1997 Asian Crisis

The vulnerabilities of the "Asian Tigers" and the fiscal response towards recovery

-*A country by country analysis*-

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Contents

1. Introduction

The Asian economic and financial crisis that happened in 1997 is considered as one of the most serious crises in the economic history. The depreciation of Thai baht in July 1997, following a massive speculative attack, triggered the crisis. The contagion effect transmitted the crisis in the other countries of the area, mainly South Korea, Malaysia, Philippines, Singapore and Indonesia. As a consequence, there were large currency depreciations and years of negative GDP growth that threatened the future prospects of all these countries.

More analytically, in July 1997 Thailand's financial authorities decided the reduction of Central Bank's foreign exchange reserves, in order to defend the currency from the speculative attack. The depreciation of the baht, which was formerly pegged with the dollar, caused all regional currencies to lose sharply their values against dollar. For example, until the beginning of 1998, baht lost about 55% of its value and Indonesian rupiah lost over 80%.

The macroeconomic consequences for the involved countries were serious: deep economic recession; large number of people under the minimum poverty level; a lot of firms defaulted; unemployment hit historical high figures; rapidly increasing inflation; intensification of income inequality; banking sector malfunctions. All these developments followed the situation that had been characterized as the "East Asian economic miracle" and it was a big surprise for the global economic system.

Regarding the involved parts in the crisis, they ranged from the local governments, local private sector, governments of the western economies and, mainly, the International Monetary Fund (IMF). IMF had a controversial role as it imposed very severe contractionary monetary policies in order to give financial assistance to the countries. However, there are a lot of stakeholders that argue in favor of IMF's role, claiming that its program helped the East Asian economies to correct their structural weaknesses and return to economic expansion in a more sustainable way.

In this essay we are going to examine the anatomy of the East Asian financial crisis and assess its output the years followed. More analytically, in Chapter 2 a detailed analysis of the characteristics of the crisis is conducted. The analysis is firstly country – oriented, that is, each country's involvement in the crisis is examined separately focusing on the macroeconomic framework before the crisis, but in the final section of this chapter the previous analysis is integrated in order to present the whole pace of the crisis with comparative analysis and statistics. Chapter 3 assesses the situation of these countries in the years that followed the crisis, aiming at the assessment of the supporting programs' degree of success and focusing on the International Monetary Fund's and countries' authorities intervention there, as well as the fiscal adjustments that became necessary in this context. The analysis in this section is country-by-country oriented, as well, in order to analyze the measures that each country implemented in order to face the problems that the crisis generated or brought to the surface. Finally, in Chapter 4 the main conclusions of the previous analysis are presented, alongside with a brief overview of the aftermath of the process on these countries, the decade following the 1997 crisis.

2. The anatomy of the crisis: a country – by – country analysis

2.1 The East Asian economic miracle and the setup of the crisis

As abovementioned, the financial crisis in South East Asia considered as a big surprise and one of the main reasons for that was the long period of economic growth for these countries.Asian countries were experiencing remarkably high growth rates until 1995; Average disposable income in Indonesia, Malaysia and Thailand increased more than four times in the time period 1965 – 1995, whereas in South Korea rose almost seven times in the same period. It is noteworthy to say that in 1965 the average income in these countries stood at 10% of US average income and in 1995 it increased at 27%. At the same countries, life expectancy in 1970 was at 57 years old and in 1995 it rose at 68 years. Moreover, average literacy rate increased from 73% to 91% during the same period. Regarding poverty rates, theyshowed significant decreases in each country. For instance, in Indonesia population share that lived under the poverty level fell from 60% in 1965 to 15% in 1995.In order to stress the rapid economic development of these countries the period before the crisis, in Table 1 GDP and employment figures for the East Asian countries, as well as for some developed ones are presented.

Table 1 GDP & Unemployment in East Asia and Developed countries

Country	Period	GDP growth(%)	Employment growth(%)
HongKong	***1966-1995***	***7.4***	***2.6***
S. Korea	***1960-1995***	***8.5***	***3.1***
Singapore	1964-1995	8.8	4.3
Taiwan	1953-1995	8.4	2.7
Indonesia	***1970-1994***	***6.7***	***3.1***
Malaysia	***1970-1995***	***7.3***	***3.7***
Philippines	***1966-1995***	***4.0***	***3.2***
Thailand	***1966-1994***	7.6	2.8
China	1965-1995	8.4	3.0
Japan	1957-1994	5.9	1.1
Canada	1957-1994	3.8	2.3
France	1957-1994	3.3	0.4
W. Germany	1957-1994	3.2	0.1
Italy	1959-1994	3.5	0
UK	1957-1994	2.4	0.2
US	1949-1994	3.1	1.7

Source: Local statistical authorities, IMF

The above table indicates that the countries of the region enjoyed the more rapid growth in the world after 1970. China for example, has had an annual real GDP growth rate of over 10% since 1979 (year of important structural reforms in the country) and industrialization helped countries such as Indonesia and Philippines to maintain low unemployment rates providing job vacancies to the vast majority of the population.

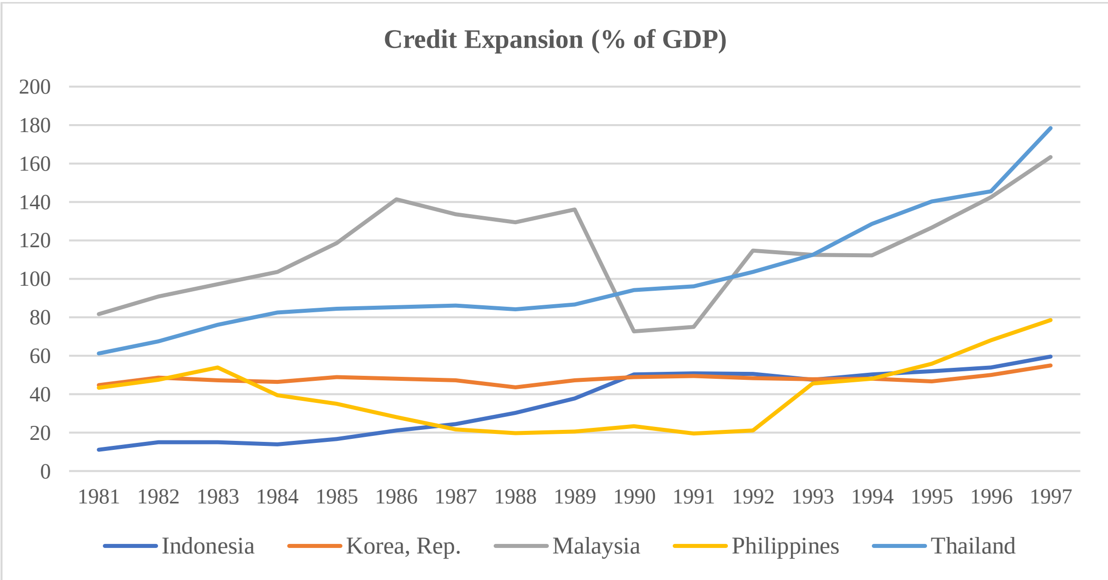
Furthermore, it is very useful to stress some significant economic, social and political characteristics of these countries in the period before the crisis. We first define the criterion, followed by the specific status of these regions:

- Global economy: favorable global economic environment;
- Governance – Regulation – Institutional adequacy: absence of an integrated and complete democratic framework;
- Average growth rates (1992 – 1997): 9.5%;
- Foreign exchange regime: fixed exchange rates, pegged with the US dollar;
- Monetary policy – real interest rates: expansionary – positive real interest rates;
- Current account deficit: 3.4% (1997);
- Deficits coverage from Foreign Direct Investments: 22% (1996);
- External debt (% of GDP): 22% (1996);
- Foreign exchange reserves (% of short – term external debt): 116.7%;
- Real Effective Exchange Rates: overvalued, single – digits;
- Fiscal balance: surpluses;
- Government debt (% of GDP): low;
- Domestic banks' ownership status: owned by domestic entities;
- Exposure to foreign banks (% of GDP): 17.2% (1997);

However, the characteristics of this growth framework created the conditions for the crisis in 1997. The development of these countries was based on non – sustainable fundamentals and contributed to the development of weaknesses and imbalances both at macroeconomic and microeconomic levels in the countries of the region.

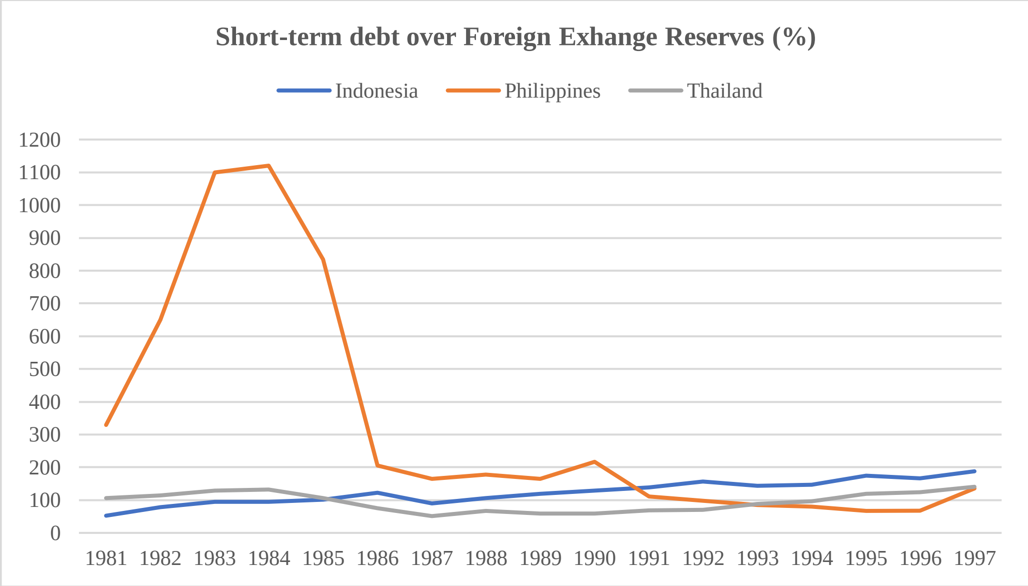
To begin with, the financial liberalization after 1990 increased capital inflows that led to inflation, real exchange rate appreciation and rapid credit expansion. All these factors played a crucial role at the setup of the crisis and it is noteworthy to be highlighted more analytically. Prices of non – tradable goods increased rapidly because of the significant capital inflows which in turn led to real exchange rate appreciation by more than 25% in Malaysia, Singapore, Thailand and Philippines and 12% in South Korea during the time period 1990 – 1996. This level was lower than the respective one in other developing countries such as Brazil and Argentina for the same time period. Capital inflows in these five countries were at 6% of GDP on average during the time period 1990 – 1996, coming mainly from banks' borrowings, supported mainly by the maintenance of almost fixed exchange rate regimes by the monetary authorities of these countries.

Furthermore, credit expansion grew rapidly during this time period. In Thailand and Malaysia domestic credit expansion as a percentage of GDP*(Domestic credit provided by the financial sector as a share of GDP measures banking sector depth and financial sector development in terms of size)*reached c.140% in 1996, from 90% in early 90s. The only exception was Korea, where providing credit remained at relatively constant levels.



Source: World Bank Database

In order to add excess value in the argument, it is worth noticing the increasing foreign short – term debt percentage of total external debt. The fact that, in Indonesia, Thailand and Philippines, the ratio was substantially high, stressed that these countries were vulnerable in a possible financial shock. A high short-debt to foreign reserves ratio implies than in case of a need for short – term loans repayment there are no adequate foreign exchange reserves to cover these needs. As the below graph indicates, all three abovementioned countries had a ratio well above 100% of the foreign reserves.



Source: World Bank Database

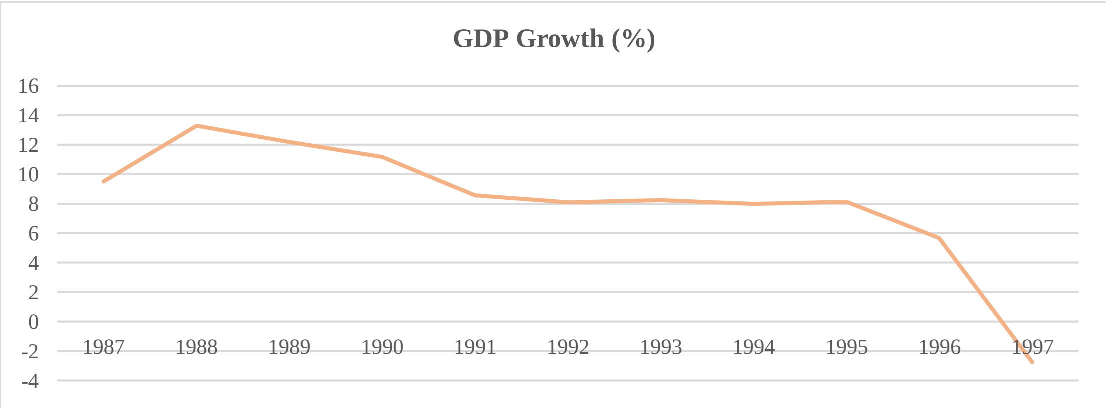
All these factors that were centered mainly at the private sectors built up the conditions for the financial crisis at the beginning of 1997. In the next sections we highlight the main characteristics of the crisis in each (main) country of the region.

Figure 1 Countries involved in the Asian crisis

2.2 Thailand

We begin with Thailand as the massive speculative attack at baht, the currency of Thailand, triggered the domino that led to the crisis throughout the region. Thai economy was growing at an average rate of over 9% from 1987 to 1996 (as shown in the below graph), one of the highest rates in the world.

Figure 2 Thailand's GDP growth



Source: World Bank Database

At the same time, monetary policy managed to keep inflation in relatively low levels, between 3.3% in 1993 to 5.8% in 1996 as local monetary authorities had maintained interest rates at very high levels (over 10%) and mainly, they had established a fixed exchange rates regime, pegging baht to a basket of international currencies (dominated by US dollar) at a rate of 25 baht per dollar. Moreover, the government followed a fiscal policy that resulted in high fiscal surpluses (for instance, 4.8% in 1991).

