herd like fashion at the slightest hint of uncertainty is the trend. Without this exposure, the crisis would not be of such magnitude. There were always some weak fundamentals that would provide the basis for confidence crises that in turn will be enough to set off a trail of disasters. Slow down in trade and an end to the property boom triggered the capital flight. Currencies depreciated. The crisis was prolonged and extreme compared to the Mexico crises because the United States did not play an active role in offering financial assistance as it had in the Mexico crises. Japan was preoccupied with its domestic economy woes. Secondly, standard IMF strategies have been argued to be inappropriate because they are typically for countries with high inflation rates and unsustainable fiscal deficits. By contrast, the problems in Asian are related primarily to asset deflation and over indebtedness that originated from the private sector that was exacerbated by the financial liberalization measures. IMF's deflationary measures such as high real interest rates will only squeeze economic growth. Other measures such as insistence on further and faster liberalization of the financial flows will render more vulnerability at this stage because of the greater probability of future scams without the supporting prudential regulation. In Korea for

instance, the IMF recommendation to eliminate restrictions on foreign borrowing by domestic corporates is really adding fuel to the already ferocious fire.

According to Tomquist (1998), the crisis in Asian is one of a political problem, rather than an economic one. Politicians, bureaucrats and officers treated public resources and regulations as though they were private. There are regulations in Asia but the crisis did not occur because of excessive regulations but because of bending of these regulations. The fact that IMF is asking more deregulation and a more open market will not solve the crises.

The root of the currency crisis in Malaysia lies in the high dependence on foreign short-term capital inflow which is highly volatile (Devason, 1998). The abrupt withdrawal of short-term capital caused the depreciation of the currency. Stock market boom was due to inflow of international capital. Thus it is better to open less and be satisfied with lower growth that is sustainable. Sound economic management is more important. The local banking system has been put to test during the crisis. Of significance are the current account deficit and how it is being financed. The lack of productivity growth, inefficient investment and imprudent lending, labour shortage and loss of competitiveness are areas that need to be overcome.

Breman (1998) attributed lack of solidity and profitability of investments as first reason for the crisis on Asia. Credit has been given too readily and there has been no control over compliance with repayment conditions. The lack of transparency of financial injections in the economy was to disguise nepotism and corruption. Only a small percentage of investments was channeled to the industrial sector. Technological innovations that fuel economic transformation are conspicuous by their absence. Wealth has been caused more by

the rising prices of real estate and speculation than the increase in size and value of the volume of production.

Masuda (1998) tried to answer the question of how to manage the international monetary system to prevent a currency crisis and maintain stable worldwide economic growth under liberalization and integration of financial markets. She blamed the international monetary system that is centered on the dollar for the quick and easy fall of the Asian currencies. Massive foreign capital flew into ASEAN. Even after the Mexican currency crisis, Asian countries continued to depend on unstable foreign capital inflows. Liberalization of financial and exchange markets advanced but there were some precautionary policies such as extending the exchange rate band and putting more emphasis on the yen. After the Mexican crisis, large capital flights from Asian financial markets turned to Japan. Asian markets had to sell yen but they did not have enough yen in their reserve to do so as majority of the foreign reserves was in dollars. They thus turn to selling the US dollars to buy yen at a time when the yen was appreciating against the dollar due to international exchange speculation. Thus their action actually promoted speculation and increased their exchange losses. Before the fall of the baht, Thailand, Hong Kong, Singapore and Malaysia jointly intervened in the foreign markets to stabilize the baht value. This was done mainly through the usage of Thailand funds. In spite of these, the baht eventually fell. This intervention was characterized by the failure to use the Tokyo exchange market because it was not possible to intervene effectively in the Tokyo market when there were few transactions in baht. The crisis reveals the great extent of international speculation. The crisis spread even when various prevention plans and large foreign reserves exist. The effectiveness of regulatory policies declined because of the promotion of liberalization.

Moreover, developing countries are expected to undergo more liberalization under the WTO regime.

Soo (1998) attributed the cause of the Asian currency crisis to the private sector decision and the Plaza Accord in 1985. In the private sector, blind lending trend was the cause. Maturity mismatch happened when borrowers borrow short-term and lend long term. Havoc breaks loss when interest rates rise. The private sector also borrow short in US dollars and lend long in their domestic currency. When the domestic currency depreciate, the cost of rolling over the short-term floating rate dollar in real terms become high. Financial institutions also compete against each other to lend money. These funds usually ended up as non-productive investments in the property sector and the stock market. Raising interest rates and tightening monetary policy to overcome the crisis will not solve the problem because the profit speculators can make from the depreciation of the Asian currencies overcomes the cost of borrowing to sell short. Speculators who have already sold short the Asian currency will also benefit from high interest rates.

The Plaza Accord of 1985 helped to bring the decline in the value of the dollar. Many Asian currencies which were pegged to the dollar benefited when the dollar value decline against the yen because this boosted Asian exports and encourages foreign direct investments in Asian. By 1995, the dollar appreciated against the yen. Asian exports deteriorated. In 1994, China devalued its yuan, adding competition to the other Asian exports.