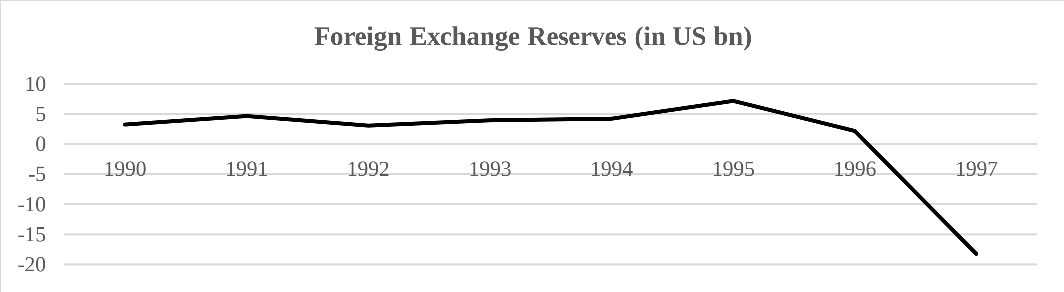
This macroeconomic framework made Thailand a very attractive destination for international investors. Thus, net capital flows in Thailand in 1995 was $14.2 billion, compared to $4.3 billion in 1992. Huge capital inflows helped Thai banks to expand very rapidly, as financial deregulation gave them the possibility to borrow funds abroad and lend them in the country at a very satisfactory net interest income. Thai banks in this period were among the first places of the world in profitability terms.

Nevertheless, the largest part of these inflows was put into sector that produced non – tradable goods for the domestic consumption, avoiding productive sectors such as real estate. Moreover, only a small share of capital inflows could be characterized as Foreign Direct Investment (FDI). Thai banks followed bad lending practices, granting loans to non – productive sectors, loans that were denominated in foreign currency (US dollar), increasing foreign exchange risk for both lenders and borrowers. This currency mismatch played a crucial role at the generation of the crisis. Additionally, the current account deficit that the country was experiencing (-8.1% of GDP in 1996) was negatively affecting Thailand's competitiveness, showing that Thai people did not produce exportable goods and services.

This framework contributed to the creation of an economic bubble in the country. Since 1995 Thai economy has started to slowdown because of a number of factors such as the emergence of China as a dynamic international competitor, the recession in real estate sector and the US dollar appreciation which worsened Thailand's terms of trade.

Thus, international speculators considered Thai economy as vulnerable to a speculative attack. At the beginning of 1997, a massive sell – off of foreign – owned domestic assets begun, resulting in a severe banks' balance sheets deterioration and causing major difficulties to firms at the servicing of their loans. However, at this time, the government claimed that it possessed enough foreign exchange reserves to defend the currency.

Thailand had adopted a fixed exchange rate regime and it was a responsibility of the government, as well as of the Central Bank, to follow policies that would maintain the exchange rate under control. At the first phase of the speculative attack, on May 1997, Thailand's Central Bank used its foreign exchange reserves in order to satisfy the increased demand of foreign currency from the speculators that was selling domestic assets. However, the amount of foreign exchange reserves was not infinite and after a short period of time the demand for foreign currency could not be satisfied. Initially, the government did not decide to abandon the fixed exchange rate regime and it declared that it would defend the baht. Below, the graphic evolution of the foreign exchange reserves' stock in Thailand.



Source: World Bank Database

However, the failure to do that triggered the crisis not only to Thailand, but also to the whole region. On July 2, 1997, Thailand abandoned the fixed exchange rate regime, and baht depreciated over 20% immediately after the announcement. The depreciation continued, peaking on January 1996, when it reached 56 baht / US dollar, the highest rate ever. Bangkok's stock exchange main index decreased by 76% and the economy entered into a recession phase. IMF announced a bailout package and Thai economy returned to positive growth rate in late 1999.

2.3 Indonesia

Indonesia was probably the most affected country by the crisis. However, the time immediately after the Thai baht depreciation there was not clear evidence that the crisis would hit Indonesia. At the beginning of the 90s, Indonesia showed a very stable and increasing GDP growth, reaching 8% in late 1994, something that caused worries about the probability of overheating in the economy. The subsequent inflation rate (9.6% in 1993 and 8.5% in 1994) led the Central Bank to follow a deflationary monetary policy, raising interest rates and increasing the rate of minimum reserve requirements. The currency, Indonesian rupiah, was allowed to move into a trading band of 2%, which widened to 3% at early 1995, to 5% in June 1996 and to 8% in September 1996. The incentive for this decision was the attempt of Central Bank to minimize the capital inflows growth because of its tightening monetary policy. However, the widening of the band was not efficient on this purpose.

On the other hand, the government was not so proactive in its fiscal policy. It tried to enhance the competitiveness of the economy by giving tax incentives to some large firms such as Asri Petroleum Group but its willingness was doubtful and this time Indonesia was characterized as the "most corrupt country in Asia".

The following table presents some useful macroeconomic figures of Indonesia for the years before the crisis.

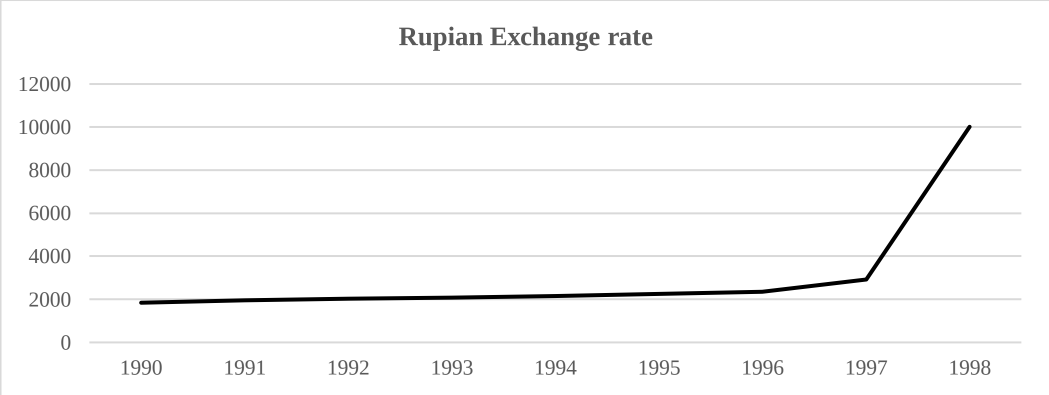
Table 2 Key macroeconomic figures for Indonesia

	1991	1992	1993	1994	1995	1996	1997
GDP Growth (%)	6.95	6.46	6.50	7.53	8.22	7.98	4.65
Inflation (%)	9.40	7.59	9.6	8.53	9.42	7.97	6.22
Current Account Balance (%of GDP)	-3.65	-2.17	-1.33	-1.58	-3.18	-3.37	-2.24

Source: Indonesian Statistical Office, IMF

Moreover, Indonesian Central Bank had large amounts of foreign exchange reserves and country's banking sector was very healthy. Domestic firms had exploited the hard currency by borrowing in US dollars at low interest rates, not exceeding 5%. This situation, along with the real exchange rate appreciation of 8% the time period 1990 – 1997, enhanced the export orientation of Indonesian firms.

As we analyzed in the previous section, the financial crisis in East Asia begun on July 2, 1997, when Thailand decided to leave the fixed exchange rate regime for baht. The response of Indonesian monetary authorities was the further widening of the band where rupiah were allowed to move, from 8% to 12%. This had been the cause of a massive speculative attack, compelling the government on August 14, 1997, to abandon the target band, leaving the currency to float freely. After this development, the drop of rupiah was very sharp, reaching a historical low in late 1997, as show in the below table.



Source: World Bank Database

This fact was attributed to the inefficient policy that was followed by the Indonesian government and monetary authorities. These policies consisted of a tightening fiscal and monetary policy, namely:

- The doubling of policy interest rate by the Central Bank of Indonesia.
- The obligation of firms by the government to transfer their deposits to accounts in the Central Bank in order to enhance liquidity.
- A large cut in budget expenses.

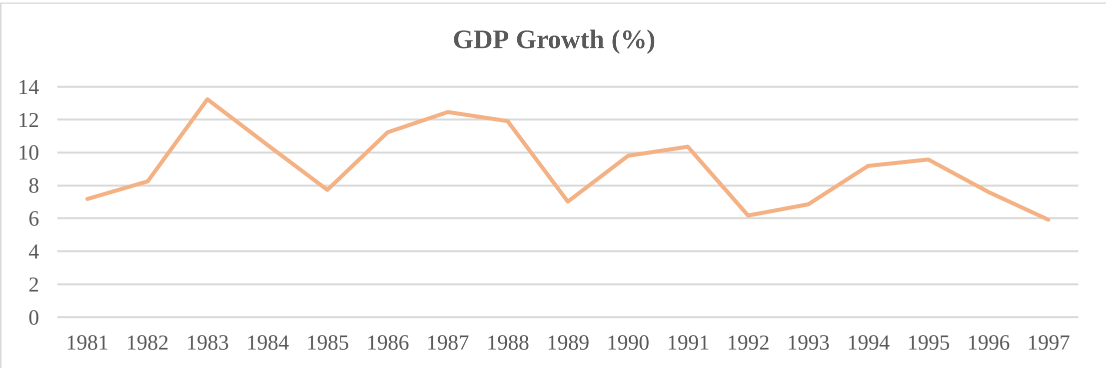
As a response to the above decisions, domestic private sector moved its funds abroad, to safer destinations, forcing a very dynamic capital outflow. Hence, the currency crisis soon transformed into a banking crisis, which in turn begun macroeconomic as domestic firms and financial institutions' balance sheets collapsed.

Seeking on the reasons of the vulnerability of the Indonesian economy to these adverse conditions, we can stress two main points. First, the financial crisis was triggered by an external contagion, namely the rapid depreciation of the Thai baht which we analyzed before. The speculative attack to Thai baht had clear contagion effects that affected very quickly the neighboring economies. For instance, two years ago, in 1995, the Indonesian economy had affected by the "tequila crisis" in Mexico. However, the rapid depreciation of the rupiah did not last for a long time as the Central Bank intervened in the foreign exchange market using its foreign exchange reserves and it adopted a tightening monetary policy. Thus, it anticipated the transformation of the external shock to a contagion and the Mexican crisis had not further consequences on the economy. Unfortunately, two years later the Thailand crisis was strong enough to be anticipated.

Second, the Thai crisis found the Indonesian economy in a weak institutional stage concerning the banking, the corporate and the political sector. Thus, the whole economic system was more vulnerable to external shocks. Hence, Indonesia soon was found in the difficult position of having actually exhausted its foreign exchange reserves by October 1997 which forced the government to seek support from the International Monetary Fund.

2.4 South Korea

The period before 1997 the economy of South Korea was seen as a paradigm of success. Since 1980, the Korean GDP had grown at an average rate of 9%. For the last 15 years before the crisis' "contamination", South Korea's GDP growth rate never fell below 6%.



Source: World Bank Database

As a result, in 1996 South Korea was at the 11th position of world economies in terms of income and it was an important member of the Organization for Economic Cooperation and Development (OECD) exporting products such as ships, cars, semiconductors and other innovative technological equipment.

The Korean economic system was based on two main pillars: (i) a bank – oriented financial sector and (ii) a particular business groups system, the so – called "Chaebol System". Regarding the financial system, Korean firms, like the Japanese ones, were relied on bank lending in order to finance their activities, unlike the Western economies that were relied on stock and capital markets funding. The banking system was influenced by the government which was appointing the management in the majority of the large Korean banks, affecting in this way the lending channels to specific sectors such as shipbuilding and construction.

As per the chaebols, they were large multi-business entities, operating in a very wide range of sectors. The most popular chaebols were well – known companies such as Hyundai, LG, Daewoo and Samsung that accounted for about the one third of the Korean national income in 1996. The government encouraged the development of the chaebols by giving industrial licenses and favoring access to bank lending. More analytically, the interest rate for borrowing from non – banks was higher than that from banks and the privilege of using foreign borrowing and bank loans significantly contributed to the accumulation of chaebols' growth. Thus, the government contributed to the creation of a very competitive and export – oriented economy.

On the other hand, this specific business structure had some significant disadvantages which can be summarized in the below points.

(i) In emerging economies like South Korea, there was lack of transparency and efficient corporate control. Important intermediaries like analysts, financial press and mutual funds were absent, whereas the regulation framework was weak. Thus, large business structures like chaebols had easy access to sources of financing due to their close relationships with bankers and the government.

(ii) The largest chaebols could use their strong brand name in order to enjoy a better access to export markets.They were characterized by strong family ownership which was combined with cross – equity holdings, resulting in family's control on very large business groups.

(iii) They were extensively relied on banking debt, both domestic and foreign, in order to finance their investment plans, even though the government policy restricted foreign direct investment in chaebols. In 1996, one year before the crisis, the median debt – to – equity ratio for the largest chaebols stood at 420%. This high leverage made chaebols even more vulnerable to the coming crisis.

Therefore, the Korean economy became a part of the crisis that started in Thailand. Foreign financial institutions started to call their loans, foreign investors started to sell – off their Korean securities, fearing of the depreciation of the Korean won. From

August to November 1997, a huge foreign capital outflow brought South Korea one step before the depletion of its foreign exchange reserves.

In the following table, a brief presentation of the main economic indicators of South Korea is given:

Table 3 Main economic indicators of South Korea

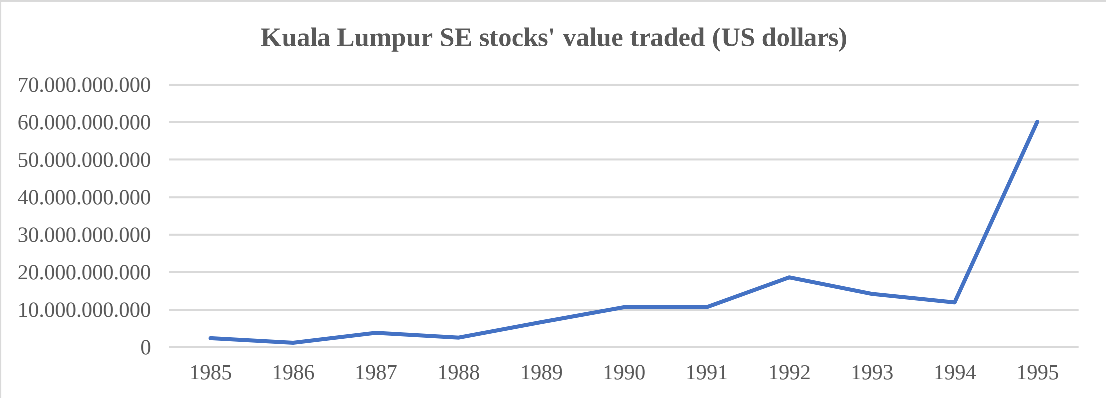
	1995	**1996**	**1997**
Korea Composite Stock Price Index	882.9	651.2	376.3
Real GDP growth (%)	9.5	7.5	5.9
Consumer Prices Index (%)	7.4	4.8	7.7
External Debt (billion US $)	82.6	90.5	91.8

Source: International Monetary Fund

The implementation of restructuring plan in South Korea was a very difficult issue. People were separated but finally accepted the proposed reform framework.