Inflows of foreign capital can be effectively reversed by taking positions in currency markets, spot or forward (Feldstein, 1994 and Sau, 1997). Capital cannibalism is the outcome, enabling a foreign investor to take position in a country's securities without

causing any net outflow of capital from the investor's own country. Sau illustrates this by giving the example of an American investing in the Indonesian capital market and then sells forward the prospective rupiah proceeds from the capital market for dollars. Dollars flow out of Indonesia, back to US, while the American investor still owns the Indonesian securities. Sau also proves that free mobility of international capital will lead to chaos in exchange rates. It is claimed that a tax on currency transactions, the Tobin Tax, will moderate capital cannibalism.

In refuting Paul Krugman's argument that the East Asia economies' miraculous growth was nothing but a myth and that the current crises is the proof, Michael Walton in 1997, then the World Bank's chief economist for East Asia, has said that the East Asia countries are just going through a development phrase. The countries still retain major advantages such as high saving and investment rates, vibrant entrepreneurial classes; intense intraregional (and intercity) competition and sharing of experiences; rising intraregional integration; and a longstanding commitment to macroeconomic stability. All these provide for both immense forward movement and substantial resilience. However, whether this will come true will also depend on the success in tackling structural and institutional challenges. The Pacific Economic Cooperation Council is also optimistic on the future of the East Asia countries.

1.5.2 Studies related to Balance of Payment Crises

Paul Krugman (1979) concluded in a seminar paper that under a fixed exchange rate, domestic credit expansion in excess of money demand growth leads to a gradual but persistent loss of international reserves and, finally, to a speculative attack on the currency.

This attack immediately depletes reserves because large amount of reserves is used to defend the currency peg and forces the authorities to abandon the parity. The process ends with an attack, because economic agents know that the fixed exchange rate regime will ultimately collapse and that in the absence of an attack, they would suffer a capital loss on their holdings of depreciating domestic money. To the extent that excessive money growth may result from the need to finance the public sector, fiscal imbalances and credit to the public sector, it would also serve as indicators of a looming crisis.

Variables that receive ample statistical support as useful indicators of currency crises include declining international reserves, currency appreciation (period before the crisis), credit growth, and increasing domestic inflation.

Some economists have not ruled out contagion effects as triggering the balance of payment crises. This may arise if foreign investors pay little heed to countries' economic fundamentals and thus do not discriminate properly among countries. If contagion effects are present, a crisis in a neighbouring country may signal a future domestic crisis.

Since the 1980s, the link between banking crises and balance of payment crises has strengthened. Kaminsky and Reinhart (1996) found 22 banking crises on 46 payment crises over 1980-1995. They found that financial liberalization which occurred mostly since 1980s played a significant role in explaining the problem of a banking crisis proceeded by a private lending boom. Currency crises followed after banking crises.

Micheal Connolly (1986) applies a speculative attack model to the Argentina currency, the peso between 1979-81. Argentina pursued a crawling peg exchange rate policy involving small adjustments in the exchange rate between the peso and the US dollar according to a pre-announced schedule during the analysis period. The integrity of this

policy held out until the early 1981 when deviations from the pre-announced schedule began to take place. During the active crawl, the real exchange rate in Argentina appreciated as prices of non-traded goods to prices of traded goods rose, then it plummeted dramatically from April 2, 1981 onward with the collapse of the pre-announced schedule policy. A dual exchange market with a controlled commercial and free financial rate was adopted in late June 1981. This was abandoned to make way for a unified and free floating peso in late December. At the same time during this period, Argentina pursued trade liberalization.

In his findings, rapid domestic credit growth that greatly exceeded the rate of the crawl played an important role in declining the reserves in 1980 and bringing massive speculative attacks on the central bank reserves in early 1981. Here, rapid liberalization of the financial sector plays a role in the resulted crises.

1.5.3 Studies related to Exchange Rates

Two episodes of exchange rate collapse within the exchange rate mechanism (ERM) of the European Monetary System have spurred interest in understanding the causes of such forced parity changes. Alun H.Thomas (1994) uses interest rate differentials as measures of devaluation risk. He found that interest rates differentials reflect devaluation risk but that movements in fundamental variables such as inflation rate, unit labour cost, unemployment, government debt-GDP ratio, and the rate of change in the foreign exchange reserves in France and Italy have only weak effect on devaluation risk. The most significant influence on devaluation risk is the position of the currency in its band. The lower the exchange value of the currency is within the band, the greater is the perceived risk of

devaluation. However, this variable is weakly related to standard macroeconomic fundamentals. Therefore, a considerable percentage of the driving force is unknown.

Glenn Tanner (1996), using intraday data in a 1987-1991 sample period found that the mark/dollar exchange rate was affected by unanticipated information about the trade deficit and the consumer price index. However the exchange rate showed no significant response to news about money supply, industrial production, the producer price index or unemployment.

The analysis of Thomas (1994) and Tanner (1996) showed that exchange rate movement is not necessarily determined by economic fundamentals.