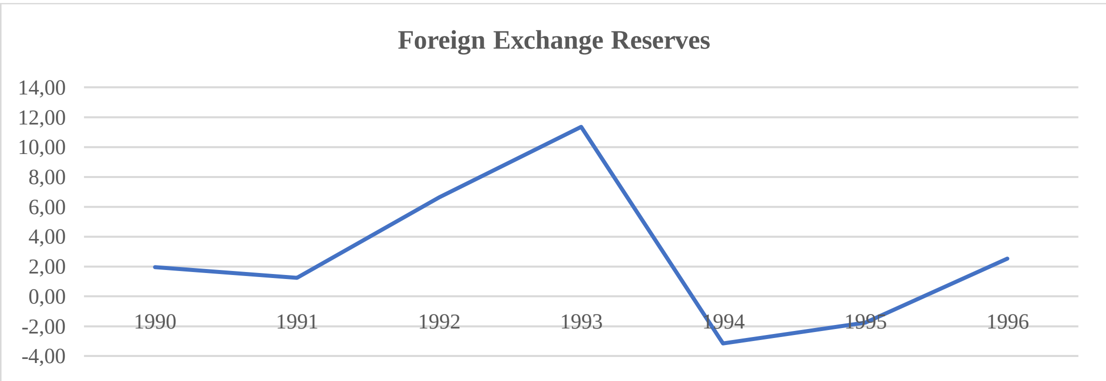
2.5 Malaysia

The economy of Malaysia had suffered a deep recession during the 80s with a subsequent banking crisis. Thus, the financial and banking regulatory framework had been tightened. In 1991, there had been a separation between the Malaysian and the Singaporean Stock Exchange in order to increase capital mobility in the country. This aim was being supported be extensive road – shows around the world, resulting in huge capital inflows in the stock market, especially in 1992 and 1993. Unfortunately, at the end of 1993 there was a trend reversal with large capital outflows from Malaysia, causing a sharp decline in the Kuala Lumpur Stock Exchange. Hence, the Malaysian government decided to impose restriction in capital flows in order to reduce the speculative movements against the country. These restrictions were abolished in September 1994 in an effort to return to a bullish stock market.The result of the restrictions abolishment was exciting: the value of stocks trading in the Kuala Lumpur Stock Exchange was approximately 60bn Us dollars, becoming the first in the world in terms of daily turnover.



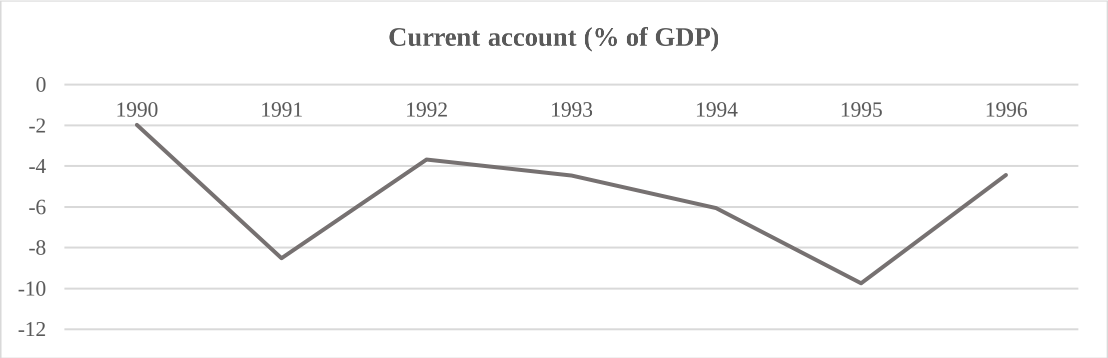
Source: World Bank Database

As per the exchange rate regime, the Malaysian currency, the ringgit, was under a fixed system until the summer of 1995, when the government decided to let it float freely. Immediately, the appreciation against the most important currencies was strong causing a corresponding increase in Central Bank’s foreign exchange reserves.



Source: World Bank Database

However, this fact widened the current account deficit which reached the level of 4% of GDP in 1996.



Source: World Bank Database

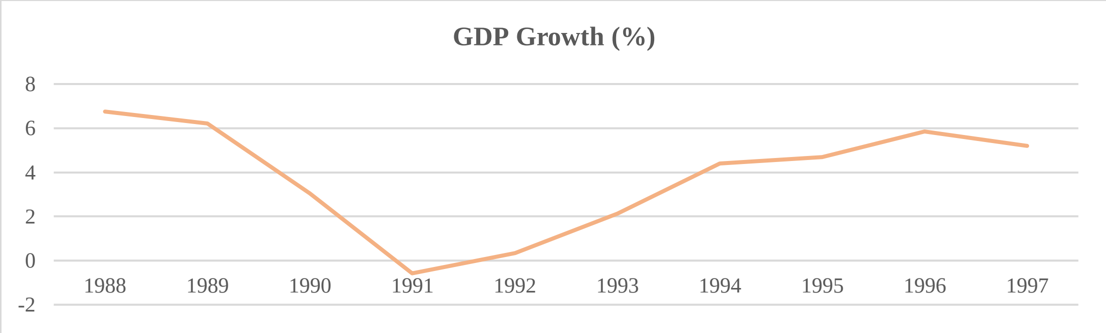
Therefore, just a few days after the baht devaluation, the Malaysian ringgit was suffered from a massive speculative attack. This led to an immediate rise of the short – term interest rates by 500% and a general collapse in stock and foreign exchange markets. Within five months, until the end of 1997, the most significant effects of the crisis were:

- Malaysian government and corporate bonds downgraded and were characterized as junk.
- The depreciation of the ringgit exceeded 50%.
- The Kuala Lumpur Stock Exchange Index fell from 1,300 to 600 points.
- The real GDP increased by 7.7% in 1997, turning into a sharp collapse of 7.5% in 1998.

As per the policy response issue, Malaysia was the big exception of the crisis as it was the only country of the region that did not seek for a bailout package from IMF. The key driver for this decision was the disagreement with IMF about the proposed approach, especially in the area of contractionary fiscal policy. The local government chose to impose capital controls, change to a fixed exchange rate regime and implement policies to restore economic activity, instead of implementing the austerity programs of IMF.

2.6 Philippines

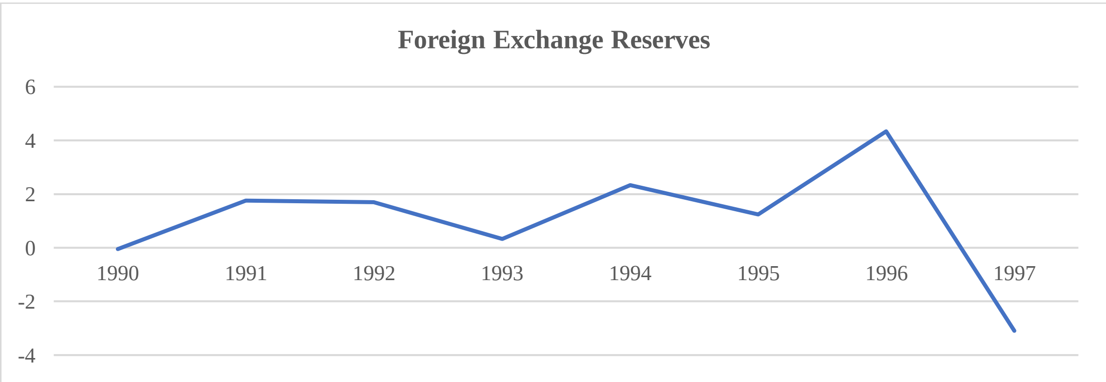
The economy of Philippines was enjoying high growth rates, between 5% and 6%, for the decade before 1997, with one small backdrop during 1991. From 1992 until 1997, when crisis affected the country, GDP was increasing again reaching pre-1991 levels.



Source: World Bank Database

This prosperous status of the economy was attributed to the structural reforms, the deregulation in financial and services sectors and the privatization of a large number of state – owned companies, as well as to the efficient fiscal policies that had led to budget surpluses. In addition, an extensive program for the alleviation of the poverty improved the life conditions of the people of Philippines.

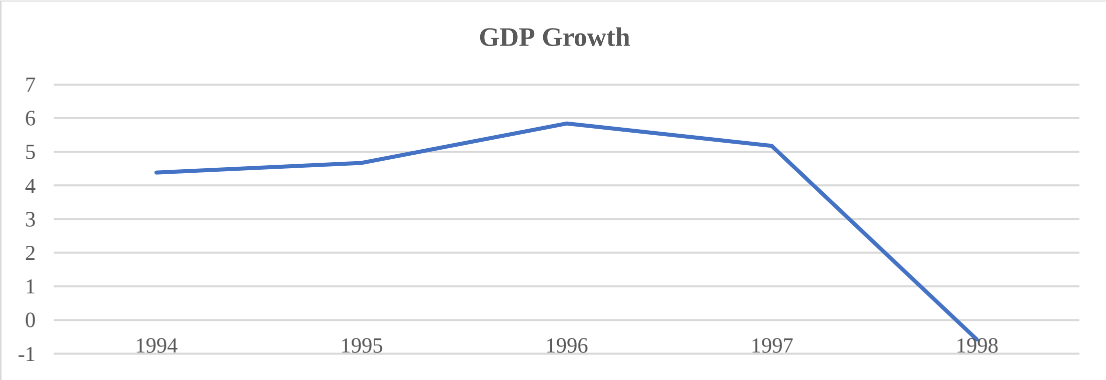
According to a large number of analysts, in 1997 the currency of Philippines (peso) was overvalued. Thus, Philippine products and services were not competitive and this had an adverse effect on the trade balance of the country. When the speculative attack on Thai baht begun, the contagion effect resulted in a withdrawal of investors' funds from Philippines as well. This put pressure on peso and the Central Bank tried to defend it by using about $2 billion from its foreign exchange reserves.



Source: World Bank Database

However, this attempt failed and the second policy response against the peso devaluation was an interest rate hike in order to stop the capital inflows. All these facts at a first stage led the country to a financial crisis.

Just a few weeks after the beginning of the crisis, the negative effects were diffused into the real economy and the real GDP growth, from 5.8% in 1996 dropped to 5.1% in 1997 and -0.5% in 1998.

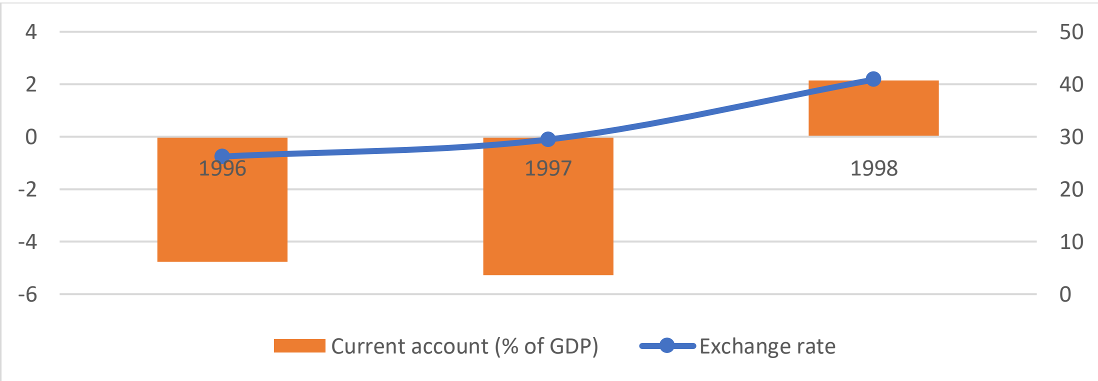


Source: World Bank Database

As per the financial sector, high interest rates along with the recession led to the deterioration of banks' assets quality, even though in 1998 the Central Bank decided to reduce the minimum reserves requirements ratio in order to restore liquidity.

As for the exchange rates, the huge capital outflows at a first stage resulted in a large devaluation of the peso. More analytically, from 26.40 pesos per US dollar in June 1997, in six months (early 1998) the exchange rate reached 42.70 pesos per US dollar.

The depreciation led from a balance of payments deficit in 1997 to a balance of payments surplus in the next year.



Source: World Bank Database

Generally, Philippines maybe were the less affected country in the region, compared to the other four countries that we examined above. However, there were severe social problems and political instability that did not let the country to recover immediately.

2.7 The crisis in an integrated context

Before the crisis, the East Asian economies were the paradigm of a success story. Prudent fiscal and monetary policies, liberalization of capital flows and high private savings rates made these countries a model for the others. However, the underestimation of the risk by the foreign investors made East Asian "tigers" a victim of their own success, as we analyzed above.

Since 1990, developing economies in the area become a new attractive source for investment for international investors and, therefore, huge capital flows have been observed there. Albeit rising economies have gained ground in constraining financial risks, it is undoubted that the possibility of monetary changes is more perceptible in these economies than in developed economies

In the previous sections we analyzed separately the particular characteristics of the crisis by country. At this point, it is very useful to present the analytical and complete chronicle of the crisis, including the developments in some other countries of the region that actually suffered superficially from the crisis:

- 1996 – Early 1997: the Thai baht suffers from a speculative attack during 1996 and early 1997 and as a result the local stock market drops throughout this time period.
- Early 1997: there are seven bankruptcies in large South Korean chaebols such as Hanbo Steel and Kia Motors.
- May 1997: the government of Thailand is obliged to adopt some kind of control on exchange rate.

- 2 July 1997: the government of Thailand decides to abandon the fixed exchange rate against the US dollar. In this forced decision, the role of hedge funds was crucial.

- July 1997: the government of Philippines also decides to abandon the currency peg with the US dollar and to impose capital flows control. This is also the case for the Malaysian authorities. Interest rate in Philippines almost quadrupled in one night.

- 14 August 1997: the Indonesian Central Bank raises interest rates but in late August it lowers them.

- 20 August 1997: the International Monetary Fund announces a $17 billion bailout package for Thailand.

- August 1997: speculators attack against the Hong Kong dollar.

- Early October 1997: Depreciation of Thai baht, Malaysian ringgit, Philippine peso and Indonesian rupiah reached 25% - 30% against the US dollar compared to spring 1997 figures.

- 17 October 1997: massive speculative attack against the Taiwan dollar and (again) the Hong Kong dollar. Short term interest rates in Hong Kong exceed 200%, the stock market lost about 25% in three days and rating agencies downgrade South Korea.

- 27 October 1997: collapse in New York Stock Exchange: the Dow Jones Industrial Average Index lost 7% in one day. Stock markets in other emerging markets, especially in Latin America, also decline.

- 1 November 1997: the Indonesian banking authorities impose the close of 15 insolvent banks

- 5 November 1997: the Indonesian government agrees with the International Monetary Fund for a $42 billion support funding.

- 4 December 1997: South Korea also agrees with the International Monetary Fund for a $58 billion bailout package.

- 16 December 1997: the Korean won allowed floating freely.

- 12 January 1998: Peregrine Securities, the largest investment bank in Hong Kong goes bankrupt.

- January – May 1998: it is a period of stabilization in markets. However, in May 1998 the second stage begins and the contagion effect starts to affect Russia, Brazil and the Western developed countries.

- 21 May 1998: President Suharto of Indonesia resigns after huge riots. In Philippines as well the government changes.

- June 1998: massive speculative attack on Hong Kong dollar. The local monetary authorities intervene in markets in order to defend the currency. The Central Bank of Japan cuts interest rates after signs of contraction in the economy.

- 17 June 1998: the Japanese yen depreciates. The close trade relationship between Japan and USA adversely affects the US trade balance, forcing the Federal Reserve Bank of New York to intervene in foreign exchange markets in order to support the yen.

- June – July 1998: the first signs of the spread of the crisis in Latin America are appeared. The monetary authorities of Brazil intervene in foreign exchange markets to defend the currency (real). Furthermore, they raise interest rates from 19% to 50%.

- July 1998: financial problems in Russia result in a large drop in developed countries' stock markets.

- 20 July 1998: the Russian Central Bank raises interest rates to 100% and the government agrees with the International Monetary Fund for a $5.5 billion bailout package.

- August 1998: third speculative attack against the Hong Kong dollar. The Central Bank uses large amounts of foreign exchange reserves to defend it.

- 17 August 1998: the Russian government "de facto" devalues the ruble and imposes foreign exchange controls.

- 1 September 1998: the Malaysian government absolutely fixes the ringgit against the US dollar.
- 2 September 1998: the Russian Central Bank decides to stop defending the currency.
- Late September 1998: the Russian government defaults on its sovereign obligations.

This is the full framework of events regarding the East Asian crisis. In the first section of this chapter we highlighted some of the causes of it. Now, we can examine these reasons again, integrated, more specifically and focusing on the structural weaknesses of these countries.

First, we mention the unsustainable current account deficits of these countries. As we can see in the table below, the countries in the region managed to sustain current account deficitsfinanced by foreign capital inflows:

Table 4 East Asian countries current account balances

(% of GDP)	**1995**	**1996**	**1997**
Hong Kong	-3.9	-1.1	-3.2
Singapore	16.8	15.7	15.4
Malaysia	10.0	-4.9	-4.8
Indonesia	-3.3	-3.3	-1.8
Taiwan	2.1	4.0	2.7
South Korea	2.0	-4.9	-2.0
Thailand	7.9	-7.9	-2.0
Philippines	-4.4	-4.7	-5.2

Source: International Monetary Fund, World Economic Outlook 1998

The free capital flows in these countries had as result the loss of control over monetary policy by the respective authorities enhancing the vulnerability of the economies to external shocks.

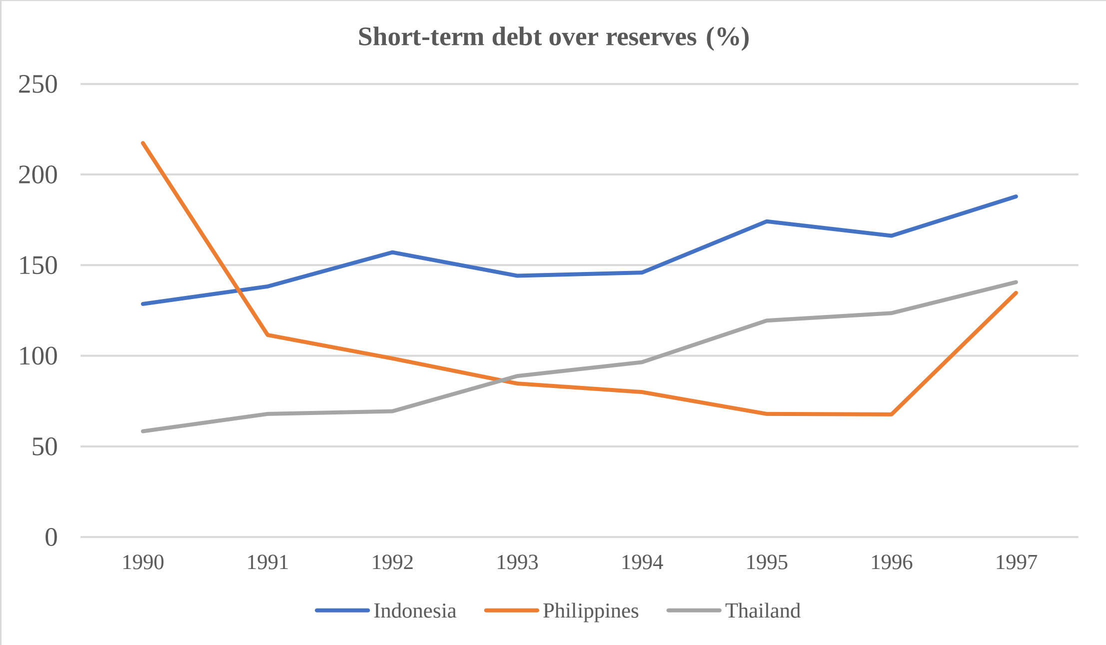
Second, the over – dependence on short – term foreign funds was also a key point the led to the crisis. The following table is very interesting in that point:

Table 5 Exposures of Developed countries' banks to East Asia

($ billions)	Japan	France	Germany)	UK	US	Other Europe	Total
China	18.7	7.3	6.9	6.9	2.9	7.0	57.9
Hong Kong	87.4	12.8	32.2	30.1	8.8	24.4	222.3
Indonesia	23.2	4.8	5.6	4.3	4.6	7.8	58.7
Malaysia	10.5	2.9	5.7	2.0	2.4	2.1	28.8
Philippines	2.1	1.7	2.0	1.1	2.8	2.0	14.1
Singapore	65.0	15.4	38.4	25.2	5.2	34.3	211.2
Korea	23.7	10.1	10.8	6.1	10.0	9.3	103.4
Taiwan	3.0	5.2	3.0	3.2	2.5	3.0	25.2
Thailand	37.7	5.1	7.6	2.8	4.0	4.3	69.4
Total	271.3	65.3	112.2	81.7	43.2	94.2	791.0

Source: Bank for International Settlements

The leverage of East Asian companies was very high and this increased the risk of adverse events. Moreover, the short – term nature of the majority of the external borrowing made them even more vulnerable to the external shocks.



Source: World Bank Database

Another important factor that contributed to the crisis was the inadequate regulatory framework in these countries. This fact enhanced corruption and other illegal and unusual behaviors. The most noteworthy case in this regard was the chaebols in South Korea: a bank could be a member of a chaebol and it was allowed to lend other enterprises of the same chaebol.

According to R. Chote, “These institutions [banks] were essentially unregulated - loan classification andprovisioning practices were too lax; there was too much ‘connected lending’ tobank directors, managers and their related businesses; there was excessivegovernment ownership or involvement in the institutions; and the quality ofpublic disclosure and transparency requirements was also poor. The institutionswere also not required to hold sufficient equity in their balance sheets. As aresult, they were subject to a severe moral hazard problem in which the owners of the institutions were encouraged to engage in excessively risky lending in the expectation that they would be bailed out if things went wrong”[1].

Overpriced assets in East Asian countries were another main reason for the crisis. The excess credit offered led to bubbles in some markets like stock market and real estate. Obviously, the burst of these bubbles had severe effects on the economy and Bank for

[1]R. Chote, “Financial Crises: the lessons of Asia”, *Financial Crises and Asia, pp.12.*

International Settlements pointed that: “In a number of centers, unsold or unused properties are being held off themarket in order to prevent a collapse in prices; moreover, current constructionplans in some cities imply further additions to supply in an already depressed market.

However, several large-scale projects – notably in the public sector –have been postponed or cancelled in recent months. The experience of industrialcountries has been that property price bubbles were followed by protracted andsubstantial declines in prices: average falls of almost 70% in real terms forcommercial property and 30% for residential property spread over about five orsix years”[2].

Finally, the macroeconomic policy and specifically the fixed exchange rate regimes were a major contributing factor for the crisis. Initially, the pegging with the US dollar had favorable effects for these countries. Until 1995 the dollar depreciated and subsequently did the East Asian currencies. Thus, their products were competitive, trade balances were being improved and export prices were falling.

Nevertheless, from 1995 onwards, the US dollar started to appreciate and the consequences of this development are clarified by the International Monetary Fund as follows, “with the dollar recovering most markedly against the yen, these countries sufferedsubstantial losses in competitiveness, with adverse effects on net exports and growth.That Japan is the largest or second-largest trading partner of these countries meant that their competitiveness was particularly sensitive to changes in the yen/dollarexchange rate”[3].

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[2]Bank for International Settlements. “68th Annual report”,p.40

[3]International Monetary Fund, “World Economic Outlook, 1998, p.3

The role of IMF and fiscal policy response

3.1 Fiscal and monetary policy adjustments

Many observers, both inside and outside the East Asian countries, were stunned by the rapid change of investor sentiment. The most popular destination of foreign investors and traders until then found themselves in the middle of an economic crisis that threatened to wipe out the fruits of hard work of a whole generation. As a sense of gloom enveloped the countries, a strong debate focused on the search for the solution of the crisis begun.

This crisis stressed some important problems of the global financial system, such as:

- The contagion or domino effect. It was the first time that this problem was so extensive and it was attributed by the analysts to the herd behavior phenomenon.
- Foreign capital flows were coming to the economies at their growth pace and exit at recession phases: this is a clear pro – cyclicality characteristic.
- Sudden reversals at the trend of capital flows can precipitate a crisis.

The International Monetary Fund was the first resort. Thus, immediately after the beginning of the crisis South Korea, Indonesia and Thailand asked International Monetary Fund to approve a rescue package for them. The IMF desired to support these countries but, of course, the imposed conditions were very stringent. The bailout programs had the following main characteristics:

- Contractionary fiscal and monetary policies: decline of current account deficits, increase of taxes, cut of government spending, stabilization of fixed exchange rates and inflation via raise of interest rates.
- Structural financial reforms: introduction of strict regulatory framework and control by the monetary authorities via closure of insolvent commercial banks and purge of financial institutions.
- Liberalization of capital and trade flows – competition: allowance of foreign banks' entrance in the banking system. The same for foreign companies.

- Removal of the protectionism in the commercial sector and removal of barriers in imports of goods and services.

- Improvement of the corporate governance.

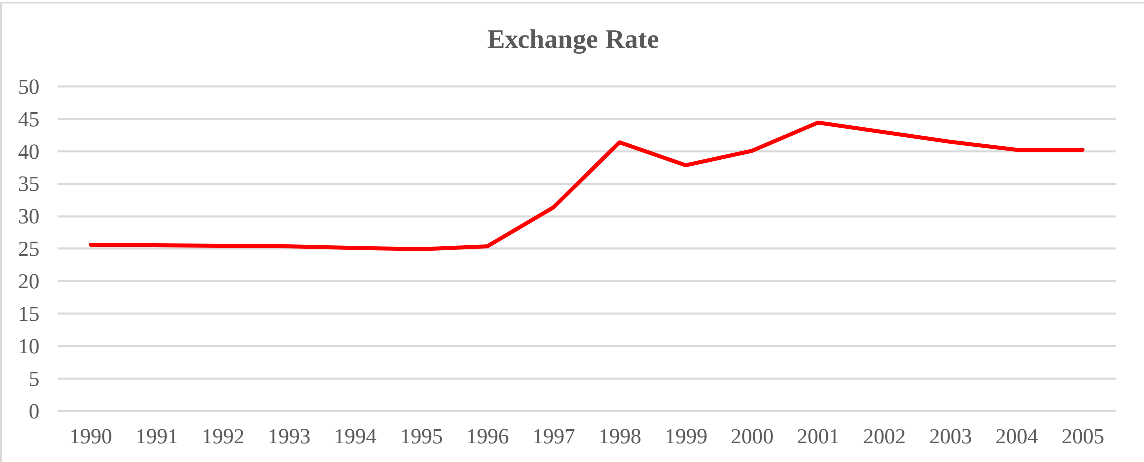
- Labor market: introduction of flexibility in labor force mobility.

In order to have a clearer view about the policy response, focusing on the fiscal adjustments imposed either by IMF or the countries' authorities, we describe the relevant measures taken by country.

<u>Thailand</u>

On August 20, 1997 a bailout package of $4 bn (SDR 2.9bn) over a 34-month period was announced by IMF for Thailand, following the speculative attack and the depreciation of baht. The total amount stemming from either bilateral or multilateral assistance was $17.2bn. Ultimately, in September 1999 the government announced that they wouldn't use more than the $14.1bn that they had already drawn from the bailout packages.

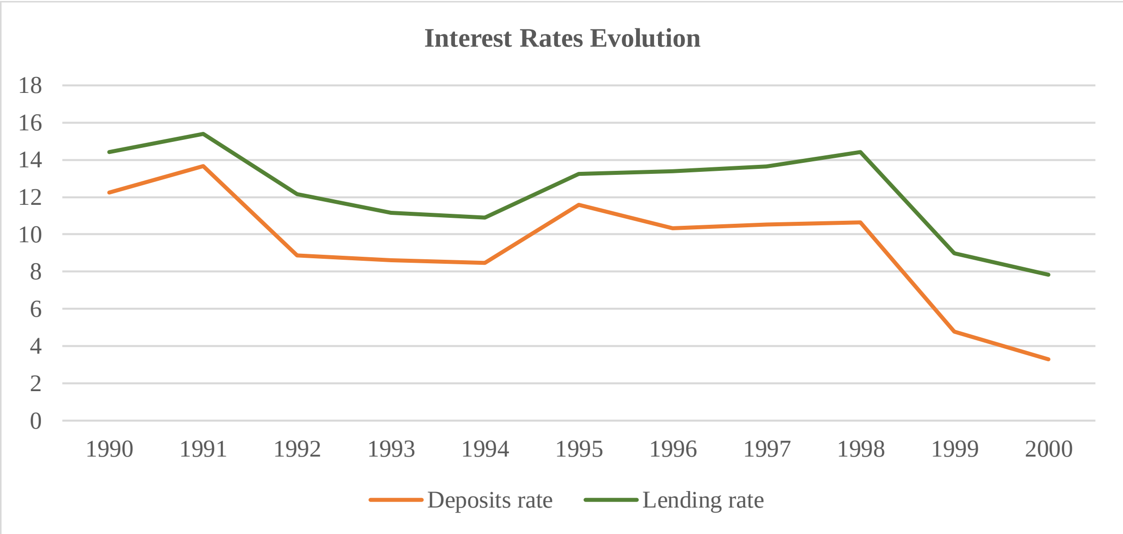
IMF requested for a contractionary monetary and fiscal policy. In the early stages of the program, policies towards a managed float of the baht were proposed.As shown in the below chart, the baht (vs dollar) had lostapproximately 64% of its power in mid-1998.