1.5.4 Studies related to the Banking Sector

A strong banking sector has prudent management in the sense it gives out loans according to good judgement. It must have a matching viability of the amount of credit creation that can be undertaken by a bank. Loans are given out to finance a project only after thorough cost benefit analysis, competent appraisal of the value of collateral pledged. There after, monitoring of loans' performance and the controlling of borrowers to assure adherence to convenants are carried out with diligence. A banking system that gives out loans freely out of complacency will face the danger of high numbers of non-performing loans. The frenzy bank lending to the property sector in Thailand caused the failure of servicing these debts when the property glut set in. The banking sector then faced a crisis that subsequently led to a currency crisis. The following literature review shows how important a prudent banking sector can be.

Gonlakez-Hermosillo, Pazarbasioglu and Billings (1997) test empirically the proposition that bank specific factors, macroeconomic conditions and potential contagion effects determine bank fragility. The proposition was tested in different condition settings such as whether there was government intervention to help banks and whether non-performing loans reaches a certain threshold. Bank specific factors used are capital-asset ratio, a variety ratio of loans to total loans, profit margin, public deposit to total loans, interbank deposits to total loans, expenditure to total assets, liquid assets to total assets and bank assets to total banking sector assets. Banking sector variables are used as proxies for contagion effects. They are total banking sector loans to GDP ratio, share of loans classified as riskiest to total loans, banking sector's non-performing loans to total loans and deposit fund. Macroeconomic variables are like exchange rate depreciation, real interest rate, economic activity and unexpected inflation. The framework is applied to the Mexican financial crisis in 1994. For Mexico, bank specific variables and contagion effects explain the likelihood of bank failure, whereas macroeconomic variables determine the timing of bank failure.

Berger and De Young (1996) examined the intersection between the problem loan literature and the bank efficiency literature. The Granger-causality techniques were used to test hypothesis regarding the relationships among loan quality, cost efficiency and bank capital. They test four hypotheses, the bad luck hypothesis, bad management hypothesis, skimping hypothesis and moral hazard hypothesis. The bad luck hypothesis predicts that external factors beyond the bank's control result in problem loans. Thus, increase in non-performing loans Granger-causes cost inefficiency because cost increases to monitor these non-performing loans. Under the bad management hypothesis, low measured cost efficiency

is a signal of poor senior management practices. Here, low cost efficiency is expected to Granger-cause higher non-performing loans. The skimping hypothesis predicts that a long run profit-maximizing bank will try to skimp on resources for monitoring and underwriting non-performing loans, resulting in greater non-performing loans in the future. Thus, higher measured cost efficiency (skimping on resources) Granger-cause higher non-performing loans. The moral hazard hypothesis predicts low financial capital will Granger-cause high non-performing loans.

Their result suggests that problem loans precede reduction in measured cost efficiency (bad luck hypothesis); measured cost efficiency precedes reductions in problem loans (bad and skimping hypothesis); reduction in capital at thinly capitalized banks precede increases in problem loans (moral hazard hypothesis). The policy implications are clear. The bad luck hypothesis implies that prudential regulation and supervision could reduce the risk of failure by *limiting banks' exposure* to external shocks. The bad management hypothesis implies that bank supervision and research should consider *cost efficiency, loan loses* and *credit risk*. Skimping hypothesis implies that banks should pay more attention to *internal credit control procedures*. Moral hazard hypothesis implies that bank supervisors should monitor *capital ratios* carefully.

1.6 Research Paper Outline

This chapter has outlined the objective, methodology and hypothesis. Chapter Two will begin the research with an overview of the countries in question. This chapter will introduce each country in their progress of economic structural change from the 1950s, an era that sees the end of colonialism and the beginning of a period of hard work and

perseverance of local governments in building up of each country's economy. The economic growth performance of each country in the 1990s will also be discussed.

Chapter Three goes into the research with the analysis of the impact of capital flows (that comes with financial liberalization) on the economies and the role they play in the events leading to the current crises. We will see whether the countries in question took any measures to counter the bad effects of heavy short-term capital inflows and whether these measures were effective.

Chapter Three and Four continue where chapter three has left off. Chapter Four deals with the banking sector and the external debt of each country, whether private or public, from within the country or from overseas. It shows how rapid liberalization of the financial sector without sufficient prudential regulations leads to excess liquidity in the economy that subsequently encourage high risk taking in credit growth. The huge amount of external debt and non-performing loans will indicate the health of the financial sector.

Chapter Five looks at how the current account balance and other macroeconomic indicators perform during the period of financial liberalization. In this chapter, important factors that affect the current account balance such as gross national saving, gross fixed capital formation, export to GDP ratio, trade balance and foreign exchange reserves will be looked into.

The effects of the financial crises are inserted in Chapter Six. Conclusion of what factors cause the different degrees of impact on the economies, in particular Malaysia, and policy recommendations are contained respectively in Chapter Seven and Eight.

All chapters will make comparison among the countries based on the topic of each chapter. They will show how differences of each country contribute to the different degree of impact the financial crisis has on their economies.