Source: World Bank Database

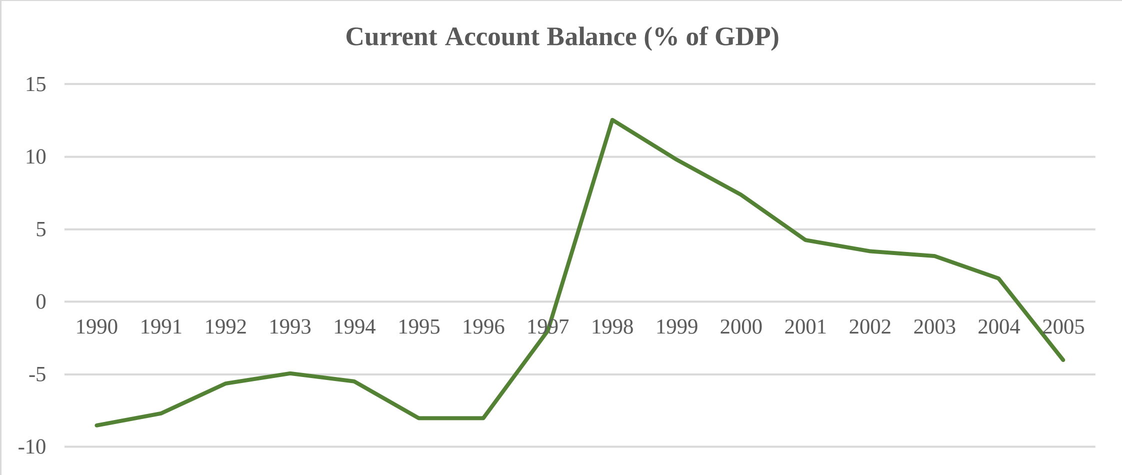
Measures stemming from the need for restructurings in the Thai economy and especially in the banking and financial sector were one of the cores of the proposal. The mentioned policy included financial institutions' restructurings, the closure of 56 bankrupt finance companies and a more active role of the private sector in the wider Thai economy. IMF requested for a 1% fiscal surplus as a prudent measure aiming at finding the funds that were necessary for the financing of insolvent financial institutions and assisting banks to liquidate the increasing volume of non – performing loans. Financial sector restructurings remained a very crucial policy area throughout the Thai program. At first, during 1997,the concentration was on liquidations and recapitalizations of the banking sector. During 1998, the focus turned to banks' privatizations, assets disposal from finance companies and corporate debt profile restructurings.

Regarding exchange-rate stability, the proposed reforms drove to reductions of the interest rates during 1998 (first deposits and then lending rates) from the Thai's authorities as seen in the below chart.



Source: World Bank Database

Fiscal policy adjustments imposed by IMF included the increase of VAT from 7% to 10%, actions to improve compliance to tax obligations, closing of nonviable banks and recapitalization of the rest. The goal was to achieve a sustainable surplus of 1% of GDP in order to cover the need of funds for financial system restructuring and current account deficit.

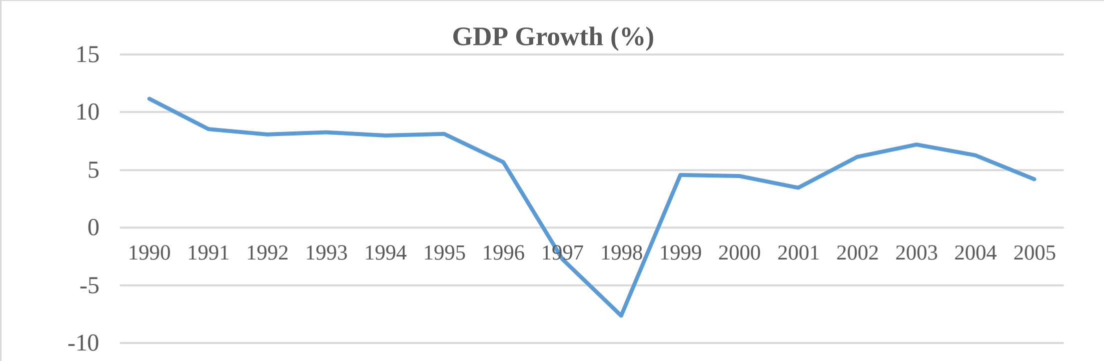


Source: World Bank Database

It should be stressed that before the crisis, Thailand had a fiscal policy that was supporting growth. To be more specific, before the crisis:

- Tax revenue mix was well diversified between taxes on consumption, on income and on international trade;
- The mix of government expenditures was diversified as well, between current and capital expenditures, whereas a very small portion corresponded to interest expenses (only 1% of GDP in 1997).

Therefore, fiscal policy in Thailand was not an issue before the crisis. Governments followed a sound fiscal policy ensuring surpluses or low and manageable deficitsand a balanced mix of taxes and spending. Austerity imposed by the IMF caused a decrease in economic activity and at the same time increased unpopularity for government that fed political uncertainty.As described in the below chart, Thailand had an average GDP growth of c.7.5% until the burst of the crisis. During IMF's austerity measures, GDP growth reduced sharply by 12% between 1996 and 1998 (reaching -8% in 1998) but during the following years and early 1999, it started gradually rising again showing sharp recovery signs.



Source: World Bank Database

The below table summarizes the main figures in order to understand how Thailand reacted to the measures implemented during the years following the crisis.

Key macroeconomic variables (post-crisis / Thailand)

	Central government debt (% of GDP)	**Externaldebt (US$)**	**Unemploymentrate**	**Inflation**
1997	4,64%	109,730,690,052	0.87%	5.63%
1998	10,67%	104,943,991,857	3.40%	7.99%
1999	20,01%	96,903,100,977	2.96%	0.28%
2000	21,96%	79,830,056,193	2.39%	1.59%
2001	24,58%	67,296,708,659	2.60%	1.63%
2002	30,07%	62,922,110,903	1.82%	0.70%
2003	27,05%	58,452,984,710	1.54%	1.80%
2004	24,40%	58,416,708,560	1.51%	2.76%
2005	25,46%	58,466,721,298	1.35%	4.54%
2006	24,38%	62,493,469,252	1.22%	4.64%
2007	22,99%	62,779,007,038	1.18%	2.24%

Source: World Bank Database

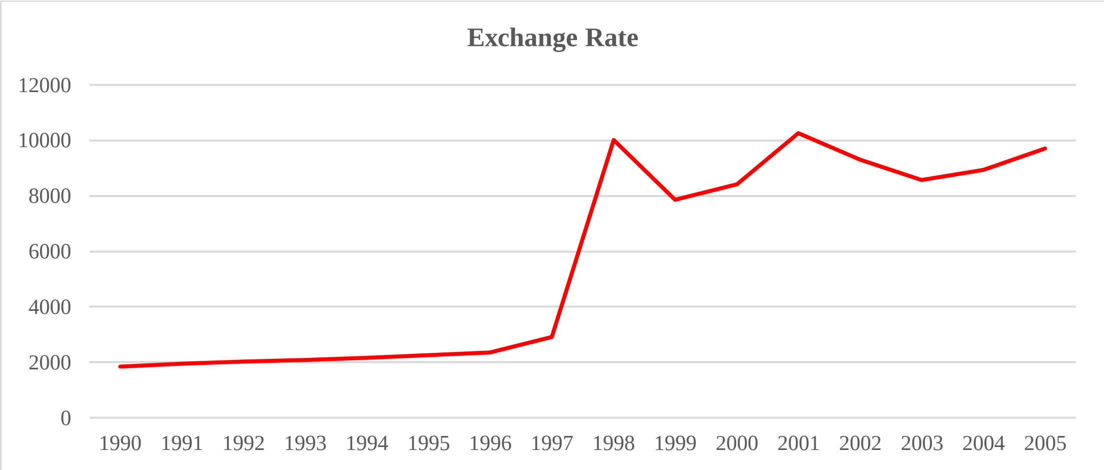
Unemployment stayed low and inflation rate remained stable, showing signs of recovery. What we've learned from the Thai example are summarized in two key points. First, the fixed rate regime is always a risk for an emerging country, especially if inflation is higher than the international interest rates. Second, if the government decides to abandon this regime, the Central Bank should have adequate foreign exchange reserves.

Indonesia

As it was analyzed in Section 2.3, Indonesia was probably the most affected country. On November 5, 1997, the authorities entered into a three-year stand-by arrangement with the IMF for US$ 10 billion, which was augmented by about US$1.4 billion in July

1998. Large amounts were also pledged by other multilateral institutions ($8 billion) and bilateral donors ($18 billion).

Due to the capital flight the currency dropped dramatically as the rupiah lost 80 percent of its value. Between July 1997 and January 1998, it dropped from 2,400 rupiah to the dollar to 10,000 rupiah per dollar.



Source: World Bank Database

With respect to the fiscal policy adjustment, Indonesia before the crisis showed a relatively sound macroeconomic management with a balanced mix of tax revenue from non-oil and gas taxes, income and VAT and a conservative expenditure mix.

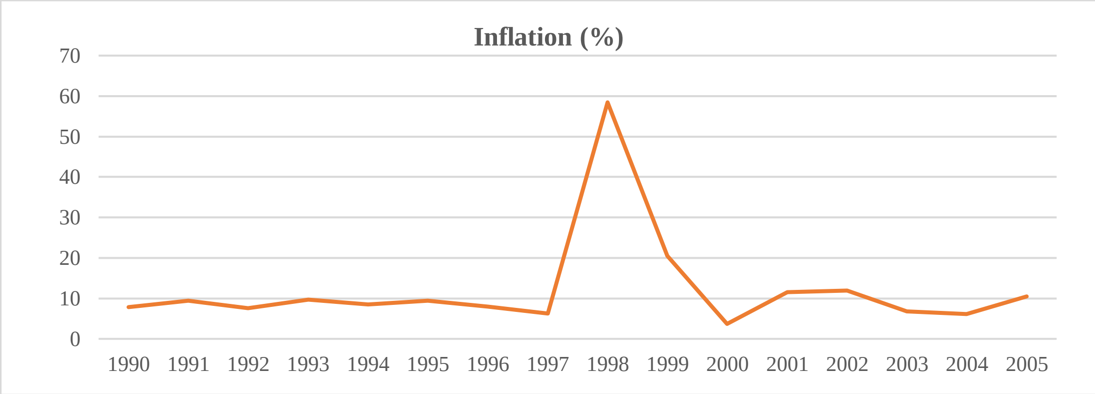
Like in Thailand, fiscal policy did not trigger the crisis at all. However, IMF imposed a number of fiscal adjustment measures in order to manage its public debt and face the vulnerabilities caused by the crisis.

In the banking sector, in order to deal with the viruses of the sector, the core of the measures were pointing to the merge of state banks accompanied with privatizations and closures of bankrupt banks.

In order to achieve a 1% of GDP fiscal surplus, the proposed measures concerned:

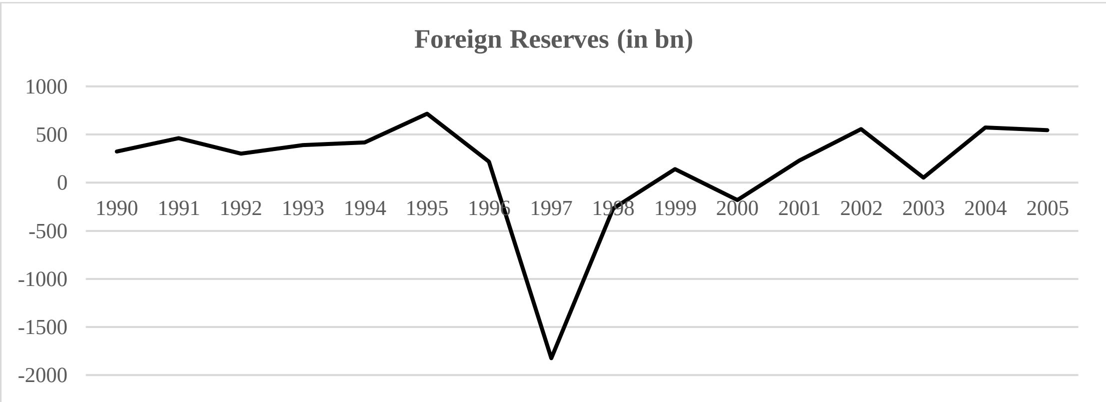
- Liberalization of foreign trade, especially in the food sector
- A wide privatization program along with the dismantling of monopolies in some sectors;
- Restructuring of state enterprises, adjustment of electricity and fuel prices
- Extremely tight monetary policy to avoid currency depreciation.

This policy framework, in the short-term, delivered significant results highlighting the inflation and currency reduction, the stock market gaining some ground, which during 1997-1998 had lost most of its value andthe recovery on the foreign exchange reserves.



Source: World Bank Database

As shown in the below chart, although foreign reserves were stable until 1995, they were severely hit in 1996-1997. Following the measures' implementation, they showed signs of recovery; not for long though.

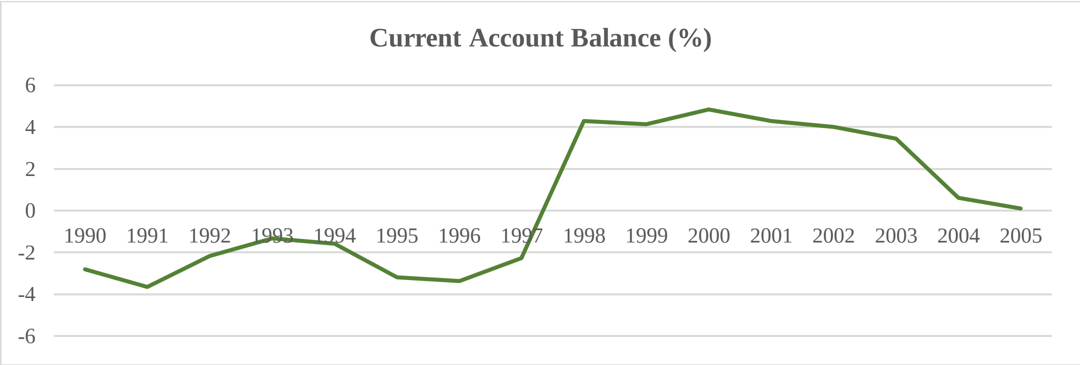


Source: World Bank Database

In the long-term, economy response to this fiscal adjustment was not the desired one.In February 2000, the newly elected government negotiated and signed a new 3-year arrangement for $5bn. The main measure towards the banking and corporate restructuring was the implementation of the Financial Sector Policy Committee. The objectives of the FSPC were:

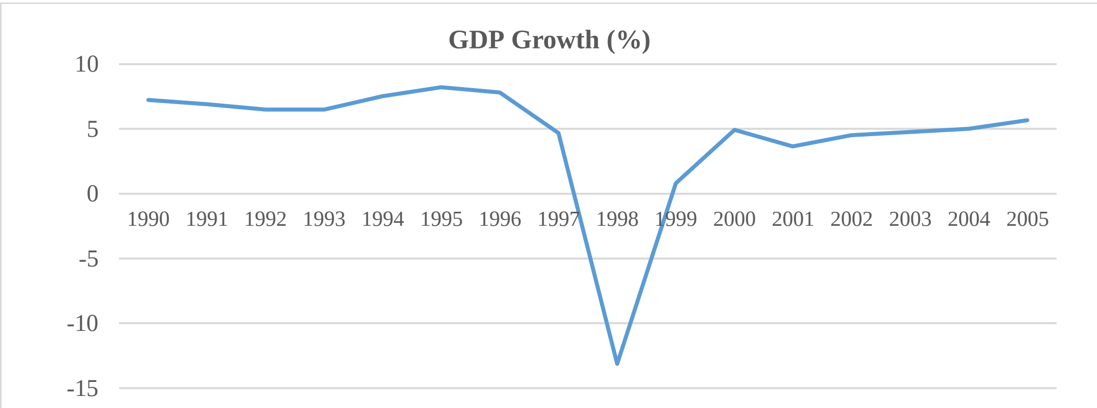
- Capitalization of all banks to an 8% capital adequacy ratio
- Restructuring of state-owned financials
- Enhanced supervision of the banking system
- Anti-corruption initiatives

The recovery of the economy was very slow compared to the other countries of the region and it took over 5 years to end IMF program.Although the Indonesian economy was showing current account surpluses;



Source: World Bank Database

GDP growth was reducing sharply during 1997-1999,



Source: World Bank Database

and inflation was almost 58% in 1998, making Indonesian economy vulnerable and showing signs more of recession rather than recovery. Only after 2000 did they manage to perform better, as seen in the below table

Key macroeconomic variables (post-crisis / Indonesia)

	Central government debt (% of GDP)	Externaldebt (US$)	Unemploymentrate	Inflation
1997	72.49%	136,322,462,441	4.70%	6.23%
1998	55.20%	151,466,816,253	5.46%	58.45%
1999	45.21%	151,788,573,424	6.30%	20.48%
2000	41.15%	144,031,660,550	6.08%	3.69%
2001	38.95%	132,693,881,752	5.88%	11.50%
2002	32.22%	128,429,121,508	6.34%	11.90%
2003	29.72%	134,358,680,167	6.18%	6.76%
2004	28.45%	138,028,989,872	6.71%	6.06%
2005	27.56%	142,120,099,440	7.71%	10.45%
2006	25.63%	135,959,442,957	7.55%	13.11%
2007	28.69%	147,817,600,604	8.06%	6.41%

Source: World Bank Database

The case of Indonesia showed that a country with sufficient foreign exchange reserves can suffer from a crisis should the financial system befragile, the Central Bank not independent and the political environment not very stable.

<u>South Korea</u>

As it has been already mentioned,South Korea and the International Monetary Fund came to a deal of a $21 billion bailout package for South Korea at the end of 1997. The main key events that characterized the South Korean response to the crisis are summarized below:

i. *November 1997*: South Korea makes a request for International Monetary Fund assistance.

ii. *December 1997*: International Monetary Fund approves a $21 billion bailout package for South Korea. The Korean Composite Stock Price Index lost about 42% in one year.

iii. *April 1998*: an independent authority, Financial Supervisory Commission, was established in order to supervise the whole South Korean financial system.

iv. The South Korean stock market was fully liberalized to foreign investors.

v. *June 1998*: Financial Supervisory Authority forced five banks to shut down operations and requested seven banks to prepare restructuring plans.

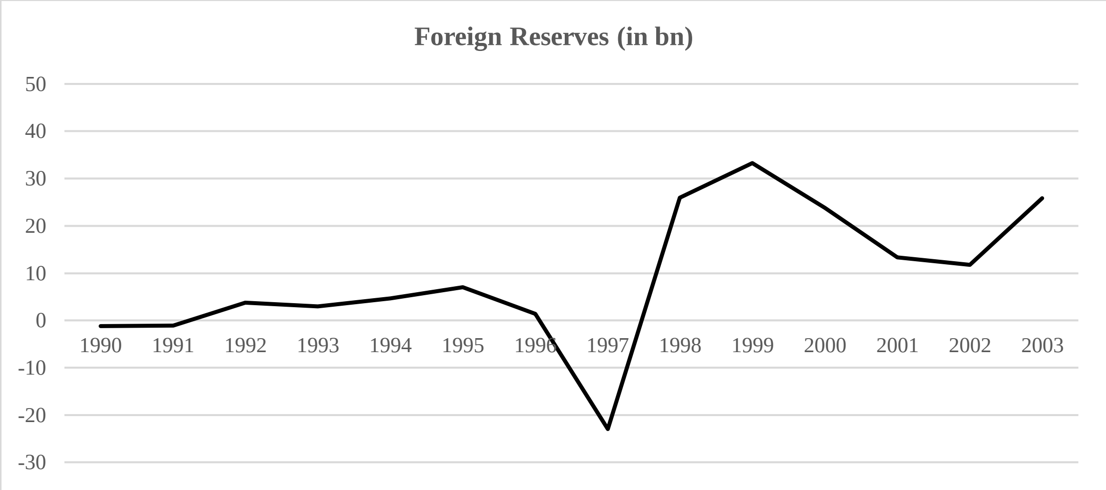
The main pillars of the restructuring platformreferred to the baking and corporate sector restructuring and the attraction of foreign capital.

Regarding **bank restructuring**, the newly established Financial Supervision Commission played a crucial role. When eight banks' capital adequacy ratio fell below the 8% threshold, the FSC requested them to implement recapitalization plans immediately. Moreover, the FSC approved the rescue of seven banks and it requested the closure of other five which finally were acquired by some healthy banks. The financing of this restructuring plan involved the raise of 50 trillion won by the government through sovereign bonds.

Corporate restructuring: the FSC played a significant role, by imposing five rules: financial and capital structure improvement, elimination of mutual guarantees of loans between firms in the same business structure (chaebol), focus on core business sectors, focus on transparency issues and emphasis on new corporate governance principles.

Finally, in order to attract **foreign capital,** the government declared its intention to make South Korea a very attractive investment destination for foreign companies. Thus, a number of new policies were established: foreign firms could establish mutual funds in the country, they reduced several constraints for foreign investors in order to freely acquire stakes in Korean companies and they gave incentives to Korean companies to invest more in capex.

It should be noted the crisis in South Korea was triggered by liquidity reasons and the particular format of the financial and non – financial system that was analyzed previously. Therefore, it was of critical importance for South Korea to restore a wide foreign exchange reserves base. As shown in the below chart, foreign exchange reserves were relatively stable until 1996 when crisis hit Korea. Korean Central Bank saw its reserves reduced by 23bn in 1997, but since then and due to regulation and austerity measures' implementation they managed to restore their reserve base.

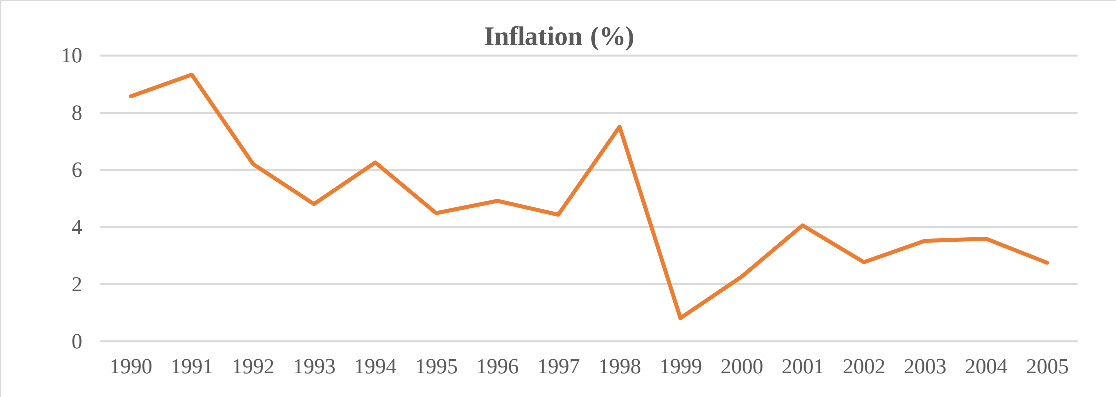


Source: World Bank Database

Regarding IMF's intervention, they focused mainly on the restore of confidence in the financial system, combined with a huge corporate restructuring program. The main pillars of the fiscal and other government policies adopted were:

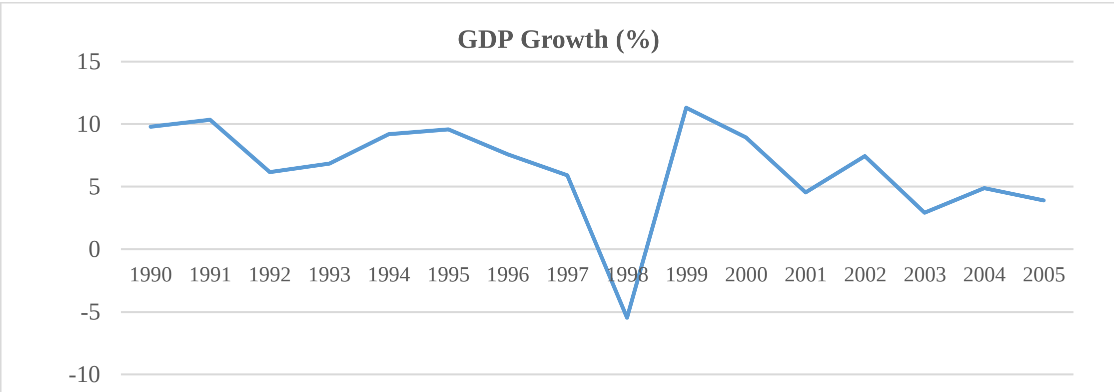
- Government guarantee of all deposits until 2000;
- Increase in interest rates (removal of cap rate) to put downward pressure to domestic and import demand, aiming at controlling external debt which had risen to 33% of GDP;
- Tightening fiscal policy by raising tax coefficients and cut government expenses in order to maintain a budget surplus (of about 0.25% of GDP) that was deemed necessary for the repayment of external debt. More specifically, fiscal adjustment included the widening of tax base, as well as the increase in VAT;
- Liberalization of short – term capital inflows;
- Deep reforms in the labor market;
- Establishment of a macro – prudential supervision framework to monitor macroeconomic stability and detect weaknesses proactively.

The situation in South Korea was urgent since the spillover effect from a liquidity crisis is immediate by definition. The assistance of IMF and USA was unprecedented and in the short run, the contractionary fiscal policy led to increase in unemployment and inflation (as seen in the below graph and table of key indicators).



Source: World Bank Database

However, the immediate response by the government and despite the social protests, the recovery was quick as financial instability issues were addressed and export – driven growth restored. As a matter of fact, GDP growth rose sharply from 1998 onwards, as shown in the below graph, while during 1999 GDP growth was at 11%, almost pre-crisis levels.



Source: World Bank Database

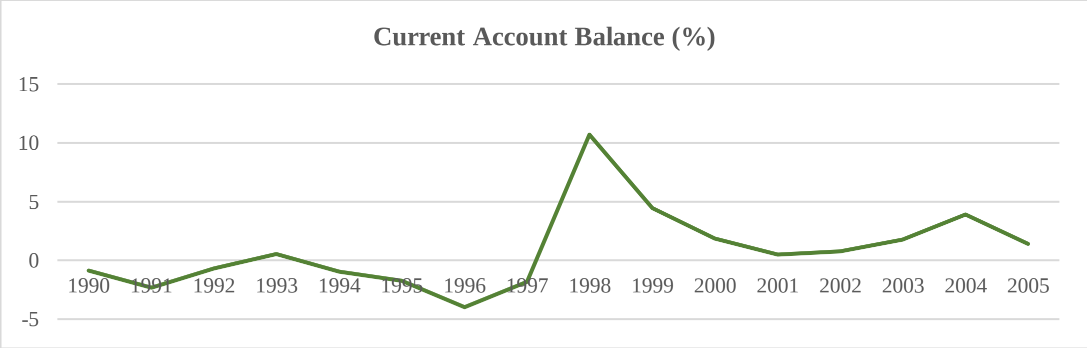
Key macroeconomic variables (post-crisis / South Korea)

	General government final consumption expenditure (% of GDP)	**Unemploymentrate**	**Inflation**
1997	10.61%	2.61%	4.44%
1998	11.83%	6.96%	7.51%
1999	11.51%	6.34%	0.81%
2000	11.34%	4.42%	2.26%
2001	12.19%	4.00%	4.07%
2002	12.13%	3.28%	2.76%
2003	12.47%	3.56%	3.51%
2004	12.79%	3.67%	3.59%
2005	13.28%	3.73%	2.75%

2006	13.82%	3.45%	2.24%
2007	13.93%	3.23%	2.53%

Source: World Bank Database

In terms of current account balances, South Korea managed to maintain surpluses for almost the next decade following the crisis.



Source: World Bank Database

The case of South Korea was a pure paradigm of liquidity crisis. The quick policy response, the implementation of necessary fiscal and other economic reforms and the commitment of the local government helped the country to have a very sharp recovery in 1999 and early 00's.

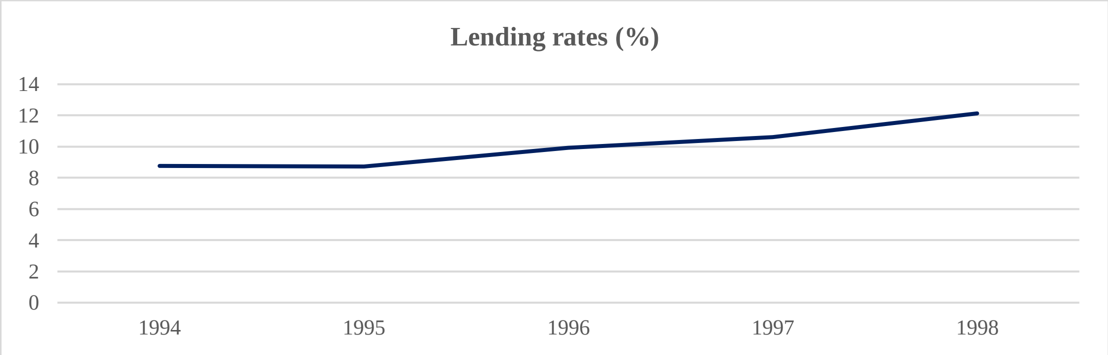
Malaysia

As it is already described in Section 2.5, Malaysia did not seek IMF support and chose to implement its own policy adjustments as a response to the crisis.

The first policy response was the abandonment of the floating exchange rate regime and the pegging of ringgit with the US Dollar. The monetary and fiscal authorities spent huge amount of money in order to defend the currency but after two weeks they failed and gave up. However, the big surprise was the decision of the government to reject the support of the International Monetary Fund and the World Bank, choosing to follow an independent policy to recover the economy..

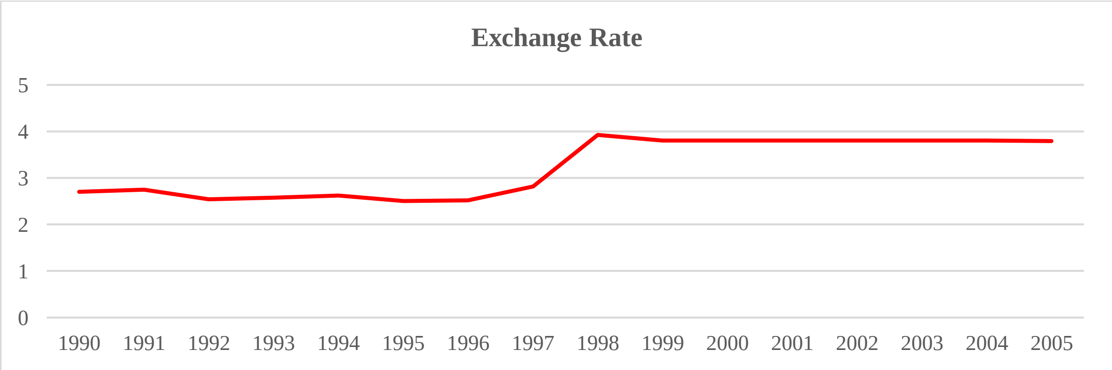
Regarding the banking institutions, several measures were taken in order to help them towards recovery. Conditions for lending were eased, limits for loans regarding purchasing shares and financial instruments were relaxed and monthly repayments were reduced.

In order to boost the recovery plan, Malaysian authorities imposed a A (below graph) and a corresponding tightening fiscal policy, cutting drastically the budget spending for approximately 20%.



Source: World Bank Database

Since Malaysian economy was strong, the relevant authorities decided to impose controls over capital in order to regulate foreign capital flows. On September 1998, Malaysian government announced the imposition of capital controls on foreign capital in order to prevent the speculative demand for ringgit and simultaneously pegging the local currency to 3.80RM to 1 US dollar.



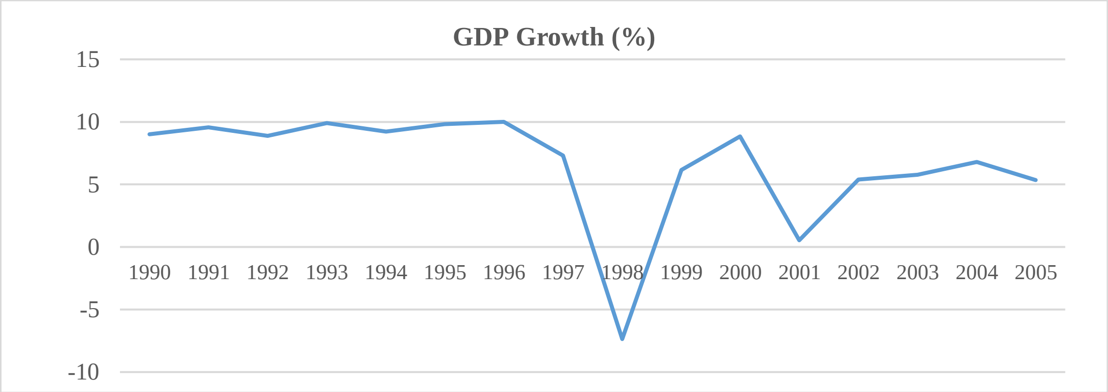
Source: World Bank Database

These policies aimed at restoring the confidence of the markets to the Malaysian economy. Thus, they would have interrupted the large capital outflows from the country, thus recovering the stock market and stopping the pressures on the currency.

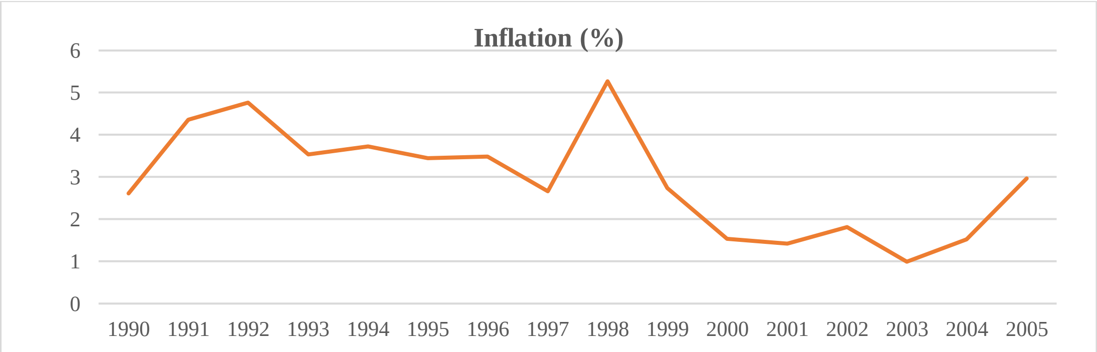
As a response to the above developments, the fiscal and monetary authorities decided to ease the contractionary policies in 1998.The Central Bank decreased the minimum reserve requirements for the banks in order to restore liquidity and started to reduce interest rates.In September 1999, capital controls were almost lifted as the one-year capital lock-in further enhanced the corporate and financial restructuring.

In the context of fiscal policy easing, the government also implemented a 1% decrease in income tax rates, other tax breaks in industries and reduction of duties. Budget deficit rose to 6.6% of GDP in 2000 and it was financed through government bonds, of which only one third was externally absorbed.

Following the implementation of the measures described above, the economy recovered, unemployment dropped, domestic demand was stabilized, and stock market increased, as shown in the below GDP growth and inflation charts.

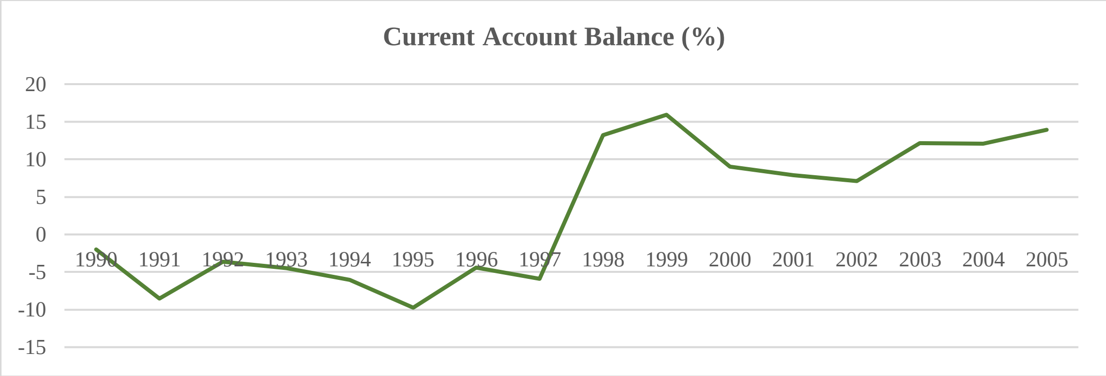


Source: World Bank Database



Source: World Bank Database

Since the causes of the crisis in the Malaysian economy was not the weaknesses of its fundamentals but the foreign capital's outflow and external lack of confidence, the implementation of the capital controls and the fixed rate regime with the US dollar were the key drivers for their recovery. They managed to create and sustain during the following years current account surpluses, as per the graph.



Source: World Bank Database

Below, the table summarizes the performance of the key economic variables following 1997.

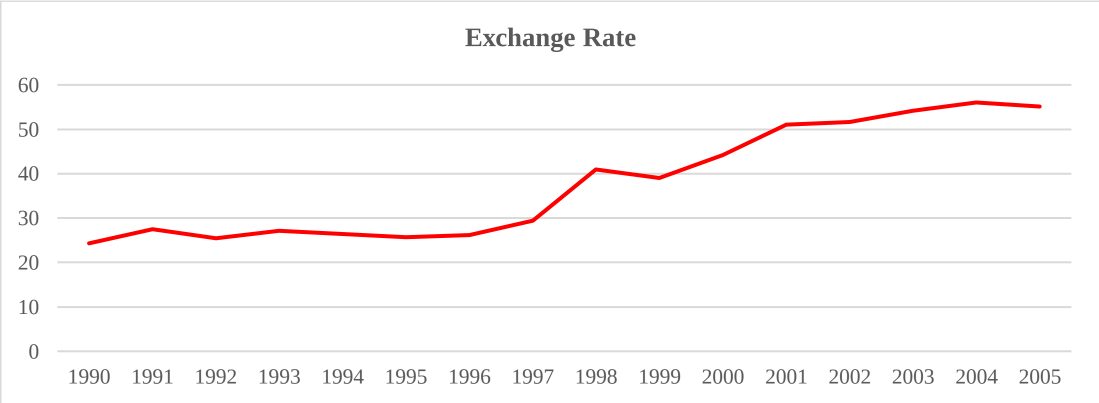
Key macroeconomic variables (post-crisis / Malaysia)

	Central government debt (% of GDP)	**General government final consumption expenditure (% of GDP)**	**Unemploymentrate**	**Inflation**
1997	45.00%	10.77%	2.45%	2.66%
1998	49.48%	9.77%	3.20%	5.27%
1999	51.26%	10.99%	3.43%	2.74%
2000	48.63%	10.17%	3.00%	1.53%
2001	47.23%	12.04%	3.53%	1.42%
2002	43.05%	12.96%	3.47%	1.81%
2003	45.08%	12.97%	3.61%	0.99%
2004	45.70%	12.58%	3.54%	1.52%
2005	42.07%	11.47%	3.53%	2.96%
2006	40.59%	11.17%	3.33%	3.61%
2007	40.09%	11.57%	3.23%	2.03%

Source: World Bank Database

Philippines

The impact of crisis in Philippines was in general moderate and appeared mainly through the depreciation of peso as a contagion effect. Between 1996 and 1998, the local currency "peso" lost 60% of its value.

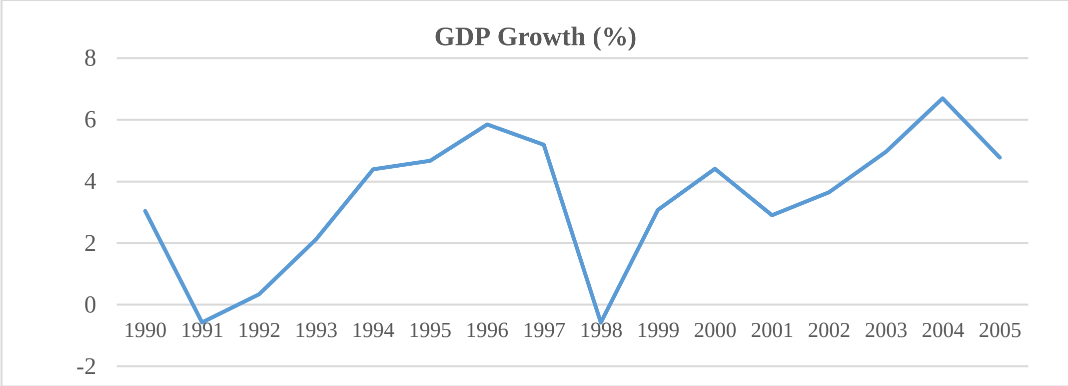


Source: World Bank Database

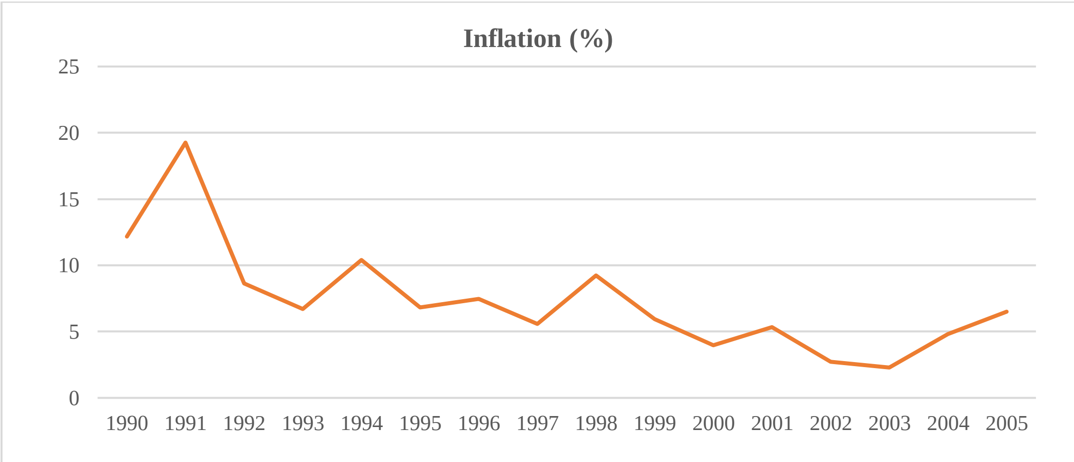
Policy response came to two pillars:

- Central Bank took some measures to manage banking sector issues, such as the stricter credit granting criteria in some sectors, combined with reforms in corporate governance;
- Government which was responsible for interest rates, kept interest rates high in order to avoid large fluctuations in foreign exchange rates.

Philippines did not use IMF support. However, from the fiscal policy point of view the government followed an IMF – wise fiscal adjustment approach by maintaining budgetary surpluses. Following the coming years, although GDP growth reduced during 1998, unemployment rate did not fluctuate, inflation remained relatively low and the authorities of Indonesia managed to have manageable current account deficits.



Source: World Bank Database



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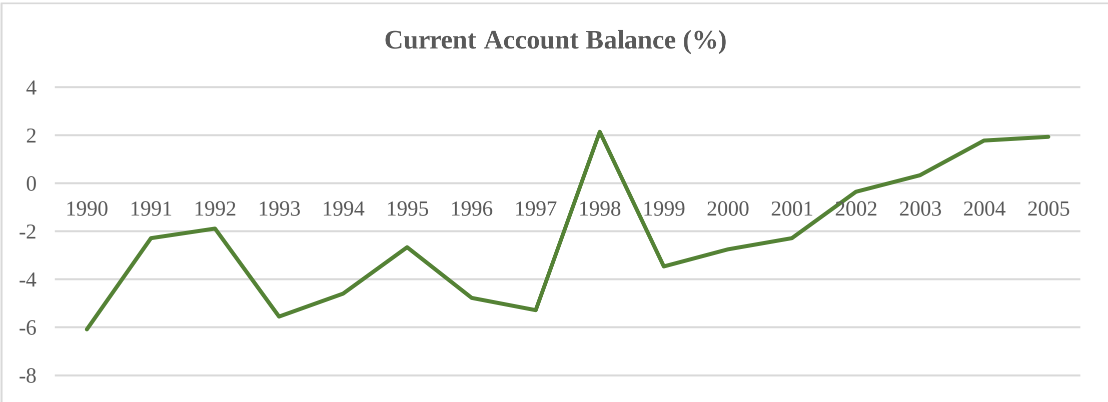


Source: World Bank Database

Overall, even though the economy of Philippines was not hit immediately by the regional crisis, the impact was severe but through the decision on keeping interest rates high as a countermeasure to the fluctuations in foreign exchange rates the overall aftermath was moderate.

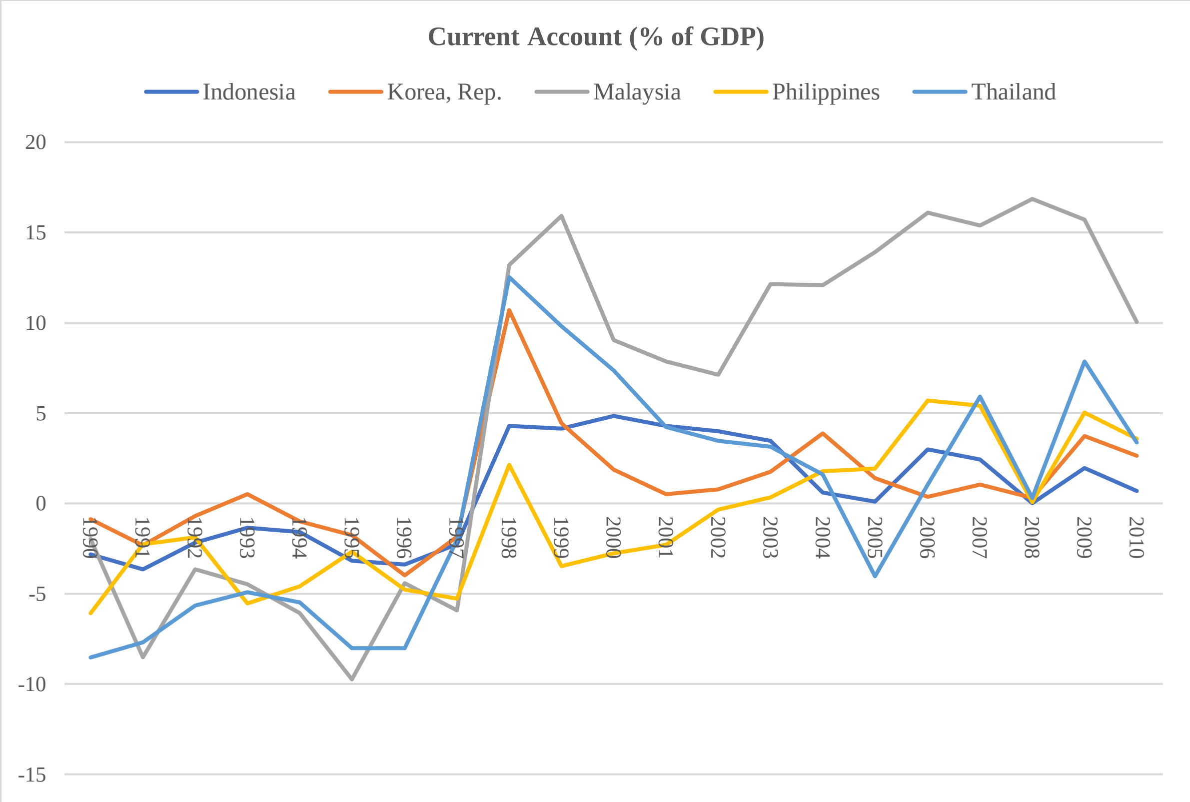
Key macroeconomic variables (post-crisis / Philippines)

	Central government debt (% of GDP)	General government final consumption expenditure (% of GDP)	Externaldebt (US$)	Unemploymentrate	Inflation
1997	55.65%	13.18%	50,705,832,981	3.76%	5.59%
1998	60.13%	13.28%	53,608,216,701	3.73%	9.23%
1999	54.52%	12.22%	58,480,699,326	3.73%	5.94%
2000	60.51%	11.42%	58,455,901,922	3.73%	3.98%
2001	61.33%	11.08%	58,399,723,506	3.70%	5.35%
2002	67.06%	10.57%	60,064,413,332	3.66%	2.72%
2003	73.77%	10.20%	62,762,530,813	3.53%	2.29%
2004	74.45%	9.38%	61,148,536,678	3.55%	4.83%
2005	68.48%	9.04%	58,692,722,322	3.80%	6.52%
2006	61.42%	9.18%	57,597,460,569	4.05%	5.49%
2007	53.86%	9.28%	59,175,573,172	3.43%	2.90%

Source: World Bank Database

3.2 Overall assessment of fiscal adjustment in Asian crisis

The main concern regarding the financial crisis in East Asia was whether the fiscal consolidation could have created a fiscal crisis. In almost all countries of the region, whether IMF supported them or not, governments followed a tightening fiscal policy as budgetary surpluses were necessary to finance debt and restore confidence. As shown in the below chart, due to the massive depreciations Asian currencies experienced, the current account surpluses were in general large providing the fuel in order to recover from the crisis.



Source: World Bank Database

However, contractionary fiscal policy has negative consequences in the economic activity. In a crisis environment, this policy further worsens the negative effects and it usually raises social responses. Thus, were the fiscal adjustments necessary or caused further problems?

Fiscal policy could have caused short – term and long – term effects in the economies. In the short – run, two main threats can be mentioned:

(i) The recession could make fiscal consolidation more difficult, as revenue declined;
(ii) Decrease in government expenditure may cause political instability and mount social reactions;

In the long run, fiscal adjustment may have the following consequences:

(i) In case of other structural issues in the economy, fiscal consolidation may not be adequate and could require further tightening measures;
(ii) The repayment of external debt should be accompanied with other market reforms.

Summarizing, the challenge for East Asian economies was to restore economic activity on a more robust and sustainable way. This could have been done via a combination of fiscal, financial and non – financial sectors reform. This combination included corporate and bank restructuring, extensive privatization schedule, balanced budgetary performance and generation of current account surpluses.

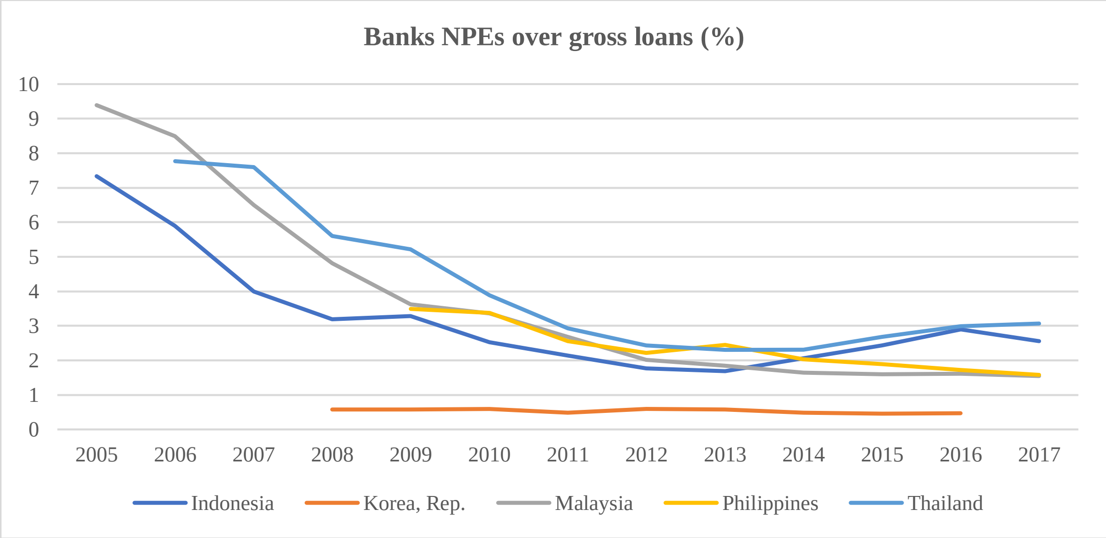
3.3 East Asian countries after the crisis

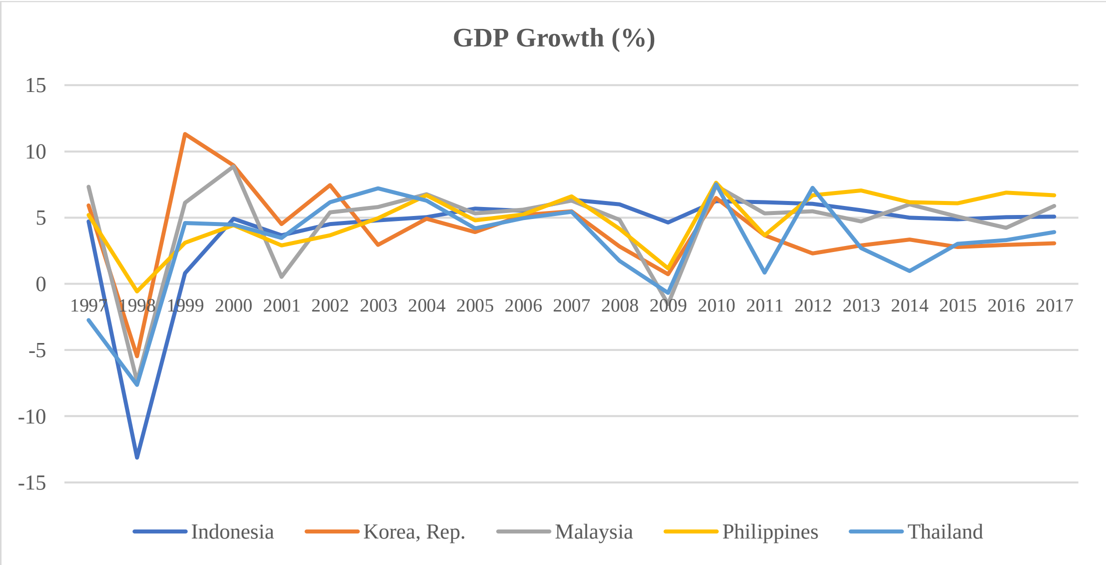
About 20 years from the beginning of the crisis, the general sense is that the International Monetary Fund’s policies applied in some cases were not very successful. Thus, the Fund’s reliability was damaged and it also lost its nature of the lender of last resort for the developing countries.

The International Monetary Fund was criticized both for its policy before the crisis and – mainly – after the crisis. IMF’s policymakers considered the crisis as a usual case, attributing it to the balance of payments imbalances. However, the problem had deeper roots which owed mainly to financial products’ overpricing.

Yet, the policies that followed by the countries after the crisis helped at their improvement in a large number of issues, so that after a decade we can say that their position is clearly better.

These countries strengthened their fiscal and monetary policies, have adopted more realistic and appropriate foreign exchange rate regimes and interest rates were set to levels that corresponded to the particular domestic needs and not to the attraction of risky foreign capital.In the region there were a big improvement in transparency policies and the availability of information. Corruption was minimized in the majority of these countries and a more integrated regulatory framework has been applied.The results of the financial and corporate sector reforms are now obvious. Bad loans of banks have reduced in all countries of the region, regulators have implemented rules and guidance for the performance of the banking sector and the position of the banks in the modern financial world is improved.





Source: World Bank Database

Thus, as Burton points “a result of these changes at both the national and regional level, thestrength and resilience of Asia’s financial sectors have been enhanced,making the region better placed to benefit from the globalization of finance.Indeed, over the past year or so emerging Asia has been able toweather successfully two moderate bouts of global financial market turbulence,recovering quickly from each episode. However, the regionaleconomy remains to be tested by a major disturbance to global financialmarkets”. [4]

[4]Muchhala, B., ed. (2007). Ten Years After: Revisiting the Asian Financial Crisis. *Woodrow Wilson International Center for Scholars Asia Program*.

Conclusions

In this essay, we made a detailed analysis of the main characteristics of the last big economic crisis of the 20th century: the crisis of the East Asian "tigers" in 1997. We followed a top – down – top approach in our analysis: first, we began with a high – level analysis of the whole framework that characterized the region at the onset of the crisis. Next, we made a county – by – country analysis, focusing on the five most – affected countries: Thailand, Indonesia, South Korea, Malaysia and Philippines. Finally, we returned to the high – level in order to see the main causes and the chronology of events, now at a more extended level including all the countries and emphasizing on the fiscal adjustments made. In Chapter 3, we examined the conditions in these countries focusing on the results of the International Monetary Fund intervention there.

Even though researchers, analysts and market participants consider the international capital markets integration, as well as the globalization as the main reasons for the creation of economic crises, the case of East Asian "tigers" in 1997 points that the causes come mainly from the internal imbalances of the countries. More analytically, as we examined thoroughly in this essay, the crisis was mainly the result of the fragile internal economic, political and institutional environment of these countries (overvalued currencies, excessive short – term foreign borrowing, increasing fiscal and current account deficits). Then, the international capital flows act simply as a multiplier and accelerator on these internal imbalances. The inter – relationship between these economies, as well as the easy and quick capital transfer create the channels for the diffusion of the symptoms. Thus, as a butterfly effect, the US dollar appreciation may lead to large – scale riots in Indonesia.

The Asian financial crisis was spectacular both for the ravages it caused—in a region of the world that was deemed immune from ravages of this kind—and for the speed of the recovery. By early 2000, the East and Southeast Asian contagion was over, and the countries that had been affected most severely—South Korea, Malaysia, Thailand and Indonesia—were more or less back on their feet. All parties involved could agree on one thing: the recovery was relevant fast. During the decade following the crisis, the central bank inventories of East and Southeast Asian economies overflow with foreign exchange reserves, used to defend their currencies—and through swap agreements, the reserves of the regional economies can be used to defend each other's currencies when they are under stress.

After the shock of the Asian and other financial crises of the 1990s,the consensus shifted from "liberalize the market" to "standardize themarket" on a global scale, implying the standardization of market institutionsaround a particular set of political economy models, therebycreating a "level playing field" in line with the spirit of "globalization."

We should stress that the East Asian crisis of 1997 moderated the enthusiasm that came from the benefits of the international capital markets integration. Yet, the crises that followed in the forthcoming years, such as in Russia in August 1998, the monetary crisis of Brazil in January 1999, the monetary crisis of Turkey in February 2001 and the monetary crisis of Argentina from December 2001 to January 2002 brought to the forefront a number of suggestions in order to deal with the economic crises. These suggestions are extended to a wide range of application: international markets control (Tobin tax), suggestions that focus on the foreign exchange markets, suggestions that emphasize the role of supervisors or the lenders of last resort, as well as suggestions that refer to the role of governance at both regional and global level. Independent of the advantages and the drawbacks of each approach, it is noteworthy to say that the East Asian crisis that we analyzed, was the trigger event for a global brainstorming for the restructuring of the international markets in order to avoid unfavorable developments in the future. However, the recent global crisis has proven that this process remained uncompleted but this could be a topic for another research paper.

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